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UNITED STATES AGENCY FOR
INTERNATIONAL DEVELOPMENT

# OECD TECHNICAL ASSISTANCE AND POLICY DIALOG ON COMPETITION LAW IN THE SOUTHERN AFRICA DEVELOPMENT COMMUNITY

# FINAL PROGRAM REPORT TO USAID/SOUTH AFRICA

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OECD OCDE

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# Final Program Report to USAID South Africa

## 1. Introduction and Summary

The U.S. Agency for International Development ("USAID") granted to the Organization for Economic Cooperation and Development ("OECD") the sum of $255,500 to provide support for a grant, number 654-G-00-01-00063-00, for a program entitled "Technical Assistance and Policy Dialog on Competition Law in the Southern Africa Development Community ("SADC"). (SADC members are Angola, Botswana, Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe.) The program period began September 25, 2001 and ended December 15, 2002. This document constitutes the Final Program Report to USAID for this grant.

The program proposal was made jointly with the Competition Commission and Competition Tribunal of South Africa and the OECD. The South African agencies have been invaluable partners for the success of the program. They contributed funds and, beyond the funds, the Commission made their conference room and facilities available for each of the events, save the adjudicators' workshop, provided on-site technical assistance and, perhaps most importantly, provided introductions throughout the region to the competition agencies and nascent agencies.

The program consisted of four seminars and ongoing informal competition policy advice. The four seminars were a (1) competition law enforcement case studies, February 2002; (2) competition policy and regulation: access issues in telecommunications, June 2002; (3) workshop for adjudicators in competition cases, June 2002; (4) competition policy and regulation in the electricity sector, November 2002.

The main result of the program has been to build capacity within the South African Competition Commission and throughout the SADC region. The two seminars on regulated sectors—telecommunications and electricity—raised the awareness of the importance of the sectors, of how to introduce competition into these sectors, and of the impact of the structure and regulation on the level of competition of the sectors, within the competition agencies. And they exposed regulatory agencies to the competition concerns in their sectors and the weight those concerns are given in developed countries. They also demonstrated how other countries have introduced competition into these sectors and how difficulties had been overcome. Discussions at the telecommunications seminar directly assisted the South African Competition Commission team investigating access complaints against Telekom, and the electricity seminar spurred the establishment of a research program in the Commission, which in turn enabled the Commission to more effectively participate in the Department of Public Enterprise working groups on electricity reform. The workshop for adjudicators assisted participants to understand how a range of antitrust issues are approached in other jurisdictions (e.g., the importance of economic reasoning, how to handle multiple assessment criteria, standards of proof, remedies) and prompted interest in further educational opportunities. The case discussions seminar helped participants to clarify their main competition concerns in individual cases and the main evidence for and against their positions. A handful of domestic policy recommendations, such as in Mauritius, changed as a result of learning in the seminars. Finally, the seminars reinforced the network for cooperation among competition authorities in the region, as well as strengthened the relations between agencies in the same country. While the perceptions of the quality of a competition authority have many sources, it is perhaps worth noting that the *Global Competition Review's* rating of the South African agency increased significantly during the period of this program. In sum, the capacity of officials in SADC countries to promote competition in a variety of sectors of their countries has improved.

The program as a whole and each of the seminars were highly rated. Most of the participants at most of the seminars gave them the highest possible rating, and the responses to the questionnaires distributed after the end of the program also were the highest possible. Competition agencies find the program invaluable and wish it to continue.

The initial proposal was for a three-year program. However, only the initial year was funded under this grant. The second year is being funded a second grant from the USAID's regional center for southern Africa, USAID/RCSA Botswana. Further funding for the program will be sought for future years.

# 2. Description of the Program

## 2.1. The role of competition in economic development

An effective competition law is a vital component in the legal framework of a country with a market economy. Together with other framework laws, such as those relating to the enforceability of contracts and to corporate governance, competition law is a major contributor to economic efficiency and growth. Specifically, by preventing powerful private interests from distorting markets by raising price and restricting output for their own gain, sound competition law enforcement ensures that market competition is able to foster innovation, promote the production of the most needed goods and services, and reduce costs and prices.

Competition policy applies competition principles to government regulation in order to try to prevent such regulation from causing unintended and/or excessive harm to markets and thus to society as a whole. This approach to regulation promotes competition, economic efficiency, and economic growth by eliminating restrictions that are broader than necessary to fulfill their intended purpose and by revising regulation to foster competition in markets, where this would be more efficient than monopoly provision. By permitting governments to meet the needs of their neediest citizens at lower cost, competition policy also enables the creation of social safety nets that are both stronger and more affordable.

Together, competition law and competition policy are mutually reinforcing measures that not only increase wealth through greater efficiency, but make possible an efficient redistribution of wealth from the privileged and powerful to the innovative and efficient; and ultimately dispersed to consumers as higher consumer welfare.

Competition law and competition policy are as vital for developing countries as for developed countries. The differing contexts imply they may differ systematically from those in developed countries. For example, less extensive or reliable transport and communications infrastructure can mean that markets have smaller geographic scope, which may also imply that some markets have fewer competitors or even that markets that would exist in a more developed economy do not exist at all. The missing markets may, in turn, imply that barriers to entry to begin to supply some markets are higher than in developed countries. The fewness of competitors may mean greater scope for anticompetitive conduct. Lower income can mean that some systems of cross-subsidies that are feasible in developed countries are not feasible in developing countries, which in turn may imply that some services are not supplied. Thus, lower income itself can have effects similar to those implied by less extensive transport and communications infrastructure, and thus be reinforcing.

## 2.2. The OECD Competition Division

The OECD's Competition Division (formerly Competition Law and Policy Division) and its Center for Co-operation with Non-Members have unique experience and resources to bring to bear on technical assistance to build capacity of competition institutions in the countries comprising the SADC. This experience and the resulting expertise stem from more than a decade of working with newly formed competition authorities in transition countries throughout Central and Eastern Europe and the Commonwealth of Independent States, as well as nearly a decade of working with developing countries in Latin America and Asia. The Competition Division staff's expertise in competition law, economics and policy derives from their close, on-going work with the competition authorities of the OECD's member countries through the Competition Committee. The staff members therefore also have unique access to a network of competition officials in the OECD's 30 member countries and certain non-members. Thus, the

Division is able to identify seminar officials with unparalleled credibility, expertise, and practical experience, and whose agencies are often willing to donate their time to OECD work with non-members.

## 2.3. The events of the program

The program had four main events. These were:
(1) Case studies seminar on competition law enforcement on February 18-22, 2002
(2) Seminar on competition policy and regulation: access issues in telecommunications on June 10-13, 2002
(3) Workshop for adjudicators in competition cases on June 28-30, 2002
(4) Seminar on competition policy and regulation in the electricity sector on November 12-15, 2002

The fourth seminar was not envisaged in the original program. However, the exchange rates moved in our favor, and the Competition Commission of South Africa did not hold its annual training seminar in 2002. Thus, the funding in the grant made an additional event possible. Consultation with the USAID officials and the Competition Commission of South Africa led to the decision to indeed hold an additional event and to focus it on promoting competition in the electricity sector.

Participating countries were the members of SADC, i.e., Angola, Botswana, Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe. (At that time, countries were still engaging Zimbabwe for capacity building.) In practice, neither Angola nor the Democratic Republic of Congo actually participated in any seminar, and some countries participated in only one or two. Also, because its level of development was comparable, Kenya was invited to participate as well.

Participating agencies were the competition authorities of the SADC countries, to the extent that they had been established, or those parts of ministries of industry that address competition concerns and may be thought of as embryonic competition authorities. For the electricity and telecommunications seminars, the competition officials were joined by officials from electricity or telecommunications regulatory boards, respectively. For the workshop for adjudicators, participants were from the South African Competition Appeals Court, South African Competition Tribunal, and judges from the corresponding institutions from Zambia, Kenya and Zimbabwe.

In addition to organizing these main events, the OECD participated in two other events, including the launch of the Southern and Eastern African Competition Forum, and engaged in consultations on the program with senior South African and Zambian competition officials when this could be done back-to-back with other missions. Finally, the OECD participated in an end-of-year consultative mission with officials from South Africa's Competition Commission and Competition Tribunal, as well as officials from USAID, to discuss how best to adjust the second year of the program in light of the experience with the program in 2002.

### 2.3.1. Case Studies Seminar on Competition Law Enforcement, February 18-22, 2002

This seminar was organized according to the "case study" method that has proved to be so effective in other OECD law enforcement seminars. In this seminar, participants present and discuss cases from their own practice, and panelists are current or former competition officials who can address not only the economic reasoning of the case, but also more practical aspects such as what information would resolve conflicting but consistent interpretation of facts and who—suppliers, competitors, customers, similar firms in other regions, government departments, and so on—might be able to provide such information.

Almost all the SADC countries were invited. (We were unable to contact Angola and Democratic Republic of Congo.) Almost all of the countries contacted sent participants. Participants at this event were from Botswana, Lesotho, Malawi, Mauritius, Mozambique, South Africa, Zambia, and Zimbabwe, as well as from Kenya.

The panelists were Dick Doidge, an attorney in the Antitrust Division of the U.S. Department of Justice, David Elliott (formerly Chief Economist in the United Kingdom Office of Fair Trading, now with PricewaterhouseCoopers), Georgios Kiriazis (an attorney in the General Directorate for Competition, European Commission), and Sally Van Siclen (formerly economist in the Antitrust Division, U.S. Department of Justice and now with the OECD Secretariat).

This first and very successful OECD event on competition policy in Africa supports the proposition that developing countries have as great a need for effective competition policies as developed countries. One country—Botswana—reported a merger that may well have reduced competition substantially in grocery distribution, but had no law under which to prohibit it. Another country—Lesotho—alleged that firms in South Africa were engaging in restrictive business practices that harmed their economy, but they had no law with which to respond. These two countries, as well as Mozambique and Mauritius, are drafting or surveying their economies as part of considering drafting a competition law. The seminar yielded other examples where intra-regional cooperation on competition enforcement might have reduced negative over-the-border effects on competition, and examples where a more robust enforcement of competition principles might have preventing the establishment of a structure of distribution that significantly exclude imports.

## *Highlights of the discussions*

**Lesotho** is a small country landlocked by South Africa. While there is no question in Lesotho of the need for a competition policy and law, there is a belief that a "gradual and selective approach" to its development would be best. Thus, discussion centered on "what first?" A South African participant suggested first assessing the state of competition: what are the worst offences, what markets pose the greatest problem, and then exploring whether the existing legislation (which is aimed more at unfair competition and mis-use of IPRs) could be applied until a comprehensive competition law is in place. When the issue arose whether there's a real need for Lesotho, surrounded by South Africa and heavily influenced by South African firms, to have a competition law of its own, it was alleged that South African firms already engage in anticompetitive conduct in Lesotho and it was pointed out that other competition authorities have neither the obligation nor the jurisdiction to protect consumers other than those in their own country.

In the discussion of a **South African** case involving a joint venture among Shell, BP, and Caltex, the discussion centered around whether this should have been viewed as a merger or as a restrictive practice (horizontal agreement), and how the competition and the public interest objectives of the law actually influence the final decision of whether to oppose a transaction or not. The Commission's competition concerns were whether the joint venture would increase the information available to firms in the market, whether this information would facilitate collusion, and whether the joint venture would give rise to efficiencies that would be passed onto consumers. Since the parties asserted but did not provide detailed support for their efficiency assertions, these were discounted and the proposed transaction was found to be anticompetitive. The transaction also was found not to have public interest grounds for approval.

A **Kenyan** case concerned the Kenyan part of a merger between Agip and Shell/BP, a deal that transferred assets in a number of countries. In Kenya, the Commission required divestiture of some facilities post-merger. Thus, much of the discussion centered on divestiture as a relief: Should it be required before the merger can go forward? Is there a concern about viability? Is there a concern about keeping the business running until a buyer can be found? More broadly, though this was not raised at the seminar, this case illustrates the difficulties both of small countries' protecting competition, and of large transactions that are on balance competitively neutral going through on a value-preserving timetable.

A **Zimbabwean** case involved the sale of the largest cement plant in the country to a South African cement company that did not export into Zimbabwe. However, a South African participant raised the question about whether the transaction should have been notified to South Africa (it had not been notified) and whether it affected South African consumers. Further discussion ensued in which it appeared that at least

one large European cement company has been buying several cement companies in Southern Africa, and then reshaping the pattern of production and trade in cement in the region, with adverse consequences for local employment in certain areas. This suggests that there may be advantages to a mechanism for regional notification, consultation, and remedy for mergers.

In **Zambia**, the merger of a soft drinks bottler and a beer brewer, each with 98% of their respective markets, meant that the competing distribution systems were also merged. While the competition authority had taken action to "open up" the distribution system by forbidding loyalty rebates, skepticism was expressed about whether the small amount of imports (some 1.9% of beer) could be feasibly increased when the distribution system was a near monopoly, even without vertical agreements which clearly provided incentives to the distributors not to carry rivals' offerings.

The countries without competition laws provided a number of examples of how the absence of a law is harmful.

- In **Botswana**, the merger of two grocery wholesalers created a near monopoly (90%), although this must be seen in the context of the entry of some vertically integrated South African chain stores. Both small retailers and the "Buy Botswana" campaign were harmed, though more information than we were provided would be needed to assess the impact on consumers.
- In **Mozambique**, the merger of two banks to more than 50% of the market was not reviewed on competition grounds. The quality of services has already declined, attributed by a participant to the decrease in competition.
- In **Mauritius**, there is a large number of monopolies and of monopoly importers. Domestic monopolies include beer, tobacco products, flour, fertilizer and pharmaceuticals. Both air freight and telecommunications are monopolized, having a direct negative effect on the competitiveness of exporters from Mauritius.

Each of these countries, and Lesotho, is in the process of moving toward adopting a competition law.

## 2.3.2. Seminar on Competition Policy and Regulation: Access Issues in Telecommunications, June 13-14, 2002

This seminar focused on access to essential facilities in telecommunications, that is, on how to ensure that access is granted in ways that promote efficiency and, where it is feasible, competition. This is a key interface between competition policy and regulation, where in many countries both competition authorities and regulatory authorities would be concerned. A well-designed access regime is necessary to induce investment, investment is needed for competition, and competition is needed for efficiency and can help to expand geographic coverage. There were also short discussions on number portability, carrier pre-selection and how to ensure universal service in a competitive sector.

Participants were competition officials and telecommunications regulators from South Africa and other SADC countries (see list below). Experts were Christopher Libertelli, Special Counsel for Competition Policy, U.S. Federal Communications Commission and Richard York, Director – Regulatory, Telecommunications, Australian Competition and Consumer Commission. Sally Van Siclen, OECD Secretariat, chaired.

The following SADC countries made presentations on their telecommunications regime, focusing on access issues: Botswana, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Zambia and Zimbabwe, as well as Kenya.

### *Summary*

The first part of the seminar consisted of lectures. In his **overview of access regime reforms**, Richard York described the economic features of telecommunications that are the reason the sector is regulated. When competition is introduced into the sector, access regimes are necessary to enable competitors in downstream markets to gain access to those essential inputs that are inefficient to duplicate. A good access

regime ensures that access seekers can actually get access to essential inputs, relatively quickly, and that the access is priced "appropriately." In the next lecture, on **competition and regulation in telecommunications,** Christopher Libertelli described the benefits of competition in telecommunications—lower prices, greater variety and innovation, faster deployment of innovations, and a spur to general economic development. He described the various ways in which competition is introduced in telecommunications—full facilities based competition, unbundled network elements, and resale. He talked about the problems of unbundling and of access to physical facilities, with many examples drawn from US experience. In the last of the three introductory lectures, Mr. York described the **telecommunications access regulation in Australia**. This is of interest because it is part of a broader infrastructure access regime, and such an integrated regime may be especially useful for countries that need to use their human capital sparingly. He provided a quick history of telecommunications reform in Australia, described the legal and institutional aspects of the access regime, the general access pricing principles and the pricing principles applied to specific services.

In the next part of the seminar, representatives of SADC countries made presentations on their telecommunications reforms, emphasizing access issues, which then led to discussions by the experts and participants. In **South Africa**, the regulator and competition authority have concurrent jurisdiction; they have signed a memorandum of understanding on how this will be managed. The period of exclusivity for Telekom ended in February 2002, and Parliament had just passed a telecommunications law that specifies the legal framework for the second national operator (SNO). Experience with the access disputes between internet service providers and the monopoly national operator means that complaints from the SNO can be anticipated; this seminar was an opportunity for the Competition Commission to better understand access issues before receiving them. According to the law, Telekom must allow the SNO to use its facilities for two years. Carrier pre-selection begins in 2003 and number portability in 2005. The company Semtech was awarded the license to be the "international carrier-of-carriers" and for broadcasting. The law specifies much of the ownership structure of the SNO: 30% is for the electricity and rail companies' telecommunications subsidiaries, 19% for black economic empowerment companies, and 51% for a "foreign equity partner." There is also provision for licenses for underserved areas, "baby PSTNs" (public switched telecommunications network) for areas where the teledensity is less than 5%.

**Botswana,** with one fixed line operator and two mobile operators (neither related to the fixed line company), has resolved one access dispute in which the fixed line company had been reluctant to provide leased lines to an ISP. After Botswana establishes a competition authority (provided in the National Plan for 2003-2009), all competition concerns in telecommunications will be handled by the new authority.

In **Kenya**, Telecom Kenya is the monopoly PSTN and was, until recently, the only mobile operator as well. Now there is a second mobile operator, and Telecom Kenya has access disputes with both mobile operators.

In **Malawi**, the sector structure is similar to that in Kenya (the PSTN monopolist owns 40% of one of the two mobile operators), and the telecommunications regulator has suspended the fixed-mobile interconnection agreement until the parties reach a more workable agreement on commercial terms.

**Mauritius** has a legal monopoly provider of PSTN, but opened value-added services to competition two years ago. Despite having licenses, there are no operating ISPs due to the high interconnection fees demanded by the incumbent. However, Mauritius just passed a "cyber access bill" patterned on India's, and expects this to facilitate development of the sector.

In **Mozambique**, institution-building is getting started; the regulator will receive more regulatory powers in future, including responsibility to ensure that interconnection is non-discriminatory and cost-oriented. The sector contains only one operator, which is both the PSTN and mobile operator. The license for a second mobile operator will be finalized shortly.

In **Namibia**, a Competition Bill now before Parliament will establish a competition authority. The telecommunications regulator is not "independent" and it is not empowered to regulate Namtel's tariffs. In

2003, Namtel's legal monopoly in telecommunications ends. Thus, the regulator is preparing to license a second mobile operator.

**Seychelles** started from a completely different situation than that of the other countries: Its telecommunications sector was never government owned. Rather, Cable and Wireless (UK) had a legal monopoly until 1997. Since then, tariffs were re-balanced and a second firm entered. Now, there are two fixed and two wireless operators. Interestingly, there are 42,000 mobile phones in Seychelles, for a population of 80,000. This raises the question of whether "universal service" should be re-defined, at least in Seychelles.

**Zambia** has a legal monopoly PSTN (Zamtel), which is also the *de facto* monopolist for international service. There are three mobile operators with a fourth on the way. Access disputes have included one between a basic local voice telephony provider and Zamtel, as well as several in which Zamtel demanded the business plans of ISPs and then replicated the planned installations or delayed implementing the requests for access.

The discussion on **Zimbabwe** focused on the problems of regulating telecommunications according to a price-cap regime in a near hyper-inflation environment.

## 2.3.3. Workshop for Adjudicators in Competition Cases, June 28-30, 2002

This workshop was devoted to judicial oversight of competition law enforcement. It was aimed primarily at those involved in the appeal procedures before the South African Competition Tribunal and the Competition Appeal Court of South Africa (CACSA).

Participants were judges of the Competition Appeal Court of South Africa, Members and staff of the Competition Tribunal of South Africa, and several commissioners of the Kenyan, Zambian, and Zimbabwean competition commissions. Facilitators/speakers were Judge Diane Wood, United States Court of Appeals for the Seventh Circuit, Professor Richard Whish of King's College London, John Clark, former Deputy Assistant Attorney General in the Antitrust Division of the US Department of Justice, now a consultant to the OECD Secretariat, and Sally Van Siclen, a member of the OECD Secretariat.

### *Highlights*

The Workshop was divided into several parts:

1. Recent developments in competition law
2. Judicial review of competition cases
3. The accommodation of multiple criteria in competition cases
4. Standards of proof
    a. Restrictive agreements
    b. Abuse of dominance
    c. Mergers
5. Remedies

The session on **recent developments in competition law** was focused on the United States and European Union developments although some note was made of developments in the transition countries. In the US, the intersection of antitrust and intellectual property, international enforcement and coordination, and how to reform enforcement were the main topics. In the EU, the anticartel campaign, the updating of the *de minimus* exception, the Commission decision (under appeal) on *IMS Health* (refusal to license a copyrighted information format) and the Court of First Instance decision on *Airtours* were the main subjects of discussion. More broadly, it was noted that improving the prosecution of cartels and procedures for merger review are the main developments at the OECD. These talks led into discussion on how a court or a tribunal could speed-up case review procedures and on how to address essential facilities, or indeed whether this is a useful concept.

The session on **judicial review of competition cases** began with a review of the different types of cases and procedures for US federal antitrust cases, and then a review of the procedures for cases in the EU brought by the European Commission and cases in the UK brought by the Director of Fair Trading. Under the US federal system, the standard of review for the judge's finding of fact is "clearly erroneous." One facilitator argued that, in the EU, the ECJ can expand or diminish the scope of judicial review depending on the needs of the system, citing the *PVC* case as an example. *Airtours* provided another example of judicial review of the quality of the evidence.

The discussion that followed had a number of strands. First, there was an acknowledgement of the dual role of the Competition Appeals Court of South Africa as having both appeal and review powers, and a discussion on speed of these processes. Perhaps, said one participant, the cases could be divided into those that need speedy review, such as mergers, and those that do not, such as cartels and some abuse cases. The second strand of discussion was on how the CACSA could get more details and explanations from the Competition Tribunal than are contained in the Tribunal's decisions. Legal advice received by the Tribunal is that it cannot appear as a party before the CACSA. Two analogies in US federal law were offered, immigration and social security. In each area, there is an internal tribunal and an internal appeals body. If the decision of the appeals body is appealed to the judiciary, then the Attorney General argues for the immigration appeals body and the Secretary of Health and Human Services argues for the social security appeals body. The final strand of discussion centered on Section 49D of the Competition Act, the role of the Competition Tribunal in consent decrees, and whether a firm must admit guilt as part of a consent decree.

The session on **the accommodation of multiple criteria in competition cases** was prompted, especially, by provisions in the Competition Act that promote greater ownership stakes by historically disadvantaged persons. In the US, *Gordon v. New York Stock Exchange* set out the analytical structure of how the competition law takes into account the criteria of other laws. The decision gives the criteria for implied repeal of the antitrust laws: "only where there this a 'plain repugnancy between the antitrust and regulatory provisions' will repeal be implied." Later in the decision, "'(r)epeal is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary." Later, the fact that the regulatory agency could not prevent application of rules that would have undesirable anticompetitive results prevented any conflict arising between the regulatory scheme and the antitrust laws. While the securities law has changed, this decision remains the one that governs, in the US, the relationships between the antitrust and other federal laws. The other facilitator did not directly address the "conflicts of law" question, but noted the need for intellectual clarity of which bit of the law a decision is taken under. Discussion, while starting on the US's Exon-Florio Act, which gives the President the power to block mergers on national security grounds, focused on African concerns where employment and black economic empowerment are objectives in the competition laws of several countries. The view of one facilitator was that a judge cannot trade-off criteria—rather, the way in which decisions are to be made must be in the law.

The session on **standards of proof in restrictive agreements** began with a description of the US antitrust law, noting the long history of change. Initially, the question "What does it mean to restrain trade?" had to be answered. In 1979, the decision in *Broadcast Music* clarified that the restrictive agreement had to be characterized as having an efficiency justification—in which case it was evaluated according to a 'rule of reason'—or as not having an efficiency justification—in which case it was *per se* illegal. However, the rule of reason was revised in some subsequent decisions; defendants can present efficiency arguments before the "characterization" phase. Thus, there is a tension between making a law easy to administer and convey to firms, on the one hand, and making it better reach its objectives, on the other hand.

In the **standards of proof—abuse of dominance** session, the differences between US and EU jurisprudence were most marked. In the EU, first dominance must be shown and then the conduct must be shown to be abusive. Market shares are the main criterion for showing dominance. Where the conduct is directly related to pricing, such as pricing to 'meet the competition,' then the firm must have a very high

market share for the conduct to be considered abusive. In the US, monopolization does not need a showing of a relevant market—rather, it is sufficient to show market power directly. Further, it is difficult to define the illegal maintenance of monopoly power under US law. Acts that only make business sense if they are aimed at driving competitors out of a market constitute illegal maintenance of monopoly power. Discussion in this session included cases in several of the participating countries where Coca-Cola provided refrigerators to small stores on condition that they were used for nothing other than Coke products. In South Africa, the Tribunal has dealt with only one abuse case to date.

The **standards of proof—mergers** session highlighted market definition and entry as the most important elements on which merger cases usually turn. Buyer evidence is usually valuable if the relevant product is an intermediate product, so that buyers are sophisticated, but e.g. consumer surveys are not valuable for consumer goods. Documents created in the normal course of business are more valuable than those prepared "specially" for the competition authority's review. Regarding competitive effects, high market shares and high barriers to entry create a presumption of anticompetitive effects from the merger, but courts in the US are increasingly interested in exactly why and by how much prices will increase as a result. Economists, wielding economic models can help to estimate this, but their models need to be well-grounded in raw facts about the industry. Economic experts tend to disagree about which facts are relevant and which model is appropriate, but should be able to explain their differences to judges. Discussion focused on experts in judicial proceedings. There can be difficulties in determining whether the person appearing in court as an expert is indeed an expert, and an "appropriate kind" of expert for the issues on which she is testifying. US Federal Rule of Evidence 703 provides guidance for judges, who are typically laypersons in the field in which the expert claims expertise, to be able to evaluate their evidence. Expert evidence is costly but the experts can be used by judges: Judges can ask for expert summaries, or require experts to write a joint report on what they agree or what they disagree on.

The session on **remedies** demonstrated that fines are not the only remedies in the competition arsenal. Note, though, that fines in cartel cases need to be sufficiently large that the prospect of their non-imposition in return for co-operation is sufficiently valuable to induce cartel members to come forward to the authorities and reveal the existence of the cartel and aid its prosecution. On the other hand, imposing a fine in abuse of dominance cases does not aid the consumers who were harmed. Rather, the remedies in such cases are more likely to be changes in conduct ordered by court decree. Access, for example, can be ordered, but then there is a need to monitor. Breaking up a company is a drastic remedy and rarely applied. That a remedial order imposes financial hardship is not, by itself, a defense.

### 2.3.4. Seminar on Competition Policy and Regulation in the Electricity Sector, November 12-15, 2002

This seminar focused on reforms and competition issues in the electricity sector. Many participating countries have extremely low electrification rates and, even if areas were served by the main network or a mini-network, the level of economic development is such that consumers would not have the wherewithal to purchase electricity. Thus, electricity provision must be seen in Southern Africa as part of broader rural economic development.

The seminar included lectures and discussions on:

- Overview of Economic Regulation--Market failures, regulatory failures, and state-led development
- The Electricity Sector--What is "special" about electricity? Overview of Electricity Reforms Around the World
- SADC Electricity Reforms
- Overall Structure and Governance of the Sector
- Transmission
- Likely Competition Problems
- International Trade

- Coordination of Long Term Investments and Private participation
- Universal Service Obligations and Pricing Final Supply
- Institutions--Regulators and the Competition Authority
- Sequencing of Reform

There were presentations from the participating countries: Kenya, Lesotho, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe.

Participants were competition officials, electricity regulators, and officials from relevant ministries in those countries that have not yet established regulators, from SADC countries (see list below). Experts for parts of the seminar were Dr. Joseph Crespo, NERA, Prof. Anton Eberhard, University of Cape Town, Mr. Morgan Sithole, Eskom (the South African electricity utility), and Dr. Sally Van Siclen, OECD Secretariat.

## *Summary of country presentations*

Representatives of SADC countries made presentations on their electricity reforms. Most striking was the weak correspondence between plans and feasibility. Almost all countries had a stated goal of electricity reform, many of them saying that they would introduce competition in generation and choice for large users. But in fact, the size of the countries' generating capacities is such as to make competition a very unlikely outcome even of well-implemented reform. Combined with the limited human resources in many countries for designing, implementing, and sustaining what is even in OECD countries a very complex reform, means that such plans are unlikely to bear fruit. Further, all of these plans require massive foreign investment—the rate of electrification is about 5% for most of these countries—and an unclear future regulatory regime will discourage such investment. It is not quite clear whether the idea for radical reform originates from (other) international organizations or domestically.

In **South Africa,** Eskom, the incumbent monopolist, was corporatized in 2002. Plans are to create "competition" in generation through the sale of 30% of the generating capacity and splitting the remainder into "competing" subsidiaries of Eskom. There are plans for a mandatory pool, from with the distribution companies and large industrial firms (over 100 GWh) can buy. "Transmission" would go into a separate company in 2004, but whether the physical assets would remain in Eskom and simply be leased to a separate company is unresolved. While the President has said there will be a poverty tariff (a subsidized price for a limited quantity of electric power for poor households), the regulator has announced cost-reflective tariffs; this inconsistency will need to be resolved. At present, all customers in Pretoria receive a certain amount of free electricity.

A radical proposal for liberalization in **Zambia**—distinct, competing generators selling to large consumers and distribution companies and free entry of new generators, was expected to be presented to Government in November 2002.

**Malawi** exemplifies the circumstances of the electricity sector in southern Africa. Total capacity is very small: 355 MW. 85% of it is hydropower, so generation is centered on the Shire River. Only 5% of the population (30% of the urban population) has access to electricity. There are high technical and non-technical (theft) losses, about 15%. There is poor reliability, with load shedding (partial blackout) and voltage reduction (brownout). Labor productivity is low and the country's network is not connected to other networks. Tariffs, set by Government, are below long-run marginal cost (4 to 5 US cents/kWh versus estimated 6 to 7 cents/kWh), but there is pervasive non-payment by large customers and government institutions. The electricity sector has been corporatized and there is a proposed energy policy to guide the reform. Some say that the desired reform would introduce private participation and competition, competition in generation through power purchase agreements and through bids to provide new capacity, and competition to provide certain retail services such as billing. A Competition Commission has not yet been established to enforce the Competition and Fair Trading Act of 1998.

**Namibia** also has a small system, 355 MW maximum demand, but it has 40% electrification and its grid is connected to other countries--indeed it has power purchase agreements from Angola, Zambia and South Africa. NamPower is the *de facto* albeit not legal monopolist in the upstream part of the sector, but distribution is split among a number of distribution companies. There appears to be limited overall regulation of the sector, with widely varying tariffs, high technical and non-technical losses (19%), and insufficient electrification planning. The 1998 Energy Policy Paper and 2000 Electricity Act envisage the establishment of NamPower as a single buyer, consolidation of distribution into three companies, and establishment of an "independent" Electricity Control Board. In practice, some distribution companies do not yet know what assets they own, NamPower has not instituted the required ring-fencing and no accounts have been provided to the Electricity Control Board.

Only 6% of the population of **Tanzania** has access to electricity. The fact that the system is 80% hydropower meant that during the severe drought in the 1990s, Tanzania had to buy power from a thermal IPP (independent power producer). The agreement, though, is in the form of a take-or-pay contract. Thus, the drought over, Tanzania is now paying for high-cost, high-priced generation. We discussed the importance of integrated resource planning, which would have identified in advance the need for alternative power during severe droughts. In conversation with other participants, it appeared that such planning is typically done by the utilities but that the "regulators" did not have the resources to actively participate in such planning. We also talked about whether capacity payments, rather than take-or-pay contracts, would have been a better way to structure the contract for the IPP.

There are plans for multi-sector regulators, e.g., energy and water, communications (telecom and broadcasting), and transport (rail, ports, and maritime). These would be responsible also for protecting competition in their sectors until they have become competitive. The regulators will be funded on fees on the regulated industries, under the minister for economy or minister for planning in order to maintain independence from sectoral interests, and managers will be recruited widely. The Competition Commission was established in the mid-1990s. A new draft competition act is now under review and is expected to be presented to Parliament in early 2003.

The electricity sector in **Mozambique** has three main participants, the incumbent, a joint venture to supply an aluminum smelter, and municipally-operated generation. Only 5% of the population has access to electricity; installed capacity is about 2400 MW, of which the incumbent has 2075 MW. A large new hydro plant, with 1300 MW capacity, is planned. The above-mentioned joint venture was held up in the seminar as another example of power purchase agreements gone wrong; the price at which electricity from the joint venture is sold is 11 cents/kWh, which is far above avoided cost. The parties to the joint venture announced an agreement on the renegotiation later in the week, according to the newspaper.

**Kenya** is 15% electrified and installed capacity is 1100 MW. There is an incumbent provider and four IPPs. There is debate about whether the procurement of power from the IPPs was competitive: the power was procured during a drought at very high prices. The incumbent is losing 2 billion Kenyan shillings annually. The only document guiding energy policy in the country is a 1996 letter to the World Bank. In the letter, unbundling and privatizing monopolies are promised. Under the 1998 Electric Power Act, an Electricity Board was set up, but it has no power to license, regulate tariffs, or set its own budget, and board members are appointed and removed at the discretion of the government. There is a rural electrification plan, funded by a 5% levy on electricity sales. However, the use of these funds is not transparent and there is said to be evidence that politically connected persons are connected earlier. There is also a policy for "accessibility" of electricity, by which there is a "lifeline tariff" for small quantities of electricity.

In **Zimbabwe**, there is a monopoly for all generation and sale of electricity, except individuals may autogenerate up to 100 kW. Reform is constrained by the broader political situation in the country.

About 5% of the population in **Lesotho** has access to electricity; the government has an objective of 25% electrification by 2010, a plan greeted skeptically by the seminar participants. Residents of Lesotho,

however, are putting intense pressure on government for electrification, as they are aware of the 60% electrification just across the border in surrounding South Africa. Consumption was 92 MW in winter 2002. (Electricity consumption in Southern African peaks in winter.) As the Lesotho Highlands Development Authority has capacity of only 72.5 MW, and Lesotho Electric Corp. only about 3 MW, the shortfall is imported from Eskom in South Africa. A 1998 Policy Statement on power sector reform removed the monopoly of LEC on transmission and distribution. According a seminar participant, the World Bank has insisted that LEC be fully privatized, an event expected in mid-2003. The criteria for choosing the new owner of LEC will include commitments regarding rural electrification. In parallel, the 'Muela power plant (72 MW) is in the process of commercialization. A 2001 law established the Lesotho Electricity Authority.

The Electricity Act in **Swaziland** gives exclusive rights to the Swaziland Electricity Board to generate, transmit and distribute electricity. The Act also gives the Board the exclusive right to license participants in the sector.

The small island country of **Mauritius** is 100% electrified, with demand about 1,600 GWh/year. Generation is coal-fired, except that of IPPs. Whereas the electricity sector is almost entirely owned and operated by a ministry, there has been recent entry by IPPs. In particular, sugar plants have long burned the fiber resulting from processing sugar cane to generate electricity for themselves. The consolidation of the sugar industry in response to changes in that sector has resulted in plants now large enough to sell excess power into the grid. The Central Electricity Board regulates the sector, which is under the control of the relevant minister, so in effect the sector is owned and regulated by the same minister.

### 2.3.5. Informal Policy Advice and Coordination Planning

The final part of the program under this grant was funding for OECD staff work in providing informal assistance to the Commission's staff on particular issues throughout the year, as well as funding for an additional "stock taking" and planning mission to South Africa. Consultations on the program with senior South African competition officials were held concurrently with the OECD's second Global Forum on Competition in February 2002. (The participation of South Africa at the GFC2 led to South Africa's institutions, laws and policies being reviewed in the OECD's third Global Forum on Competition. That review was funded by a grant from DFID, and the insights gained in that review will aid the Competition Division to focus its future work with South Africa, if funded.) Other consultations with senior competition officials of South African and Zambia were back-to-back with an UNCTAD seminar in late 2002 in Livingston; and then a few days later in Pretoria, where a consultative meeting also was held with officials from USAID. These meetings in late 2002 were designed to discuss and finalize the program for 2003 (which became a program for 2003-2004). Also under this rubric, the OECD sent a representative to the launch of the Southern and Eastern African Competition Forum (which was back-to-back with the electricity seminar) on November 16, 2002, and to an UNCTAD-organized seminar on Zambian Competition Policy in Livingstone, November 28–December 3, 2002.

## *3. Effect of the Program*

The major effect of the program has been to build competition law enforcement capacity within the South African Competition Commission and throughout the SADC region. In addition, the two seminars on regulated sectors—telecommunications and electricity—raised the awareness of the importance of the competition in the sectors, and of the impact of the structure and regulation on the level of competition of the sectors, within the competition agencies. And they exposed regulatory agencies to the competition concerns in their sectors and the weight those concerns are given in developed countries. Local regulatory authorities were also shown how competition can be effectively introduced into the telecommunications and electricity sectors. The workshop for adjudicators assisted participants to understand how a range of antitrust issues are approached in other jurisdictions and prompted interest in further educational

opportunities. Finally, a handful of policy recommendations have changed as a result of learning in the seminars.

The program built various kinds of capacity. First, being required to write-up case studies to be presented to an international audience helped staff members to clarify their main concerns and the main evidence for and against their positions. Indeed, discussion of case studies often led to the presenter recalling additional facts that she/he had not identified as salient and had not included in the case write-up. This helps economic and legal analysis and it helps to improve strategies for investigation. Second, and very closely related, the telecommunications and electricity seminars gave staff members an opportunity to learn, from objective sources, many of the facts about the sectors. Third, the telecommunications and electricity seminars enabled staff to learn, from a variety of sources, about the interaction between industry-specific and competition laws, including how they interact in a variety of jurisdictions. Fourth, by improving investigatory strategies, the capacity of the agency is increased by reducing low-value activities, such as investigating to determine facts that are not salient. Fifth, staff members were introduced to additional sources of information and ideas, officials in other SADC jurisdictions and officials in OECD jurisdictions (which facilitated valuable network-building).

The telecommunications seminar directly assisted the team involved in the investigation of accusations against Telekom in South Africa. Team members were able to ask questions bearing on the cases and acquired a general overview of access issues internationally.

The electricity seminar helped forge an understanding of and interest in the sector and the issues involved. This in turn spurred the establishment of a research project within the Competition Commission of South Africa in February 2003 to examine the restructuring of the electricity sector in South Africa, including restructuring models, challenges, regulatory framework, international experience and policy issues. A policy brief, newsletter article, and a presentation to the South African Competition Economists Forum have followed from the research project. Further, the Competition Commission has been more effectively participating in working groups set up by the Department of Public Enterprises since February 2003.

The adjudicators' part of the program also had the beneficial effect of demonstrating to adjudicators in the SADC region how adjudicators in OECD jurisdictions have become familiar with and comfortable with using economic reasoning. This demonstration has already induced some judges to attend further workshops on competition issues where economic reasoning is integral.

Mauritius and Zimbabwe reported specific impacts of the program as well. The recommendation of an interministerial group on liberalization of the price of soft drinks, water and beer canned or bottled in Mauritius was modified as a result of participation in the program. Deficiencies in the Zimbabwean competition legislation, notably as regards the separation of the investigative from the adjudicative functions and the treatment of sectoral regulators, were identified and will be taken into account in the next amendment of the Competition Act.

While it would be incorrect to attribute all changes in the perceptions of the quality of the work of the competition commission to the OECD's work under this grant, it is perhaps worth noting that the *Global Competition Review's* rating of the agency in 2003 was up 1.25 "stars" over its 2002 rating, to 2.75 "stars" and thus comparable to Israel, Austria, Brazil and Mexico.

In sum, the program had more effect on improving the capacity of staff to investigate and analyze competition cases, including those related to telecommunications access, and to participate in policy debates involving electricity and telecommunications reform. It facilitated cooperation between agencies within the same country, as well as of agencies within the SADC region. Indeed, the multi-national aspect was particularly appreciated by participants: The greater similarity of competition issues and investigatory capacities of agencies in neighboring jurisdictions made it easier for officials to relate others' competition and regulatory issues to their own. And the program has had a direct effect of improving competition advocacy in several countries, not least South Africa.

## 3.1. Evaluation by Participants

The program as a whole and each of the seminars were highly rated. The seminars were rated by a questionnaire distributed at the end of the seminar; the program was rated by a questionnaire sent in mid-2003. The case discussions seminar was rated very highly, more than two-thirds giving it the best grade available. One participant wrote on the evaluation, "You have started do not stop." A majority of participants at the telecommunications seminar gave it the best grade available. As with the case discussions seminar, several participants encouraged the OECD to continue to provide such seminars. The electricity seminar averaged a rating of 4 out of a possible 5.

Participants highly valued the workshop for adjudicators. For participants from outside South Africa, this was a rare opportunity to discuss competition law in depth. For the senior judges from South Africa, this was a rare opportunity for them to meet and to exchange views with each other and with counterparts from other jurisdictions. And for the members of the Tribunal, this was an opportunity to put questions to outside experts and, in an indirect way, their own judiciary. Participants expressed wishes to hold another such workshop in future.

The program questionnaire responses were invariably very positive toward the program. "These type[s] of seminar/workshops are essential in improving [the] competition system in [the] respective countries. The exchange of experience from officials in different countries in the implementation of competition policy and law are indeed very useful." "The Commission generally was extremely satisfied with the content and outcome of the seminars." "The seminars were well-tailored for the participants...." And, from South Africa, "The Commission views these seminars and workshops as being critical to building capacity in the organization," and "The level of expertise of the facilitators has ensured that the Seminars and Workshops were of a very high standard."

# *4. Lessons Learned and Next Steps*

A lot has been learned about the needs of the various competition agencies, and also some of the specific issues faced by them. In particular, it is clear that the analytical capacity of competition authorities in South Africa and Zambia is somewhat more sophisticated than that of the other agencies, but there remains room for improvement of the resource allocation for investigations, e.g., regarding internal policies for establishing priorities and screening those cases/complaints that do not raise significant issues from those that warrant more time and resources. Also, the competition issues in the less developed countries in the region were somewhat different, e.g., greater problems of distribution. Further, some countries still do not have a competition law and thus do not have meaningful tools to address anticompetitive conduct. In these countries, advocacy efforts directed towards helping key policy-makers to understand the links between competition and key pillars of economic development (e.g., investment, privatization, regulatory reform, trade, development of an SME class, innovation, etc.) will be critical. We have also learned how to improve some of the organizational aspects of the seminars, e.g., to include a background/overview session at the beginning of seminars on particular regulated sectors, in order to provide a factual or technical basis for the discussions and analysis to follow.

In terms of next steps, the OECD Competition Division would like to continue this work and will seek further funding in a proposal that will be made to the regional USAID office in Gaborone, for USAID's 2004-2010 strategic planning cycle. This proposal will reflect a desire to continue regional events as well as the type of country-specific work that was begun in 2004, at the suggestion of USAID. (See below.)

The case discussions seminar demonstrated that the case discussion style of seminar works very well in southern Africa. The case presentations and analysis from South Africa and Zambia were somewhat more sophisticated than those from Kenya and Zimbabwe, and in turn these were more sophisticated than those from the other countries, who do not have competition laws. (Malawi has a law, but had just established an interim secretariat in November 2001 so has little practice.) The level of sophistication suggests that the

peer review of South Africa in the 2003 OECD Global Forum on Competition can indeed be comparable to the peer reviews in the Competition Committee as South Africa can be held to world standards.

One feature of the South African competition regime, which was illustrated in the case descriptions but has also been noted by other technical advisers, is that fewer investigative resources could have been used in some cases. During the seminar we tried to provide checklists and what were effectively simple logic trees, but it would be useful for us to focus some resources on helping competition authorities in the region to determine how to decide which complaints to pursue, which investigations to shut down, and when.

The mixed backgrounds of participants in the two competition and regulation events created both opportunities and challenges. In the telecommunications seminar, the differing familiarity with technical terms and issues meant that some aspects of the discussion were not as useful as they could have been for certain participants. It was this experience that prompted us to hold a preliminary session, optional for the regulators, aimed at providing the competition officials with more background about the electricity sector and its issues when we held the second competition and regulation event. For both seminars, the orientation might have evolved toward fewer lectures and more discussion while meeting our objectives on the substance. Already there were more discussions in the second seminar, but further moves in the same direction would likely be useful. In the electricity seminar, more so than the telecommunications seminar, the satisfaction with the seminar varied and was correlated with whether the participant was a competition official (about half) or from an electricity regulatory authority or a relevant ministry (about a quarter each). This suggests that where a topic truly demands specialist knowledge, for example where the efficiency and competition implications of the underlying technology are counterintuitive, the participation should be more homogeneous.

### Next steps

The OECD wishes to continue this program. As initially proposed, this program had a three-year duration since, in our experience, a one year program is of little value. It typically takes much more time for capacity to be built and know-how to be transferred, as participants and organizers become fully acclimated to a new institutional, legal, economic and social environment. The second year of the program has been funded by USAID/RCSA Botswana and is being implemented in late 2003 and in 2004. Further funding for this program will be sought as described above.

Different countries in SADC have different institutions, legal framework, and "culture" of competition, as well as different degrees of development in these elements. It is important recognize that needs and priorities may vary from one country to another. Thus, the second year of the program added a country specific component, beginning in this year with a "needs assessment" of Tanzania and Zambia. A "needs assessment" workshop involves a team of OECD experts and various stakeholders in the recipient country attempting to inventory the country's most important needs in the competition area; and then elaborating an activity plan to respond to the highest priority needs. Based upon these plans, and following further consultations with the USAID, targeted activities hopefully will be planned.

Looking forward, we understand that Namibia, Botswana, Swaziland, Mauritius and Seychelles are each drafting competition laws. Assistance in drafting these laws may be one of the most effective ways to help promote competition.

Finally, helping to establish a domestic "competition policy dialog" among academia, the private bar, and other parts of government may help establish a self-sustaining commitment to competition.

## *5. Conclusions*

The program has helped to build capacity within the South African Competition Commission and throughout the SADC region. The seminars on access in telecommunications and on electricity have raised the awareness within the competition community of the importance of the sectors, and of the impact of the structure and regulation on the level of competition of the sectors. And they made regulatory agencies

aware of the weight given to competition concerns in other, developed countries; as well as how competition has stimulated the development of the industry there. Adjudicators from developed countries were able to demonstrate the standards of analysis used in other jurisdictions, and this has prompted interest in further educational opportunities. Finally, a handful of policy recommendations have changed as a result of learning in the seminars.

The program as a whole and each of the seminars were highly rated. Competition agencies find the program invaluable and wish it to continue.

The partnership with the Competition Commission and Competition Tribunal of South Africa has worked very well. The South African institutions have lent the program their network of contacts with regional competition agencies and nascent agencies, their credibility with these agencies, as well as their on-site technical assistance. The OECD Competition Division has brought its wide experience in capacity building and network of contacts and experts from the 30 OECD member countries' competition agencies.

The initial proposal was for a three-year program in order to allow time for the content to percolate throughout the competition and regulatory agencies. This grant provided funding for the initial year. However, only the initial year was funded under this grant. The second year is being funded by a second grant from USAID's regional center for southern Africa, USAID/RCSA Botswana. In light of the extremely positive responses from competition agencies in the region, further funding for the program will be sought

# *ANNEX 1: Lists of Participants*

## 1. Case Studies Seminar on Competition Law Enforcement

**BOTSWANA**
Mr. Mmoshe Mookodi
Principal Commercial Officer
Department of Trade and Consumer Affairs

**KENYA**
Ms. Alice N. Mwololo
Deputy Head, Investigations Division
Monopolies and Prices Commission

Mr. Wesley Too
Section Head
Monopolies and Prices Commission

**LESOTHO**
Ms. Thato Moletsane
Trade Promotion Officer
Ministry of Industry, Trade and Marketing

Ms. Likonelo Lebone
Legal Affairs Officer
Ministry of Industry, Trade and Marketing

**MALAWI**
Brian G. Mtonya
Deputy Director of Planning
Ministry of Commerce and Industry

Mrs.K.M. Musukwa
Economist
Ministry of Commerce and Industry

**MAURITIUS**
Mr. Preetam Radha
Senior Trade Analyst
Ministry of Commerce and Cooperatives
Foreign Trade Division

**MOZAMBIQUE**
Mr. Célio Elías Zaqueu Nhachungue
Legal Department
Ministry of Industry and Trade

Mr. Agonias António Macia
Head of Department
Ministry of Industry and Trade

**SOUTH AFRICA**
Competition Commission

Ms Nandisile Mpikashe
Mr Beverly Rhikotso
Ms Diane Terblanche
Ms Leona Mentz
Ms Koekie Mdlulwa
Adv. Menzi Simelane, Commissioner
Ms Shaazia Adam
Ms Zodwa Ntuli
Ms Rhorho Cloete
Ms Annalee van Reenen
Mr Charles Mabuza
Ms Lizel Blignaut
Ms Seema Nunkoo
Mr Nkonzo Hlatshwayo
Mr Maarten van Hoven
Mr John Nesidoni
Mr Kopano Tshikare
Mr Nelson Lolwane
Ms Iona Dhladhla
Mr Bhavik Diar
Ms Lulama Mtanga
Mr Allan Coetzee
Ms Alicia Stevens

**ZAMBIA**
Mr. Martin Sampa
Commissioner
Zambia Competition Commission

Mr. Frywell S. Chirwa
Director, Economics
Zambia Competition Commission

**ZIMBABWE**
Mr. Gladmore Mamhare
Senior Economist
Industry and Trade Competition Commission

Mr. Edwin Mubataripi
Economist
Industry and Trade Competition Commission

## 2. Seminar on Competition Policy and Regulation: Access Issues in Telecommunications

**BOTSWANA**
Mr. Mmoshe Mookodi
Principal Commercial Officer
Department of Trade and Consumer Affairs

Ms Boipuso Tshweneyayae
Chief Corporate Counsel
Botswana Telecoms Authority

**KENYA**
Mr Peter Muchoki Njoroge
Monopolies and Prices Commission

**MALAWI**
Mr. D.E. Kadwa
General Counsel,
Malawi Communications Regulatory Authority

**MAURITIUS**
Mr. H. Garibah
Senior Trade Analyst
Ministry of Commerce & Co-operatives

Mr. Bhojendranath Radhakissoon
Chairman
Information and Communication Technologies Authority

**MOZAMBIQUE**
Mr. Francisco Chate
Member of the Board of Directors, INCM
Mozambique Telecommunications

**NAMIBIA**
Mr. Kombadayedu Kapwanga
Namibian Communications Commission

**SEYCHELLES**
Mr. Jeffrey Dogley
AG Principal Engineer
Ministry of Information, Technology and Communication

**ZAMBIA**
Mr. Banji Milambo
Zambia Competition Commission (ZCC)

Mr. Thomas Katuma Malama
Communications Authority of Zambia

**ZIMBABWE**
Mrs. Dinah Mandaza
Commissioner
Industry and Trade Competition Commission
Zimbabwe

Mr. Gideon Magodo
Director Communications
Postal & Telecommunications Regulatory Authority of Zimbabwe (POTRAZ)

**SOUTH AFRICA**

**COMPETITION COMMISSION**
Mr. Geoff Parr
Ms. Seema Nunkoo
Ms. Yandeya Mashau
Ms. Mondo Ntlha
Ms. Leona Mentz
Mr. Norman Chauke
Mr. Keith Weeks
Ms. Julia Mboweni
Mr. Nkonzo Hlatshwayo
Mr. John Nesidoni
Mr. Rueben Mohlala
Mr. Maarten van Hoven
Ms. Karin Coode
Ms. Nozipho Buthelezi
Ms. Shaazia Adam
Ms. Miriam Sebothoma
Ms. Neliswe Zondi

**DEPARTMENT OF TRADE AND INDUSTRY**
Ms. Thokozile Nkabinde
Ms. Magauta Mphahlele

**COMPETITION TRIBUNAL**
Mr. Eugene Tsitsi
Ms. Kim Kampel

## 3. Workshop for Adjudicators in Competition Cases

**SOUTH AFRICA**

**COMPETITION APPEAL COURT**
The Honourable Justice Dennis M Davis
The Honourable Justice Thabani SB Jali
The Honourable Ms. Justice Lucy M Mailula
The Honourable Mr Justice Selwyn Selikowitz
The Honourable Justice Ismail Hussain
The Honourable Justice Francois R Malan

**COMPETITION TRIBUNAL MEMBERS**
Mr. D Lewis, Chairperson
Adv. Marumo Moerane, Deputy Chairperson
Ms. Urmila Bhoola
Prof. Merle Holden
Mr. Norman Manoim

**COMPETITION TRIBUNAL STAFF**
Mr Shan Ramburuth, Chief Executive Officer
Mrs. Rietsie Badenhorst
Ms. Kim Kampel
Mr. Thulani Kunene

**KENYA**
Mr. Mathew Emukule
Chairperson of Kenya's Restrictive Trade Practices Tribunal

**ZAMBIA**
Mr. Friday Nyambe
Commissioner, Competition Commission
Mr. Andrew Sinyangwe
Commissioner, Competition Commission
Mr. Sylvester Tembo
Commissioner, Competition Commission

**ZIMBABWE**
Ms. Jean Maguranyanga
Member of the Competition Commission

## 4. Seminar on Competition Policy and Regulation in the Electricity Sector

**KENYA**
Mr. John M. MATHIU
Legal Counsel
Electricity Regulatory Board

Mr. Benson Oluoch NYAGOL
Monopolies and Prices Officer
Monopolies and Prices Commission
c/o Ministry of Finance and Planning

Mrs. Catherine Khasoa SIAMBI
Monopolies and Prices Officer
Monopolies and Prices Commission
c/o Ministry of Finance and Planning

**LESOTHO**
Mr. Batalatsang KANETSI
Director of Energy
Department of Energy

Mr. T. NTLAMA
Economic Planner
Ministry of Natural Resources
Department of Energy

**MALAWI**
Mr. McPetrie Newman HANJAHANJA
Director General
Electricity Council

Mr. Welton KUNJE
Director of Technical Services
Electricity Council

**MAURITIUS**
Mr. Dhananjay KAWOL
Assistant Secretary
Ministry of Commerce & Co-operatives
Commerce Division

**MOZAMBIQUE**
Mr. Chico Manuel GOBA
Head of Electrical Department
National Directorate of Energy
Ministry of Mineral Resources and Energy

**NAMIBIA**
Mr. Andrew K. MWAZI
Chief Electrical Engineer
Ministry of Mines and Energy

Mr. Paulinus SHILAMBA
General Manager: Technical Services
Electricity Control Board

**SOUTH AFRICA:**
**Competition Commission**
Mr. Zolile Ntukwana
Ms. Karin Coode
Mr. John Nesidoni
Mr. Nkonzo Hlatshwayo
Mr. Charles Mabuza
Mr. Odie Strydom
Mr. Nomfundo Maseti
Mr. Hendrick Senakal
Adv Menzi Simelane

Ms. Rizia BUCKAS
Legal Advisor
National Electricity Register of South Africa

Mr. Katishi MASEMOLA
National Bargaining Secretary
Bargaining Department
Economics Desk

**SWAZILAND**
Mrs. Teresa MLANGENI
Legal Advisor
Ministry of Enterprise and Employment

**TANZANIA**
Mr. Haruna MASEBU
Regulatory Co-ordinator
Presidential Parastatal Sector Reform Commission
(PSRC)

Mr. Shadrack M. NKELEBE
Assistant Director - Restrictive Trade Practices
Fair Competition Commission

**ZAMBIA**
Mr. Muyenga ATANGA
Director, Consumer Welfare and Education
Zambia Competition Commission

Mr. Lawrence S. CHIINDA
Manager - Research
Energy Regulation Board

Mr. Joseph KAPIKA
Inspector Electricity
Energy Regulation Board

Mr. Allan Gozen KASONSO
Legal Officer
Zambia Competition Commission

**ZIMBABWE**
Mr. Elijah MUNYUKI
Law Officer
Competition and Tariff Commission

## Experts

| | |
|---|---|
| Mr. John Clark<br>Principal Administrator<br>Competition Division<br>Organisation for Economic Co-operation and Development (OECD)<br>2 rue André Pascal<br>75775 Paris Cedex 16<br>FRANCE<br>Tel: +33-1- 4524 7860<br>Fax: +33-1-4524 9695<br>e-mail: john.clark@oecd.org | Workshop for Adjudicators in Competition Cases |
| Mr. Joseph G. Crespo, Ph.D.<br>National Economic Research Associates<br>One Main Street, Fifth Floor<br>Cambridge, MA 02142<br>UNITED STATES<br>Tel : (617) 621-4104 (Phone)<br>Fax : (617) 621-0336 (Fax)<br>Email : joseph.crespo@nera.com | Seminar on Competition Policy and Regulation in the Electricity Sector |
| Mr. John Richard Doidge<br>Antitrust Division<br>U.S. Department of Justice<br>2220 20th Street, N.W. #24<br>Washington, D.C. 20009<br>UNITED STATES | Case Studies Seminar on Competition Law Enforcement |
| Mr. David Elliott<br>PricewaterhouseCoopers<br>Valuation and Strategy<br>2nd Floor<br>1 Embankment Place<br>London<br>WC2N 6NN<br>UNITED KINGDOM<br>Tel: +44-207-213-2910<br>Fax: +44-207-804-6680<br>E-mail: david.d.elliott@uk.pwcglobal.com | Case Studies Seminar on Competition Law Enforcement |

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| Professor Anton Eberhard<br>Graduate School of Business<br>University of Cape Town<br>SOUTH AFRICA<br>Email: eberhard@gsb.uct.ac.za | Seminar on Competition Policy and Regulation in the Electricity Sector |
| Mr. Georgios Kiriazis<br>Principal Administrator<br>Direction Générale<br>European Commission<br>DG COMP, Direction A<br>200, rue de la Loi<br>Brussels<br>BELGIUM<br>Tel: +32-2-295-6268<br>Fax: +32-2-299-0746<br>E-mail: georgios.kiriazis@cec.eu.int | Case Studies Seminar on Competition Law Enforcement |
| Mr. Christopher Libertelli<br>Special Counsel for Competition Policy<br>Federal Communications Commission<br>445 12th Street, SW<br>Room 5-C-453<br>Washington DC 20554<br>UNITED STATES<br>Tel: +1-202- 418 7152 or +1-202- 232 1276<br>Fax: +1-202-418 2825<br>E-mail: cliberte@fcc.gov | Seminar on Competition Policy and Regulation: Access Issues in Telecommunications |
| Mr. Morgan Sithole<br>ESKOM<br>SOUTH AFRICA<br>Email: Morgan.Sithole@eskom.co.za | Seminar on Competition Policy and Regulation in the Electricity Sector |
| Ms. Sally Van Siclen, Ph.D.<br>Administrator<br>Competition Division<br>Organisation for Economic Co-operation and Development (OECD)<br>2 rue André Pascal<br>75775 Paris Cedex 16<br>FRANCE<br>Tel: +33-1-4524-7830<br>Fax: +33-1-4524-9695<br>E-mail: sally.vansiclen@oecd.org | Each of the four seminars/workshop |

| | |
|---|---|
| Mr. Richard York<br>Director – Regulatory<br>Telecommunications<br>Australian Competition and Consumer Commission (ACCC)<br>Level 35 The Tower Melbourne Central<br>360 Elizabeth Street<br>Melbourne 3000, Victoria<br>AUSTRALIA<br>Tel: +61-3- 9290 1883<br>Fax: +61-3-9663 3699<br>E-mail: richard.york@accc.gov.au | Seminar on Competition Policy and Regulation: Access Issues in Telecommunications |
| Professor Richard Whish<br>School of Law<br>King's College London<br>Strand<br>London WC2R 2LS<br>UNITED KINGDOM<br>Tel: (44) 207 848 2237<br>Fax: (44) 207 848 2211<br>E-mail: richard.whish@kcl.ac.uk | Workshop for Adjudicators in Competition Cases |
| Judge Diane Wood<br>United States Courthouse<br>219 S. Dearborn St.<br>Room 2602<br>Chicago, IL 60604-1803<br>UNITED STATES<br>Tel: +1- 312-435-5521 or 435-5850<br>Fax: +1- 312-408-5117<br>E-mail: dwood@ca7.uscourts.gov | Workshop for Adjudicators in Competition Cases |

# ANNEX 2

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## OECD TECHNICAL ASSISTANCE AND POLICY DIALOG ON COMPETITION LAW IN THE SOUTHERN AFRICA DEVELOPMENT COMMUNITY

# FINAL PROGRAM REPORT TO USAID/SOUTH AFRICA

**GRANT NO. 654G-00-01-00063-00**
**SEPTEMBER 25, 2001 – DECEMBER 15, 2002**

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OECD

competitioncommission south africa

## Seminar on

# Competition Law Enforcement

## Pretoria, 18-22 February 2002

## Competition Commission of South Africa
## and
## OECD Centre for Co-operation with Non-Members

**ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD)**
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## Agenda

# Competition Law Enforcement Case Seminar
# Pretoria, 18-22 February 2002

## Monday, 18th February

| | |
|---|---|
| 9.00 | Welcome by Adv.Menzi Simelane : Commissioner |
| 9.15 | Introduction to the seminar |
| | **1. OVERVIEWS** |
| 9.30-12.30<br>(10.30 tea/coffee) | A Short Description of the State of Competition, *Seychelles* |
| | Competition Law in Lesotho, *Lesotho* |
| | **2. JOINT VENTURES AND HORIZONTAL MERGERS** |
| | Commission's Recommendation and Reasons in the "Large" Merger Between: Shell South Africa (Proprietary) Limited, BP Southern Africa (Proprietary) Limited, and Caltex Oil (SA) (Proprietary) Limited *and* Trident Logistics (Proprietary) Limited, *South Africa* |
| 12.30-13.30 | **Lunch** |
| 13.30-16.30<br>(15.00 tea/coffee) | A Case of the Take-Over of M/S Agip Kenya Limited by M/S Kenya Shell Limited and British Petroleum Kenya Limited, *Kenya* |
| | The Acquisition of Jumbo Cash & Carry, Browns Cash & Carry and Weirs Cash & Carry from Rebhold Limited and Tiger Foods by Massmart Holdings Limited, *South Africa* |

## Tuesday, 19th February

| | |
|---|---|
| 9.00-12.30<br>(10.30 tea/coffee) | Case Study: Avery Dennison/Jackstadt Merger, *South Africa* |
| | A Case of Takeover of Ilara Dairies Limited by Brookside Dairies Limited, *Kenya* |
| | Merger Case Study: Acquisition of Lyons Zimbabwe (Pvt) Limited by Dairibord |



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Zimbabwe Limited, *Zimbabwe*

12.30-13.30 **Lunch**

13.30-16.30
(15.00 tea/coffee)

Mini-lecture: the failing firm defence

Breakout discussions

- Case study: A merger Between Iscor Limited & Saldanha Steel Limited, *South Africa*
- Merger Case Study: Acquisition by Pretoria Portland Cement Company Limited of Portland Holdings Zimbabwe Limited, *Zimbabwe*
- Case Summary: Merger: ADT Security Services (Pty) Ltd/ Sentry Group Limited (Case No: 2001May4), *South Africa*

Joint discussion of three cases

Mini-lecture: cartels

Simultaneous mini-lectures:

- (for economists) Quantitative methods in market definition
- (for lawyers) Going on a dawn raid?

## Wednesday, 20th February

### 3. ABUSE OF DOMINANCE and VERTICAL RESTRAINTS

9.00-12.30
(10.30 tea/coffee)

Atkinson, *South Africa*

A Case of Vertical Restraint Between R J Reynolds and British American Tobacco (K) BAT Kenya Limited, *Kenya*

Mini-lecture: abuse of dominance

Breakout discussion:

- Abuse of Dominance: Zambia Breweries PLC and the Loyalty Rebates with its Distributors, *Zambia*

12.30-13.30 **Lunch**

13.30-16.30
(15.00 tea/coffee)

Joint discussion of above case

Report on Investigation into Allegations of Restrictive and Unfair Trade Practices of the Cement Industry of Zimbabwe, *Zimbabwe*

Mini-lecture: vertical restraints

Break-out discussion:

- Report on Investigation Into Allegation of Restrictive and Unfair Trade Practices in the Coal Industry of Zimbabwe, *Zimbabwe*

Joint discussion

## Thursday, 21st February

9.00-12.30
(10.30 tea/coffee)

Case Study: All Joy Foods and Tiger Brands, *South Africa*

Mini-lecture: excessively high pricing

Enforcement and Exemptions Final Report: XYZ Packaging vs ABC and Others, *South Africa*

Mini-lecture: refusal to deal

12.30-13.30

**Lunch**

13.30-16.30
(15.00 tea/coffee)

Breakout discussion on horizontal and vertical agreements in the Zambian Poultry Sector:

- Vertical Agreements: Hybrid Poultry Farm Limited Exclusive Dealing Arrangements With Galaunia Farms Limited
- Horizontal Agreements: Hybrid Poultry Farm (Z) Limited and Tamba Chicks Limited

Joint discussion of the two cases

**4. HORIZONTAL AGREEMENTS**

A Case of Horizontal Restraint by the Kenya Association of Hotel Keepers and Caterers Against Wines and Spirits Distributors, *Kenya*

## Friday, 22nd February

**5. VERTICAL MERGERS**

9.00-12.30
(10.30 tea/coffee)

Case Study : The Merger Between Daimlerchrysler (« DCSA ») and Sandown Motor Holdings Limited (« SMH »), *South Africa*

Mergers: The Takeover of Zambia Bottlers Limited by Zambian Breweries PLC, *Zambia*

Mini-lecture: vertical mergers

12.30-13.30

**Lunch**

**1. OVERVIEWS**

| | |
|---|---|
| 13.30-16.30<br>(15.00 tea/coffee) | Fact Situation Presentation, *Malawi* |
| | Fact Situation Presentation, *Botswana* |
| | Fact Situation Presentation, *Mozambique* |
| | Mini-lecture: predation |
| | Mini-lectures as requested during the week |
| | Additional case discussions as requested |

# A Case of the Take-Over of M/S Agip Kenya Limited by M/S Kenya Shell Limited and British Petroleum Kenya Limited

*Alice N. Mwololo, Senior Economist*
*Monopolies and Prices Commission, Kenya*

## Introduction

An application was made in June 2000 to seek approval for the take-over the operations of Agip Kenya Limited by Kenya Shell Limited and its joint venture company the British Petroleum Kenya Limited. This proposal was a consequence the parent companies decision to sell all the assets belonging to Agip Petroli International BV in five African countries namely, Kenya, Uganda, Eritrea, Ethiopia and Côte d'Ivoire. Agip Kenya and Kenya Shell/BP are some of the 8 multinational oil companies operating in Kenya.

## Market Definition

The proposed deal involved the sale of storage and handling facilities at the Agip depots in Nairobi and Mombasa, the network of retail outlets, and various machinery and equipment. To determine the competition concerns, the Commission defined the relevant market as those components of Agip that were capable of being operated independently and at the same or higher levels of technical efficiency and which potentially threatened the interests of other market operators, consumer welfare and the competition process itself. The components of the proposed takeover that raised serious competition concerns are the storage and handling facilities that were owned by Agip.

## The Structure of the Oil Sector

Kenya is non-oil producing country. The heavy dependence on imported oil and the high sensitivity of domestic oil prices to world market prices means that the price of oil is one of the major sources of domestic inflation. The main players in the industry at that time were 8 subsidiaries of multinationals, the partly state-owned Kenya Petroleum Refineries and the government owned Kenya Pipeline Company. The Kenya Oil Refinery which is owned jointly between the government and 2 of the multinationals is the only refinery in the country and the Kenya Pipeline Co. transports petroleum from the port of Mombasa to the major towns in the interior of the country.

The multinationals dominate the oil sector as they are the ones who import the bulk oil and own the storage facilities. They also operate majority of outlets in the country. Their operations are concentrated in the main urban centers and surrounding areas.

The table below shows the major oil companies and their respective % market shares in 1999.

**Distribution of Market Shares %**

| Company | Petrol | Jet Fuel | Diesel Fuel | Oils | Kerosene | LPG |
|---|---|---|---|---|---|---|
| Agip | 10.9 | 10.0 | 9.0 | 5.0 | 8.4 | 19.0 |
| Shell/BP | 23.4 | 29.0 | 29.0 | 19.8 | 11.2 | 25.0 |
| Caltex | 16.4 | 27.3 | 16.4 | 17.0 | 16.2 | 19.5 |



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| | | | | | | |
|---|---|---|---|---|---|---|
| Kenol/Kobil | 19.4 | - | 17.6 | 18.6 | 25.1 | - |
| Mobil | 14.0 | 15.0 | 12.2 | 23.2 | 18.2 | 12.6 |
| Total (K) Ltd | 15.9 | 13.0 | 15.4 | 16.4 | 20.0 | 23.7 |

The approval of the merger meant that the combined operations of Agip Kenya and Kenya Shell/BP would control 44.3%, 44.0%, 40% and 38% of the petrol, LPG, jet fuels and diesel respectively. These market shares are more than the 33a threshold provided in the Restrictive Trade Practices, Monopolies and Price Control Act. It was regarded as necessary to apply the provisions of the competition law to curtail such dominance so as to safeguard against potential misuse of market power.

**Barriers to Entry**

The first step towards liberalization of the oil sector in Kenya was the decontrol of oil prices in 1994.This was further enhanced in 1999 through the opening of the sector to independent importers and distributors. As of July 2000, the number of independent dealers had risen to 113 and it was estimated that their market share by the end of 2001 would increase to 10%.

Investment into petroleum business requires heavy capital outlay which is out of reach to many would be competitors. The multinationals are the sole importers of bulk oil and they own the storage facilities. This restricted many potential entrants who would have to rely on the multinationals for importation and storage facilities.

Operations in the oil industry is governed by very high safety standards therefore restricting operators that do not meet the required standards

**Provisions of the Law Applied**

Section 30 of the Restrictive Trade Practices Monopolies and Price Control Act provides among other things that *"a merger or a takeover will be disadvantageous to the extent that it reduces competition in the domestic market and increases the ability of producers of the goods or services in question to manipulate domestic prices in accordance with the principles of oligopolistic interdependence".*

Section 31 stipulates the criteria that the Minister shall follow after the Commissioner recommendations as:

i) After considering the recommendation of the Commissioner made under Section 30, the Minister may make an order concerning the application for authorization of a merger or takeover.

ii) An order made under subsection (i) may approve or reject the application, or, it may approve the application on conditions that certain steps may be taken to reduce the negative effects of the merger or takeover on competition.

iii) The Minister shall cause an order made under sub-sections to be published in the Gazette notice as soon as reasonably practicable after it is made.

Section 23 of the Law empowers the Minister for finance to review the structure of production and

distribution of goods and services on a continuous basis so as to detect instances of unwarranted concentrations of market power over and above the statutory level of 331/3% of the market share which may be detrimental to economic efficiency, national development and community benefits.

Under Section 24, the Minister on the recommendations of the Commissioner after carrying out investigation under subsection 2 of Section 23 may make an order directing any person whom he deems to hold unwarranted concentrations of economic power in any sector to dispose of such portions of his interests in production or distribution or the supply of services as the Minister deems necessary to remove the unwarranted concentration.

**Investigations and Findings**

Firstly, a preliminary research on the oil industry was made using information available in the Commission's offices. Using this information and examining the provisions of the law concerning mergers and dominance it was possible to determine the type of information that needed to be collected through investigations. The Commission officials conducted interviews among the various stakeholders in the sector, studied documents and obtained information on the various market players, the products, geographical location, sales, volume, imports, prices, market shares etc. This enabled to define the market and estimate the market shares.

**Decision Made**

Considering that the merger proposal was triggered by the parent companies intentions to consolidate their business activities, recommendation had to be made to minimize concentration of economic power. It was therefore recommended that the takeover be approved under the provisions of Section 31 subject the following conditions:

i) That the purchases of the said assets will after consummation of the merger, divest from the storage and handling facilites for both white and black oils and LPG at Mombasa and Nairobi depots that were owned and operated by Agip Kenya, within a period of one year from the date of gazettement.

ii) That prior to the gazettement of the Ministerial order, the participating parties undertake to sell the 2 Agip depots situated in Nairobi and Mombasa at competitive market terms.

**Implications of the Above Decisions**

The above decisions was taken to reduce concentrations of economic power in the distribution of petroleum products. It was predicted that by divesting, other market players would be able own storage facilities and reduce the dominance of Kenya Shell/BP Limited.



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# A Case of Vertical Restraint Between R J Reynolds and British American Tobacco (K) BAT Kenya Limited

*Alice N. Mwololo, Senior Economist*
*Monopolies and Prices Commission, Kenya*

**Introduction**

The two companies are cigarette manufactures and distributors. It is a case of exclusives dealing where BAT allegedly refused distributors and retailers of its products to distribute and sell a competitors product.

BAT has been manufacturing and distributing its peroducts in Kenya since 1956.
R J Reynolds, an American Company on the other hand entered the Kenyan market in 1996. It did not have a manufacturing plant and imported its products from outside the country. It was operating only in the capital whereas BAT was entrenched all over the country.

In early 1997 in Kenya a complaint was made in the media by R. J. Reynolds that distributors and stockits were being threatened and forced not to stock the Aspen Brand (R J Reynolds only product in Kenya)

At the time of this case, BAT commanded 80% of the total cigarette market in Kenya and had over 50 distributors, over 1,000 wholesalers and over 40,000 retailers spread all over the country. Before RJ Reynolds entered the market, the only competitor to BAT was Mastermind Tobacco Kenya Ltd. which entered the market in 1989.

The Commission detected this case from a statement made in the media by RJ Reynolds alerting the distributors and retailers of the provisions of the Restrictive Trade Practices, Monopolies and Price Control Act, Cap 504 which allows them the freedom of choice of what to stock and sell. The Commission officials contacted RJ Reynolds and found that they were complaining that:

(a) its advertising materials including billboards and posters had been destroyed by agents of BAT, and

(b) distributors were being threatened by BAT agents.

When BAT was requested to respond to the allegations, they denied but agreed that they had entered into what they referred to as a 'gentleman's agreement' with specific operators, to stock BAT products only. They also said that distributors were contented with BAT products and thus competitors had difficulties entering the market.

**Provisions of the Competition Law Applied**

Section 10 (i)(a) of the law describes an action intended to drive a competitor out of business, or to deter a person from establishing a competitive business in Kenya, as a predatory trade practice.

Section 6a (i) also makes it an offence, an agreement hindering or preventing the sale or supply or

purchase of goods or services between persons engaged in the selling or buying of goods and services.

The allegations made were placed under these provisions of the law and the Commission embarked on investigations.

Section 15(1) (a) provides that if the Commissioner finds the allegations true, he may inform the person that specific evidence has been found and invite the person to comment on the allegations and evidence and to indicate what remedies (if any) the person would propose in order to bring his trade practices into conformity with the law.

**Investigations and Findings**

The Commission sought to verify the allegations by interviewing sales representatives from both companies and even the distributors and the stockists. It was found that:

a) sales representatives from BAT removed posters and billboards of RJ Reynolds,

b) BAT sales representatives threatened to stop supplying distributors if they stocked the competitors brand,

c) BAT actually stopped supplying those who stocked RJ Reynolds product.

**Decision Made**

As the Commission was in the process of invoking section 15(1)(a) to inform BAT that specific evidence was available to implicate them and ask them to comment and propose remedies to bring their trade practice into conformity with the law, the Director of RJ Reynolds sent information that BAT had stopped their predatory trade practices and that RJ Reynolds were able to distribute their products without any more threats.

The Commission halted the case but kept an eye on the events in Kenya's tobacco industry. The Commission has not detected any such practices again.

# A Case of Takeover of Ilara Dairies Limited by Brookside Dairies Limited

*By Wesley K. Too*
*Economist I*
*Monopolies and Prices Commission of Kenya*

**Introduction**

The application to purchase plant, machinery, equipment, contracts and intellectual property of Ilara Dairies by Brookeside Dairy Limited was made in 2001.

The two companies were in the business of processing milk and producing diary products. The reason given by Ilara dairies for divesting the dairy sector is because it found it difficult to operate in 1999 and 2000 as raw milk was not available due to drought. It was also experiencing rising fixed and transport costs and the options available was either to sell the plant to another company or close down.

**Structure of the Dairy Industry**

Production of milk in Kenya is dependent on the variations of weather with high production during the wet seasons and substantial declined during dry periods. The main market players in the sector are the Kenya Cooperative Creameries (KCC) a parastatal, and the small scale dairy farmers who account for about 70% of the marketed milk in Kenya.

Until the liberalization of the dairy industry in 1992, KCC had a monopoly status in purchasing milk from dairy farmers, processing and marketing packaged milk and other dairy products throughout the country. Liberalization resulted in the entry of private sector participants in processing and distribution of milk and other dairy products.

About 55% of the total milk produced is sold in unprocessed form by dairy farmers, informal sector traders, cooperative societies and self help groups.

In 1997 there were 45 registered milk processors. These comprised large scale processors with 60% of the market, 4 medium sized processors composing 30% of the market and other small scale processors that controlled 10% of the market. Brookside Dairies and Ilara Dairy controlled 10% and 2% of the market respectively.

**Barriers to Entry**

Production of milk in Kenya, the main raw material in dairy processing is dependent on weather which has been very unfavourable in the recent years. This has deterred many would be entrants because they may not afford to source raw milk from other regions in the country. The industry also involves high capital investments in processing equipment, refrigeration facilities and transport costs. It is therefore out

of reach to many would be processors in the sector.

**Provisions of the Law**

The takeover proposal was analyzed based on the provisions of Section 30(b) of the Restrictive Trade Practices, Monopolies and Price Control Act which stipulates among other things that a merger will be disadvantageous if it reduces competition in the domestic market and increases the ability of producers of the goods and services in question to manipulate domestic prices.

**Effect of the Takeover**

Given that there are many market players in the dairy sector, the merger would not comprise competition in the sector as the combined market shares of the a parties is only 12% which is far below the statutory threshold of $33^1/_3$%.

Also considering that the country is not self sufficient in dairy products, it is important to enhance the capacity of existing firms to grow and produce more products.

The takeover gave continuity to farmers who supplied their milk to Ilara and many employees who would have lost their jobs if the firm was closed.

# A Case of Horizontal Restraint by the Kenya Association of Hotel Keepers and Caterers Against Wines and Spirits Distributors

*Wesley K.Too, Economist 1*
*Monopolies and Prices Commission of Kenya*

**Introduction:**

The Kenya Association of Hotel Keepers and Caterers (KAHC) wrote to the Commission on 26th September, 1994 alleging that Wines and Spirits Distributors were engaging in a restrictive trade practice.

National Distributors of Wines and Spirits, an association of Wines and Spirits Distributors, were alleged to have held a meeting and passed resolutions that were in contravention of the Restrictive Trade Practices Monopolies and Prices Control Act.

KAHC is an association of Hotel Keepers and Caterers and the allegations they forwarded were that the distributors had jointly agreed, during a meeting:

(a) not to extend credit facilities to any hotels, restaurants, bars etc, all sales to be paid for in cash and

(b) that no further discounts would be accorded by the distributors.

Pursuant to Section 13 of the Restrictive Trade Practices, Monopolies and Price Control Act (RTP Act) the aggrieved party, the Chief Executive of Kenya Association of Hotel Keepers and Caterers (KAHC), lodged a complaint to the Minister of Finance through the Commissioner.

**Sections of the Act contravened and implications**

The gist of the case centred on a meeting which was held by the National Distributors of Wines and Spirits Association and passed resolutions, listed above, that contravened the RTP Act section 7(1)(b)(ii) and 7(2).

Section 7(1)(b)(ii) of the Act states that:

*"The making directly or indirectly of a recommendation by a trade association to its members - which relates to terms of sale (including discount, credit, delivery, and product and services guarantee terms) of such members or any such class of members and which directly affect prices, profit margins included in the prices, or the pricing formula used in the calculation of prices"* is declared to be a restrictive trade practice.

Further, Subsection (2) states that:

*"A recommendation by a trade association as described in subsection (1) (b) shall be deemed to be a restrictive trade practice notwithstanding that any statement in the recommendation may or may not be*

*complied with as the members or class of members to whom the recommendations is made think fit"*

National Distributors of Wines and Spirits Association operated at national level and therefore its actions were bound to cause serious competition concerns. Their act of meeting and coming up with the said resolutions is in contravention of the quoted sections of the Act and was seen to be tantamount to cartel activities which is against the spirit of competition the Commission is mandated to enforce.

**Findings and Action taken**

The evidence presented was a copy of the minutes of the proceedings which revealed that the Law (RTP Act) was contravened - the said minutes had been signed by eight (8) members of the National Distributors of Wines and Spirits Association and with their respective rubber stamps bearing their names and addresses. The copy of the minutes of the alleged meeting was submitted to the Commission by the KAHC.

The Commissioner invoked Section 15(1) (a) of the RTP Act informing the distributors that allegations had been made against them and specific evidence presented to substantiate the allegations.

The distributors were asked to comment on the allegations and indicate what remedies they proposed to bring their trading practices into conformity with the Act within 14 days from the date of the Commissloner's letter.

All members of the association did not respond within the stipulated time except one distributor whose advocate inquired on the kind of evidence submitted and was appropriately responded to. The Commissioner found it imperative, therefore, to invoke section 15(3) of the same Act inviting the members to come, negotiate and sign a satisfactory consent agreement. This was to be done on 26th October, 1995. However the members failed to attend the said meeting to deliberate on a consent agreeement. The Commissioner then invoked section 16 which requires the holding of a hearing on the desirability and contents of a proposed recommendations of Ministerial order regulating the trade practices in question. This was to be done on 9th February, 1996.

However this meeting was attended by only two of the expected eight members of the association. Consequently the Commissioner, pursuant to section 17 of the Act, recommended that the following issues regarding the institution of a Ministerial order be formally gazetted:

(a) that the resolutions passed by the National Wines and Spirits Distributors (Coast Branch) during their meetings held on the 29th June, and 7th July, 1994 were in contravention of section 7(1) (b) (ii) of the Restrictive Trade Practices, Monopolies and Price Control Act in so far as trade agreements in restraint of trade are concerned and should therefore be rescinded immediately.

(b) that the distributors shall cease to make and enforce joint decision that infringe any section of the Restrictive Trade Practices, Monopolies and Price Control Act, unless there is valid commercial reason that should be notified through the Commissioner after such decisions are made.

(c) that the distributors shall publish a circular in the three (3) local daily newspapers indicating that the decision made during the said meetings shall not apply during the course of trade in Wines and Spirits within Kenya and a copy of such publication be sent to the minister of Finance.

**Conclusion**

The Minister concurred with the said recommendations and hence the gazettement of the order on 27th February, 1996 copies of which were sent to all members of the association.

The case file was closed since there has not been any more complaints alleging that the distributors did not comply with the Ministerial order.

# COMPETITION LAW IN LESOTHO

**PREPARED BY:**
**MS. LIKONELO LEBONE**
**MS. THATO MOLETSANE**

**MINISTRY OF INDUSTRY, TRADE AND MARKETING**
**LESOTHO**

Lesotho is a small country landlocked by the Republic of South Africa. In terms of size is only about 31000 $KM^2$ with a population of about two million. The country has no strategic minerals or commodities that are in demand worldwide, at least not in competitive quantities or quality. Since independence the Government embarked on a policy of direct Government participation in production and commercial activities. This gave rise to a number of partially and wholly owned state enterprises. Some of these enterprises were statutory bodies and the establishing Acts created a monopolistic situation. For instance, the Lesotho Telecommunications Cooperation was made the sole provider as well as the regulator of this sector, and so was the Lesotho Electricity Cooperation. These corporations also gave them powers to regulate themselves and their competitors in the industry and to grant operating licenses. In this scenario the participation of private firms was either banned or limited. This was the state of affairs till 1995 when the Government engaged in a privatization program and since then about twenty-five state enterprises have been privatized and therefore the markets have been opened for private sector participation where it was previously limited.

As of today, the industrial sector is composed of large-scale enterprises that are export oriented and small-scale enterprises that operate on an informal artisan scale. The narrow domestic industrial base means that the country relies on imports for primary or consumable goods while the narrow domestic market means reliance on export markets in order to achieve economic development.

Lesotho does not have comprehensive competition legislation although a couple of provisions in the Industrial Property Order 1989 address unfair competition activities. Section 34 of the said Order provides that any act of competition contrary to honest practices in industrial or commercial matters shall be unlawful, particularly:

(a) All acts which create confusion by any means with the establishment, the goods or the industrial or commercial activities of a competitor,

(b) False allegations to discredit the establishment, the goods or the industrial or commercial activities of a competitor, and

(c) Indications or allegations to mislead the public as to the nature, the manufacturing process, the characteristics, the suitability for their purpose or the quality of the goods.

However, what is to be regarded as dishonest in commercial or industrial matters is not defined, the courts would have to decide. This section remains unused till today.

Secondly, Section 36 (5) provides that any contract concerning a patent, a Utility model certificate, a registered mark, or an industrial design should be submitted to the Registrar on pain of invalidity. The Registrar is empowered to declare a clause null and void if such a clause renders the contract harmful to the economic interests of Lesotho by imposing unjustified restrictions on the licensee. Subsection 8 details clauses that the Registrar must always consider. Among these are clauses whose effect would be

(i) To oblige the licensee to acquire any materials from the licensor or from sources designated or approved by the license or restrict his freedom to acquire materials from any source unless it is otherwise impossible to ensure the quality of the products to be produced and provided that the said materials are supplied at a reasonable price.

(ii) To limit the quantity of the products produced and to fix prices for the sale or resale of the products produced by the licensee and to sell to certain specified persons.

This Section applies only to agreements relating to intellectual property rights to the exclusion of other agreements with the same effect. Again the section remains unused.

In Lesotho we do not question the need for a Competition policy and law; we believe that it gives guidance as to how firms should behave in the market place and as such represents a code of conduct in the economic arena. However we also note that competition law involves some complex aspects while the concept is rather new in Lesotho. The Government is desirous of developing a competition regime, a decision has been made to secure the services of a consultant in this regard, but we believe that a gradual and selective approach in developing a competition regime is favorable so as to give everybody time to accommodate and adjust to the changes that are required, given the lack of human and financial resources required to establish a competition regime for the first time. We believe that this will allow Lesotho to build a firm foundation for the competition regime by fully assimilating one aspect of competition rules before progressing to the next.

# Fact Situation Presentation by the Interim Secretariat of the Malawi Competition Commission

## I. Factual and Legal Context

The Competition and Fair Trading Act of 1998 brought the Competition and Fair Trading Commission into being and defines its functions, and confers the powers it uses to carry them out. The Commission exists both as an enforcer of the law and as a public educator. Together, these two groups of functions give the Commission a wide role in helping to steer the country's economic development.

## II. Procedural Aspects

### PANELS OF COMMISSIONERS

At the outset of an investigation, the Commission will establish a Panel of Commissioners (normally three in number) to take charge of it. The Panel Committee will supervise the staff members involved as the investigation proceeds.

### POWERS IN SUPPORT OF INVESTIGATIONS

The Act entitles the Commission to obtain such information as it considers necessary for the purposes of its investigations. It can : -

- summon and examine witnesses under oath (Section 10). Note also that third parties can be required to provide relevant information (Section 10.3) and may demand the right to be heard (Section10.2);
- call for and examine documents (Section 10),
- enter premises, demand information and records and seize documents (Section 46).

These powers to seek information are backed by criminal sanctions, including the possibility of a fine up to K10,000 or imprisonment(Section 46.3).

### HEARINGS

These represent the most formal part of an investigation, usually the culminating part. There may be one or more hearings. They maybe held in public (Section 11) unless special circumstances otherwise dictate. The Commissioners assigned to the investigation would preside at hearings, supported by Commission staff who have conducted the investigation.

### FINAL DECISIONS

At the end of an investigation the Panel of Commissioners will reach a decision in two parts:

- a finding as to the facts of the case (whether anti-competitive conduct has been proved, whether a merger is anti-competitive, as the case may be);
- a penalty for the full Commission to recommend to the High Court.

When the Panel finds that the Act has been contravened, it will then consider what penalty to recommend to the full Commission.

- In some cases it is sufficient to issue a public warning to the offender. Such warnings will be seen by the business community at large, and will help to build up case-law, making clear the kinds of conduct that the Commission regards as contravening the Act
- Commissioners may also demand undertakings from the offender, that it will cease and desist from the offending conduct, and refrain from any other conduct of similar effect

## A. CARTELS

### THE CARTEL PROVISIONS OF THE ACT

Sections 32-34 of the Act deal with cartels, or anti-competitive agreements. It is a broad prohibition of all agreements, decisions or concerted practices likely to result in the prevention, restriction or distortion of competition to an appreciable extent. This prohibition covers not only explicit agreements, but also any arrangement having the same effect, including decisions, for example by associations of enterprises and concerted practices, i.e. arrangements between enterprises, falling short of explicit agreements.

Section 34 makes clear that anti-competitive agreements include recommendations by Trade Associations; it also requires Trade Associations to accept members on a non-discriminatory basis.

### WHEN IS COMPETITION AFFECTED "TO AN APPRECIABLE EXTENT"?

Although the Act prohibits anti-competitive agreements in general terms, it applies only when competition is affected to an appreciable extent. The Commission will be issuing guidelines to make sure businesses know what extent this is. The guidelines make clear that anti-competitive agreements will be regarded as affecting competition to an appreciable extent if they have the object or effect of monopolising the market. This means in particular that agreements will be not be regarded as affecting competition to an appreciable extent if :

- they are minor agreements between small companies where the parties do not command an aggregate share of any market in excess of 30%; or
- they are vertical agreements (on which see below).

### HORIZONTAL AND VERTICAL AGREEMENTS

Horizontal agreements are agreements between competitors. Vertical agreements are agreements between customers and suppliers.

The Commission's guidelines make clear that they will apply the prohibition of anti-competitive horizontal agreements : -

- to horizontal agreements in general, subject to the exception of minor agreements;
- to vertical agreements only in special cases.

The special cases are these: the Commission will take action against a vertical agreement only if : -

- the enterprises involved include an enterprise in a dominant position. If so they will be dealt with under Section 41 (on which see below) which deals with abuses of dominant positions.
- they are agreements between retailers and their suppliers, which seek to fix the retailers' selling prices. This is Resale-Price Maintenance, and is explicitly banned in Section 32.2f of the Act.

### CARTELS FOUND IN PRACTICE

Two types of anti-competitive agreement are especially common : -

- Price-fixing cartels, where members agree to a common price higher than they could obtain in competition with each other;
- Market sharing cartels, where members divide up the market, or agree among themselves who should get a particular contract.

The Act gives considerable power to get at the facts. Section 9 entitles the Commission to obtain such information as it considers necessary for the purposes of its investigations. The Commission can: -

- without invoking its formal powers, seek information in writing from suspected cartel members. (Note that this should be sought from the Chief Executives in person. This is in order to make them personally liable if information is misleading or withheld.)
- remind those approached for information about the Commission's Amnesty Policy for the first party to disclose a cartel (see below);
- resorting to the Commission's formal powers, summon and examine witnesses under oath (Section 10), both from those involved and (Section10.3) from third parties;
- call for and examine documents (Section 10).

In addition, the Commission can, if necessary, enter premises, demand information and records and seize documents (Section 46). The Commission will after starting operations, announce a transitional amnesty policy to apply for a limited period of six months. During this period, no penalty is to attach to any illicit agreement in contravention of Sections 32-34 of the Act, provided that : –

- the contravention is notified to the Commission during the six-month period following the announcement of the amnesty; and
- the parties to the notified agreement then agree with the Commission an acceptable plan and timetable for phasing the illicit agreement out. All such plans for phasing out contraventions must be completed within at most 24 months following the announcement of the amnesty.

### CIVIL LIABILITY FOR ANTI-COMPETITIVE AGREEMENTS

Section 52 of the Act provides a right for anyone injured by an infringement of the Act to recover damages through civil proceedings in the High Court. There are similar provisions in other countries, notably in the Anti-Trust Laws of the US, and these are widely used.

## B. MERGERS

### THE MERGER PROVISIONS OF THE ACT

Anti-competitive mergers are covered in Sections 35-40 of the Act. If a merger is likely to result in a substantial lessening of competition it must (Section 35) be submitted to the Competition and Fair Trading Commission for authorisation.

If an anti-competitive merger is completed without the Commission's authorisation, the relevant contracts are unenforceable. (Section 36. Note however that this does not amount to a power to undo a merger once it has taken place.)

The Commission is required (Section 38) to decide whether the merger is beneficial on balance (offsetting economic balance). It counts against a merger if the Commission believes it will reduce competition; and it counts in its favour if the Commission considers it will improve efficiency, exports, employment, economic or technological development, or prices to the consumer. For this purpose the Commission has power (Section 37) to require information to be provided both by the parties to the merger and by third parties.

The Commission is given 45 days to decide whether to authorise a merger (Section 39), starting on the day when the parties give it the information it requires. The Commission's decision is contained in an Order, which can (Section 40) be given the status of a judgment of the High Court.

An Order can approve or reject the application, or approve it subject to conditions designed to reduce its adverse effects on competition.

### EVALUATING MERGERS

The Act's definition of the effect on competition (Section 2.5) is also of great importance to evaluation of mergers. This says the effect is to be determined by reference to all the factors that affect competition in the market, including competition from outside Malawi. When a merger is being assessed on whether it is likely to reduce competition in the domestic market (Section 31.1.a) ,not only is the concerned with competition from other suppliers in Malawi. Given the small size of Malawi's market, it is important to remember that a merger may have the effect of producing a high level of concentration of local production, but without materially lessening competition, provided imports of the product concerned are unimpeded and plentiful. Clearly therefore, the freedom of international trade in the product concerned is a key factor in the evaluation of a merger.

We have seen that the Act gives the Commission two main tasks in evaluating a merger :

- Assessing its impact on competition;
- If it finds an anti-competitive impact, weighing that impact against any offsetting economic advantages the merger may bring.

### ASSESSING THE IMPACT ON COMPETITION

The issues fall under four main headings : –

- First, the markets in which the parties to the merger are engaged have to be identified. It is where markets directly overlap - in a 'horizontal merger' - that there is the most obvious possibility of a lessening in competition. But competition issues may also arise where the merger involves markets that are 'vertically linked' (affecting different stages of the production or supply of the same goods or services).
- Second, analyses on the structure of the markets affected by the merger, and assessment of its likely effects on competition in those markets. The extent and impact of any barriers to entry would be important, including especially any barriers standing in the way of imports.
- Third, such factors as the buying power of customers may be relevant, and also the size and growth rates of the markets involved, if for example they affected the prospects for new entry.
- Fourth, need to reach a conclusion on whether the merger would lessen competition so as to allow the merged company to raise prices or reduce quality to the detriment of its customers.

### ALLOWING A MERGER ON CONDITIONS

The Commission may approve an application to authorise a merger subject to conditions (Section 39.2) designed to reduce its adverse effects on competition. Most typically, such conditions would be that some part of the merged business be divested.

### JOINT VENTURES

There is need to assess some joint ventures as mergers, namely those which have the effect of combining two or more existing enterprises.

Such joint ventures fall within the definition of a merger in the Act. This is couched in terms of the acquisition of a controlling interest, and a controlling interest is defined (Section 2) as an interest conferring any degree of control - it need not entail a shareholding in excess of 50%. On this basis, the parties to a joint venture will have a controlling interest, and the formation of such a joint venture will qualify as a merger. If it is anti-competitive it will require authorisation by the Commission.

## C. ABUSE OF DOMINANCE/ MONOPOLY ABUSE

### THE MONOPOLY PROVISIONS OF THE ACT

Monopolies are common in Malawi. They are sometimes called dominant positions. They are not against the law, unless they abuse their monopoly power. They can do this in two ways :

- Exclusionary abuses. These are devices to entrench their monopoly positions by preventing other companies entering the market and competing with them.
- Exploitative abuses. These use monopoly power to raise prices, by restricting output or sales.

The Act deals with exclusionary abuses in Section 41. It is an offence for anyone in a dominant position of market power to use that position to : -

- eliminate or damage a competitor,
- prevent the entry of a potential competitor,
- deter or prevent a competition.
- The offence attracts both penalties and civil damages.

The Act deals with exploitative abuse in Section 43.1a This Section prohibits the withholding of goods with the aim of raising prices.

With monopolies therefore, the Act therefore implies the determination of : -

- First, whether the company concerned is in a position to exercise monopoly power;
- Second, whether its conduct is such as to abuse that power.
- We shall look at these questions in turn.

### IDENTIFYING MARKET POWER: WHAT TO LOOK FOR

The Act defines a monopoly in Section 2. It is substantial control over the market, whether exercised by a single person or by two or more connected persons. Whether a company has substantial control over its market is a matter of economic analysis.

The first guide is the degree of concentration in the market. It is regarded as an indication of monopoly power if the market contains a single company with a market share above 40%. If it does, then monopoly power

looks more likely than not, unless other evidence points clearly in the other direction.

Here the question of market definition arises. All the points made there on market definition apply to the investigation of monopolies also. In particular, the more international the market is, the less likely is any company to have monopoly power in it.

However, although market shares provide a useful pointer to the existence of market power, there are other relevant factors as well. These include the following : -

**Entry barriers**. Potential newcomers may well be dissuaded from entering a market by the start-up costs or the marketing costs entailed. Where there are no such barriers, even a company with a high market share may not have real market power, because the ever-present threat of new firms entering the market may be an effective constraint.

**Import penetration**, and the potential for it to expand, may be another sufficient constraint on the real strength of a monopoly. The strength of the competitive discipline from imports depends upon formal barriers such as tariffs, and upon economic impediments to trade, such as transport costs, the difficulties of establishing distribution for the imported product, and sometimes domestic regulatory requirements.

**Buyer power**. Powerful customers can sometimes help to wring competitive terms from companies that would otherwise have market power. Large customers may threaten to underwrite the entry of a new supplier, or to replace an existing supplier with their own in-house operation. An assessment should be made on whether buyer power is sufficient to outweigh any likelihood that large suppliers can successfully exert market power.

**Supplier behaviour and performance**. Evidence of market power may be provided either by persistently excessive levels of profit, or by conspicuous inefficiency. Also by pricing structures involving internal cross-subsidy between one area and another, since such pricing policies would be unsustainable in competitive conditions.

**Market dynamics**. The dynamic factors that affect the way the market works, and the forces that alter competition through time should be taken into account. A market that is growing fast is generally more likely to sustain new entry and to see changes in the established ranking of suppliers than one where demand is static.

### ABUSIVE CONDUCT: EXPLOITATION

The Act is concerned with the exploitation of market power to force up prices (Section 43.1a). As an empirical matter however, the clearest sign of exploitation is often likely to be persistently excessive profits. However there are other kinds of evidence. These would include barriers to entry, anti-competitive practices, a mature market no longer expanding, and the performance of the company under examination in terms of efficiency, innovation and alertness to meet customers' needs.

### EXCLUSIONARY PRACTICES: ELIMINATING COMPETITION

We have seen that the Act distinguishes three forms of exclusionary practice (Section 41) : -

- practices which eliminate or damage a competitor;
- practices which prevent would-be competitors from entering the market; and
- practices which deter or prevent competitors from competing.



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## EXCLUSIONARY PRACTICES: PREVENTING ENTRY

Monopolies prevent entry most often by imposing vertical restrictions on their customers or suppliers. Vertical restrictions imposed on a company's distribution chain sometimes make it difficult for competitors to get access to distribution, or therefore to enter the market. Some typical examples of anti-competitive vertical restraints are : -

**Exclusive purchasing.** A distributor is required to agree to deal exclusively with a single supplier. If a monopoly supplier succeeds in persuading all distributors to sign such agreements, it can become impossible for any competitor to find outlets.

**Exclusive supply.** Suppliers are all required to agree to supply only one distributor. In this way entry by new retailers may be prevented, and monopoly power entrenched at the retail level.

**Long-term supply contracts.** Long-term contracts can have a similar effect, even if they do not contain an exclusivity term, if long-term contracts are the only terms available, and customers are faced with onerous termination provisions.

**Restrictive terms.** Such terms occur in agreements which restrict customers from dealing with the contracted supplier's competitors, or where loyalty rebates and discounts inhibit them from switching to another supplier.

**Tie-ins.** A tie-in exists when a supplier of one product or service (the tying item) insists that customers must buy all or part of their requirements of another product or service (the tied item) from the same source. Customers may find it convenient to buy several items from one supplier, but if they are required to do so, and if the supplier has market power in the tying item, the tie-in may restrict competition for the tied items.

**Restrictions on the supply of parts required by competitors.** Such restrictions exist where a vertically integrated company refuses to supply items needed by a competitor who is not vertically integrated, or agrees to supply them only at prohibitive prices.

All such restrictions may be entirely acceptable business practice in a competitive market, but are nevertheless unacceptable when used by a monopoly to entrench its position.

## EXCLUSIONARY PRACTICES: DETERRING OR PREVENTING COMPETITION

Monopolies can achieve this by refusal to supply, and especially through refusal of access to networks or similar essential facilities. In many markets, access to existing networks or physical facilities is an essential condition for a small company to compete with a big one, or for a new supplier to enter and compete.

This can be true in transport industries (bus stations, harbours, airport slots).

In other sectors, access to intangible networks can be just as essential, such as cheque clearing systems in retail banking.

In each case, if a company in a dominant position prevents competition, either by denying new entrants access to such a network, or by granting access only on discriminatory terms, that will be exclusionary conduct calling for you to investigate.

**SEMINAR ON COMPETITION LAW ENFORCEMENT CASE**
**PRETORIA, 18 – FEBRUARY 2002**

## A SHORT DESCRIPTION OF THE STATE OF COMPETITION IN MOZAMBIQUE

Despite that the Code of Industrial Property, approved by decree no. 18/99 of May 4th, makes reference in broad terms of unfair competition being one of the infringements, Mozambique does not have any experience in matters concerning to competition law and policy and does not have an agency or a division in the Government dealing with competition issues.

The fact of the matter is that we have been facing situations which would require a competition policy in place to regulate business practices in the economy in view of promoting competitiveness to ensure good products and /or services to the consumers.

With the advents of globalization and the country's participation in the world economy through the multilateral trading system, as well as the SADC Trade Protocol, the country will have to define its competition law and policy soon to regulate fair business practices and competition which should stimulate economic growth, competitiveness and defend consumers' interests.

To illustrate the need of a such competition law and policy, we would like to refer to the examples bellow:

Last year we saw the merging of two banks which now control more than 50% of the market and the information which came out was that the operation received the blessing of the Government and that the merging would not disrupt the basic rules of fair competition. We believe that this should have gone through a consultation process, at least with other interested parties in the financial sector in the absence of a competition law and policy.

The immediate results of this merging shows that the quality of services previously offered by individual bank has decreased considerably, which proves that the concentration of companies is not always beneficial to the consumers who are left with limited choice.

Also, with more than 50% of the market in their hands, it is felt that the merging can have an impact in the formulation of the future monetary policies due to their strong position.

Another example, is the intention of a milling company which pretends to acquire other mills. This can result in abuses of dominance and lessen competitiveness in the industry if the process is concluded successfully and there are no legal means to prevent such kind of business operations to go ahead, and consumers will have limited choice to final products, in terms of price and quality.

Other areas where competition law would play an important role in defending the consumers, are the telecommunication and electricity sectors where services are provided in a regime of exclusivity without any competitors. In these sectors, Regulatory Authorities are in charge with issuing licenses, price/tariff control, research and studies and the existing legislation regulates activities of the sectors rather than competition.

In our opinion, the Government should adopt legislation to encourage new operators in these two sectors as the only way to improve competitiveness and quality of services provided and fair prices.

The establishment of a good environment for new comers to the market and the trade liberalization should be accompanied by the formulation of a competition law and policy to avoid possible unfair business practices in the future.

As we said before, Mozambique does not have a competition law and policy yet, and we understand that competition as a legal issue is something new in many countries. However, the Ministry of Industry and Trade has been in contact with other institutions abroad in order to collect more information on this issue and initiate studies which will lead to the adoption and implementation of competition law and policy.

Apart from that, the Directorate for International Relations has been entrusted to organize a national workshop on **trade and competition and/or competition law and policy**, during August/September, or early.

At this seminar, we expect to learn from your experience and recommend to the Ministry of Industry and Trade the necessary steps towards the establishment of a competition law and policy.

Maputo, February 2002

## A SHORT DESCRIPTION OF THE STATE OF COMPETITION

## SEYCHELLES

### Facts on the Seychelles

Seychelles do not have in place a Law on Competition as such at the time being.

A question to be raised here therefore is - **HOW DO WE GOVERN TRADE IN SEYCHELLES**?

Trade in the Seychelles is so forth governed by the **TRADES TAX REGULATIONS**.

Trades Tax Regulations are a set of legislation to oversee trade. Due to the fact that over 90% of what is consumed in the country has to be imported, most economic players, i.e. traders, are simply **IMPORTERS** and/or **RETAILERS** and to those the Trades tax Regulations apply. Domestic companies are also regulated by the Trades Tax Regulations and this is complimented by the Licensing Regulations.

The Trades Tax regulations 1995, operate by having fixed rates on imported goods and regulations according to which trade is conducted, e.g.: Importers having to pay Trades Tax, Bills of Entry etc..

A Comptroller of Trades Tax, responsible for the levy, assessment and collection of tax, the landing entry, examination and taxation control of goods imported into Seychelles and a Commissioner of Taxes responsible for the levy, assessment, collection and recovery of Trades tax on services and locally manufactured goods are appointed.

As part of the Trades Tax Regulations, retailers are also subject to the **PRICE CONTROL ACT.**

The Price Control Act forms part of the Trades Tax Regulations.

However, we do realise that at present, this is not enough to protect consumers and to deal with abuse.

We therefore have also prepared the **CONSUMERS PROTECTION BILL** so as to protect consumers. This Bill will be presented to the Assembly shortly.

Given that we are momentarily negotiating the accession terms with the WTO and are also members of **SADC - The South African Development Community and COMESA - The Common Market for Eastern and Southern Africa**, we are therefore looking at the possibility of having Legislation to further regulate competition, i.e.: **COMPETITION LAW.**

### Commerce - The Major Players

The major Monopolies in the Seychelles are **SMB - Seychelles Marketing Board.** This is more or less the *'trading arm of the Government'* and has a Monopoly over the imported basic foodstuffs, i.e.: Meat, Rice, Fruit & Vegetables, Cooking Oil, Dairy Products, Tea & Coffee, Flour and Sugar.



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**PUC - Public Utilities Corporation** - the Supplier of water and electricity in the Seychelles and **SEPEC - Seychelles Petroleum Company,** the sole importer of petroleum products.

We have nevertheless started the program of deregulation in the Seychelles, especially in Telecommunications, the Service Sector, Tourism and the Hospitality Sector. Our privatisation program started in the mid -1990's and as a result we currently have only very few state-owned companies.

- 1 Insurance Company — SACOS — state owned
- Have shares in only one commercial bank - Nouvobanq Bank
- 2 Hotels (managed by an International Company - Le Méridien) which are momentarily being sold - The Fisherman's Cove and Barbarons
- And the above-mentioned SMB, PUC and SEPEC.

We have moved towards privatisation. Well over 95% of hotels in the country are owned by the private sector at the moment. The Tourism Industry and related industries are in private hands e.g.: Hotels, Diving centers, Car Hires etc..

Interestingly, the Port services have also been privatized, making it far more efficient and competitive.

In a nut-shell, even though we have a small economy we feel that an Institution to ensure "fair trading" is essential for business in Seychelles.

# Case Study: All Joy Foods and Tiger Brands

*Submitted by Ms Leona Mentz*
*Competition Commission South Africa*

## INTRODUCTION

The Abuse of Dominance section of the Enforcement & Exemptions division received the following complaint with regard to an allegation of excessive pricing. It is alleged that the Respondent is abusing its dominant position in the tomato paste market by charging excessive prices to the detriment of consumers. The Competition Act 89 of 1998 has the following provisions in this regard:

Section 8(a):
"Abuse of Dominance prohibited
It is prohibited for a dominant firm to –
Charge an excessive price to the detriment of consumers."

4.2 Section 1 defines "excessive price" as follows:
"excessive price means a price for a good or service which bears no reasonable relation to the economic value of that good or service; and is higher than the value referred to in subparagraph (a)"

### Complainant

The Complainant is All Joy Foods; a company with limited liability duly incorporated in accordance with the company laws of the Republic of South Africa. "All Joy" develops, procures, manufactures, markets and distributes a range of tomato sauces, mayonnaise, salad creams, speciality sauces and drinking chocolates as well as some other condiments and preserves.

### Respondent

The Respondent is Tiger Brands Limited; a company with limited liability duly incorporated in accordance with the company laws of the Republic of South Africa. Tiger Oats, a food and pharmaceutical group changed its name at the end of 2000 to Tiger Brands. "Tiger Brands" is a management company with operations primarily in a variety of food and health related businesses Tiger Brands Ltd is owned by CG Smith Foods Ltd, which in turn is owned by CG Smith Ltd.

## NATURE OF COMPLAINT

Tiger Brands has three culinary manufacturing units in South Africa, namely Messina, Lutzville and the Duiwelskloof manufacturing unit acquired from Nestle in April 2001[1]. Tiger Brands produces its own tomato sauce under the brand name "All Gold". Tomato paste is an input required in making tomato sauce. Tiger Brands is the only producer of tomato paste suitable for use in tomato sauce in South Africa that has the necessary septic container facilities that are required to sell paste to outside parties. There are, however, imported pastes available.

[1] This was a small merger.



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The Complainant, a manufacturer of tomato sauce, previously obtained its tomato paste from the Duiwelskloof facility, then owned by Nestle, and a competitor of Tiger Brands.

The Complainant alleges that the price charged by Nestle (prior to the acquisition by Tiger Brands) was R5-36/kg. The Complainant further alleges that after the acquisition, Tiger Brands sold its tomato paste at R6-35/kg. All Joy regards this price as excessive. Accordingly All Joy alleges that Tiger Brands is abusing its dominant position in the tomato paste market, by charging excessive prices for their tomato paste

## EVALUATION OF COMPLAINT

### Dominance

A stated above, Tiger Brands is the only producer of tomato paste suitable for use in tomato sauce in South Africa and holds approximately 76% of the total tomato paste market in South Africa, which includes the paste of lower quality that is used for fish canning. The balance of the market is held by Giants Canning CC, Ashton Canning and imports, although the exact shares held by them are uncertain. Giants Canning CC, a competitor of Tiger Brands, also produces tomato paste suitable for tomato sauce, but it does not have the required septic container facilities to enable sales to outside parties.

### Excessive Prices

According to Tiger Brands its price for tomato paste compares as follows with imported tomato paste:

**"TABLE A"**

| | |
|---|---|
| Tiger Brands | R 6-35 per kilogram |
| China | R5-36 - R 6-61 per kilogram |
| Turkey | R6-58 per kilogram |
| Italy | R6-85 per kilogram |
| Israel | R7-11 per kilogram |

Tiger Brands informed the Commission that their pricing strategy for tomato paste is linked to the international price of tomato paste of similar quality. Tiger Brands states that in order to be able to remain competitive the price objective is to better or at least match the imported price. They claim that this is becoming increasingly difficult to achieve against Chinese imported products, although they allege that the Chinese products are of lower quality.

Tiger Brands has provided us with a detailed breakdown of the different components and the final amount charged to customers:

**"TABLE B"**

| Component | Cost per kg-R |
|---|---|
| Fully absorbed factory costs | 4-14 |
| Admin expenses | 0-17 |
| Sales and distribution expenses | 0-79 |
| Line discount | 0-07 |
| Profit margin | 1-18 |
| Final amount charged to customers | 6-35 |

In terms of our internal informal guidelines on the evaluation of excessive pricing, there may be many objective justifications in competitive markets for prices, which seem "excessively high". These justifications may include, higher quality, reward for innovation and many others. Accordingly, allegations of high prices do not raise concerns of abuse except when they clearly are not performing the normal pro competitive functions of prices.

In Bellamy and Child's European Community Law of Competition, (5th ed), the Commissions position with respect to high prices was summarized as follows:

> " The existence of a dominant position is not itself against the rules of competition. Consumers can suffer from a dominant company exploiting this position, the most likely way being through prices higher than would be found if the market were subject to effective competition. However, the Commission in its decision-making practice does not normally control or condemn the high level of prices as such. Rather it examines the behavior of the dominant company designed to preserve its dominance, usually directly against competitors or new entrants who would normally bring about effective competition and the price level associated with it. A dominant company therefore has a special obligation not to do anything that would cause further deterioration to the already fragile structure of competition or to unfairly prevent the emergence or growth of new or existing competitors who might challenge this dominance and bring about the establishment of effective competition."

Tiger Brands claims that their tomato paste is of a very high standard, and is approved by the CSIR. The CSIR analyze 34-36 degrees tomato bricks taking into account the amount of foreign matter, the texture, the pH and acidity, color, consistency and the presence of hermophilic sporeformers.

Tiger Brands provided the Commission with its Executive Overview wherein the decision to acquire the Duiwelskloof facility is discussed. An important factor to bear in mind is that Nestle intended to exit the tomato paste market and close down the facility if they had been unable to find a buyer. From this document it appears that after an evaluation of the Duiwelskloof facility, it was found that the plant was

not capable of meeting the standard of paste set by the CSIR. Tiger Brands decided not to upgrade the plant that produces tomato paste. It decided to rather utilise the other two divisions at the facility, which is the tomato sauce preparation and bottling division, and the division for canned tomato products.

All Joy accordingly no longer obtains its tomato paste from the Duiwelskloof facility when ordering tomato paste from Tiger Brands but receives it from the Lutzville facility. This, we submit, may explain the difference in prices between the price previously charged by Nestle and the price charged by Tiger Brands.

We compared Tiger Brands' cost structures provided in paragraph 3.2.3 above, with that of Giants Canning. Although Giants Canning charges R6-13 /kg tomato paste to its customers, its product does not comply with any assessing agency standards and it also does not have the septic container facilities to enable it to sell the raw product to outside parties. Taking the cost of implementing a septic container facility that is estimated at approximately 6 million, the price charged by Tiger Brands can still not be said to be excessive.

Based on the information available to us, it does not appear that the price charged by Tiger Brands for tomato paste is excessive. The prices may be explained by the higher quality of Tiger Brands product and the cost of the required septic container distribution facilities.

**CONCLUSION**

Based on the information available to us, it does not appear that the price charged by Tiger Brands for tomato paste is excessive, or that the price charge does not serve a pro-competitive function. As explained above the price may be explained by the higher quality of Tiger Brands' product and the cost of the septic container facilities.

In light of the above we recommend that a notice of non-referral be issued.

# Case Study: Atkinson

*Submitted by Ms Nandisile Mpikashe*
*Competition Commission South Africa*

## 1. COMPLAINANT

The Complainant is Dr. P. M. Atkinson ("Complainant") and is representing Atkinson Pathology Laboratory.

The Complainant is practicing as a pathology practitioner at No. 17 Klip Road, Observatory, Rand View 2198, Johannesburg.

The Complainant together with other pathology practitioners used to be contracted with the Respondent to provide pathology services to members of the Respondent. The pathologists were paid directly by the Respondent for services provided to members of the Respondent.

## 2. RESPONDENT

The Respondent is Cape Medical Plan ("Respondent"), a self-administered medical aid scheme based in Cape Town.

It is a non-profit organization that provides for the health management of its members.

The Respondent has entered into a capitation agreement in respect of pathology. The manner this system operates is that the service provider is paid a fixed monthly fee per member irrespective of the service rendered by the provider.

## 3. BACKGROUND TO THE INDUSTRY

### 3.1 The relevant product market

The Complainant renders pathology services to his customers. It is with respect to pathology services that Cape Medical Plan deemed the Atkinson Pathology Laboratory to be non-qualifying practice.

Cape Medical Plan indicated that pathology services comprise 4% of the total medical claims processed by it.

It is submitted that the relevant product market is the market for the provision of pathology services.

### 3.2 The relevant geographic market

Atkinson Pathology Laboratories operates from Rand View in Johannesburg. Dr. Atkinson has indicated that his patient base consists of patients only in the Johannesburg area.

His patients do not consist of members of any one particular sector of the community eg. miners, or employees of a certain company. His patients consist of members of the community in general.

The operations of Cape Medical Plan are conducted from Cape Town. Its membership however, whilst concentrated in the Cape, is spread throughout South Africa.

Dr. Atkinson stated that he lost approximately R10 000,00 or 1% of business when Cape Medical Plan deemed Dr. Atkinson as a non-qualifying pathology practice.

In light of the fact that Cape Medical Plan operates nationally and the customers of Atkinson Pathology Laboratories can source the services of a medical aid nationally, it is submitted that the relevant geographic market is South Africa.

The relevant market is therefore defined as the market for pathology services in South Africa.

### 3.3 Regulatory aspects (if any) that have an effect on the conduct

The Council for Medical Schemes lays down the policy for the medical schemes in such a manner that it is complimentary with national health policy. With the introduction of the 'managed care' policy by the National Department of Health, medical aids have increasingly been concluding contracts with preferred service providers with a view to reducing costs for their members.

The abovementioned contracts, though concluded for the benefit of medical aid members, may have an adverse effect on competition and the competitors of the non-preferred service providers. The team is of the view therefore that the Council for Medical Schemes should be engaged in this respect to ensure that the manner in which preferred service providers are selected, is pro-competitive.

### 3.4 Other relevant aspects

None identified.

## 4. INTERNATIONAL PRECEDENT

Research into the manner in which preferred service providers are perceived internationally has produced the opinion the generally, the selection of preferred providers is beneficial for the members of the medical aids, in that it reduces costs and may be beneficial for competition, in that it encourages potential service providers to compete for the contracts of the medical aids. Several opinions issued by the Federal Trade Commission of the United States supports this viewpoint:

"the growing demand from both patients and payers for more information and more cost-effective care has led to a more competitive environment and, in turn, market responses such as health maintenance organizations and preferred provider organizations."

The Federal Trade Commission is of the view that preferred service provider selection may only be beneficial to consumers if it is based on exclusivity:

"A state legislative proposal aimed at giving New Hampshire consumers who subscribe to health maintenance organizations (HMOs) greater freedom to choose among pharmacies for filling their prescriptions actually may have the unintended effect of raising costs and restricting the number and types of prepaid health-care programs from which consumers may choose, staff of the Federal Trade Commission said. The bill, New Hampshire House Bill 470, would require any HMO in the state that solicits bids from pharmacies to become a preferred provider for the HMO's subscribers to contract with any pharmacy that "meet[s] the bid acceptable" to the HMO.

HMOs -- and similar programs that limit the number of doctors, pharmacies or other health care providers their subscribers can use -- have proliferated in some areas in response to increasing demand for ways to moderate the rising costs of traditional, fee-for-service health care. The HMOs find these arrangements attractive because doctors and pharmacies may offer lower prices and additional services in order to win a contract to provide care – sometimes under an exclusive arrangement -- to the HMO's subscribers. Doctors and pharmacies may find it profitable to offer lower rates to an HMO, because the HMO often can provide a substantial customer base for their services. In turn, the health care providers often can count on more predictable sales volume and reduced administrative and marketing costs. The benefits to consumers who subscribe to these prepaid health-care plans can include lower premiums, lower deductibles, and broader coverage, when competitive conditions among health care plans exist."

The opinion concluded that if a preferred provider is not able count on obtaining a substantial portion of a medical aids business, it may be unable to offer the medical aid lower prices or additional services.

The Federal Trade Commission is also of the view restrictions may be imposed on the way preferred providers operate for the benefit of consumers:

"consumer protection requirements that are included in legislation authorizing PPO's can themselves impose new restrictions on the way PPO's operate,"

In light of the provision of the Competition Act which states that it is the purpose of the Act to ensure that small and medium sized enterprises have an equitable opportunity to participate in the economy, the team is of the view that the Council for Medical Aid Schemes should be engaged in order to determine the manner in which preferred provider organisations should be selected and should operate.

## 5. THE ALLEGED CONDUCT

The Respondent operates as a medical aid scheme on behalf of its members. The Complainant was one of the pathologists who offered pathology services to members of the Respondent and received payments for the services provided directly from the Respondent.

On the 1st of December 1999 the Complainant received a letter from the Respondent informing him that as from the 1st of January 2000, his practice will be deemed to be non-qualifying pathology practice.

The Respondent informed the Complainant that it has appointed preferred pathology providers who will qualify for direct payment in terms of the rules of the Respondent.

According to the Complainant, the process of selecting the few chosen and preferred providers was not transparent and there were no tender proceedings followed.

The effect of being a non-qualifying pathology practice is that direct payments from the Respondent for the Complainant's practice will no longer be made and all payments for services rendered to the members of the Respondent and their dependants by the Complainant's practice will be for payment by the member.

In view of the above the Complainant is of the view that its practice is being excluded from rendering services to the members of the Respondent.

## 6. APPLICABLE SECTIONS OF THE ACT:

The effect of this restrictive agreement may be to substantially lessen competition within the market in that it excludes non-qualifying pathologists from rendering services to the members of the Cape Medical Plan in this market.

## 7. EVALUATION

The alleged conduct in this healthcare case revolves around the restrictive practice by certain medical aid schemes to contract with so-called preferred providers in respect of rendering of a health care service to their members. Consequently this preferential arrangement favours certain pathologists at the expense of non-qualifying service providers.

According to section 5 (1) of the Act, an agreement between parties in a vertical relationship is prohibited if it has the effect of substantially lessening competition in a market, unless the party to the agreement can prove that any technological, efficiency or other pro-competitive gain resulting from that agreement outweighs that effect.

Cape Medical Plan does not deny that it has entered into a preferred provider agreement with a pathology service provider.

However, it avers that it has approximately 0,5% of the South African Medical Scheme market and pathology comprises approximately 4% of the total medical claims processed by the Respondent. This means that the Respondent participate in a negligible share of the market for the provision of pathology services. Hence it cannot be construed as substantially lessening competition.

Moreover, the following should be taken into account:

A capitation agreement would not be beneficial if it was awarded to more than one service provider, as it would mean that many providers would receive the lump sum.

The agreement is entered into for a maximum period of twelve months, which means that other providers could also have a chance in participating in the agreement.

The other pathologists are not completely excluded from servicing the members of the Respondent as they are still allowed to consult any service pathologist, including the complainant, the difference being that they would have to pay cash and later claim from the Respondent. The conduct, therefore, does not completely eliminate competition between pathologists nor diminish the choice of the members of the Respondent.

The Complainant has indicated that the conduct of the Respondent has not substantially affected his business as the members of the Respondent only formed approximately 1% of his business.

It is acknowledged that the Respondent does not seem to have a definite open tender process that accommodates all service providers, however, there is no sufficient grounds to claim that the Respondent has breached a specific section of the Competition Act.

## 8. RECOMMENDATION:

In light of the above, it is recommended that the Commission should issue a notice of non-referral.

The Complainant has indicated that his main concern is that more Medical Aid Schemes will follow suite and engage in similar conducts as the Respondent. To address this, it is recommended that the Commission should exercise its advocacy role and engage the Medical Scheme council to address the issue of preferred service providers in a broader sense.

## Case Study : The Merger Between Daimlerchrysler (« DCSA » ) and Sandown Motor Holdings Limited (« SMH »)

*Competition Commission South Africa*

## COMPETITION CONCERNS

The issue that was of concern in this transaction was the entry by an automobile manufacturer/supplier into the retail business.

DCSA operates as a manufacturer and supplier of passenger cars, as well as light, medium and heavy commercial vehicles to the South African market. SMH carries on business principally as a dealer in both new and used vehicles. Note that SMH sells only DCSA products.

The parties thus have an existing business relationship with one another, i.e. DCSA supplies passenger cars, vehicles and other products to SMH. Accordingly, the transaction results in vertical integration of a manufacturer/supplier and a dealer. Consequently the business relationship between the parties and the issue of vertical integration was a key consideration in this analysis.

Also, against the background of the vertical integration that would result from the deal, retailers raised strong concerns regarding the following issues post the proposed deal: supply and distribution, pricing policy, including discounts, outlet representation (future awarding of dealerships), brand separation, financial assistance to the primary target firm.

The unique aspect of this transaction is that although there are numerous suppliers and retailers of passenger cars and commercial vehicles in South Africa, the primary acquiring firm has established certain brand names with a "prestigious" image. Also, many of the retailers in question exclusively stock DCSA products. These retailers have no other source of supply than the primary acquiring firm and this is a very important consideration in this analysis. Thus, this transaction is dissimilar to other transactions where participants in the downstream sector could source their products from alternate suppliers. These retailers have only one alternative and that is DCSA. This fact was a key issue in the assessment of this transaction and the potential anticompetitive effects and potential harm to the public interest that may result from this transaction.

It is against this background that the entire transaction was evaluated never loosing sight of the fact that this vertical integration has certain unique characteristics.

## FACTUAL AND LEGAL CONTEXT

The transaction constituted a merger in terms of section 12(1) of the Competition Act of 1998, as amended, (Competition Act No. 89 of 1998) ("the Act") in that it relates to the acquisition by a firm of part of the business of another firm, and is constituted through the purchase of shares as contemplated in section 12(1)(b)(i) of the Act.

The Commission was notified of the transaction by the merging parties in terms of Section 13A of the Competition Act. In terms Section 11(5)(c) of the Act the proposed transaction is a large merger.

The parties explained the need for the transaction as discussed below.

DCSA stated that the rationale for the transaction is that it wishes to enter the retail sector of the motor industry in South Africa. The transaction will give it a retail outlet from which it will render vehicle dealership services to existing customers. Other benefits envisaged by DCSA from the transaction are:

- Direct access to customers,
- A better understanding of customer needs, requirements, perception and expectation, and
- An improved distribution system of new vehicles and availability of parts. The parties state: "This proposed acquisition, along with its projects to improve distribution of new vehicles and availability of parts, are all indicative of the trend at DCSA towards a seamless chain of supply to the customer and progressive preparation for future e-commerce initiatives.

The parties submit that it is necessary for manufacturers/suppliers to have a presence in the national market in order for them to stay competitive.

In support of the application the merging parties alleged that the transaction would not place DCSA's other dealers at a disadvantaged position vis-à-vis motor vehicle orders by customers. They allege that DCSA will not be able to interfere with the current dealership structure.

**Distribution Policy**

The parties submit that DCSA operates on a central stock file known as the "New Distribution Policy" ("NDP").

NDP is a "pull system" which came into operation in the year 2000 to improve the new vehicle ordering process. In terms of the system, dealers no longer keep stock of models on their premises; they keep demonstration models on their show room floors, these models are owned by DCSA.

Purchase of vehicles allegedly occurs as follows:

A customer enters any dealership of his choice and orders a motor vehicle. This order is placed directly with DCSA, and becomes the next order on the list. Delivery takes place when that vehicle is available. The parties aver that if a customer cancels an order when the vehicle has already arrived at the dealership, that vehicle must be returned to the pool so that it can be delivered to the next person on the waiting list for that vehicle, wherever that person may be. If a dealership fails to adhere to these rules, it is fined and it runs the risk of having its franchise cancelled.

According to the parties, the NDP system operates as follows:

(i) At the point of sale, through electronic ordering, every customer's details and requirements are fed into a central computer system,

(ii) The system places the required vehicle into the distribution and delivery process,

(iii) Vehicle delivery is on a first-ordered-first received basis, and

(vI) Dealers enjoy equal access to DCSA's motor vehicle stock.

The benefits of the system, according to the parties, are:

- An ordered vehicle can be accurately tracked from point of purchase to delivery,
- The system does not discriminate between individual (single) dealerships and dealership groups or dealers in urban or rural areas,
- Customers enjoy the same service from any dealer in South Africa,
- The system eliminates multiple ordering of vehicles through different dealers by customers trying to speed up delivery,
- The system gives dealers the same access to DCSA's vehicle stock.

*Please note that the above alleged benefits were not efficiency arguments in that this system is already in place and thus not unique to the instant deal.*

**Cancellation of agreements**

The parties aver that if the other dealerships were to perceive that they were being unfairly treated, they would cancel their agreements with DCSA, which would result in fewer outlets for its product.

*The Commission is of the view that this argument does not hold water since this is unlikely to happen due to the brand strength of the DCSA products. The value of the business of the retailer is directly related to the fact that it has a supply agreement with DCSA. It would certainly not be in the interest of the retailer to cancel the supply agreement since this would overnight render his business virtually worthless.*

**Foreclosure**

The parties aver that there can be no question of foreclosure of the market, since DCSA would want to continue to market their product through as many outlets as are economically viable in order to ensure a widespread market presence.

Furthermore, the parties aver that if DCSA were to foreclose the market, it would lose the widespread service access in respect of its products, since non-dealers would not give service in respect of DCSA products. It would allegedly be impossible for the existing facilities of SMH to provide the service infrastructure offered by the various dealerships. The parties argue that the loss of the service infrastructure would have a negative impact on the sales of new vehicles, since customers would not want to buy a vehicle if there is no infrastructure to support the service in respect thereof.

**Case law**

The parties quote from the following case law:

In the *Green Paper on Vertical Restraints in EC Competition Policy*, in which the European Commission argued that: "The heated debate among economists concerning vertical restraints has calmed somewhat and a consensus is emerging. Vertical restraints are no longer regarded as *per se* suspicious or *per se* pro-competitive. Economists are less willing to make sweeping statements. Rather, they rely more on the analysis of the facts of the case in question. However, one element stands out: the importance of market structure in determining the impact of vertical restraints. The fiercer is inter-brand competition, the more likely are the pro-competitive and efficiency effects to outweigh any anti-competitive effects of vertical restraints. Anti-competitive effects are only likely where inter-brand competition is weak..."

The Commission states further: "... vertical agreements should be analysed in their market context. It is only when inter-brand competition is weak and market power exists that it becomes important to control vertical agreements. This should facilitate a relaxation of the form-based requirements ...".

The difficulty with vertical restraints or vertical integration from the competition perspective arises from the need to determine whether a particular vertical restraint or integration is anti-competitive or pro-competitive. There are numerous European Commission decisions that have stated that, *unless the object of an agreement has a clear anti-competitive intent*, the applicability of Competition Laws to a vertical restraint cannot be determined simply by taking into account its formal terms.

The parties submit that in Chrysler/ Distributors (Benelux and Germany) (Case No IV/ M.1036), a case concerned with vertical integration between a manufacturer and distributor in the motor industry, the European Commission held that the vertical integration did not create any increment to the parties' market share, but could affect the market vertically. However, since none of the parties had more than a 25% market share in the relevant markets, the Commission held that the transaction would, at most have a minimal effect on competition. The parties submit that consequently it was held that the transaction, though being a vertical integration, did not create or strengthen a dominant position as a result of which effective competition would be significantly impeded.

The parties also submit that in the matter of Suzuki Motor/Suzuki KG/Fafi (Case No IV/ M.1825), the European Commission once again held that the vertical integration between a manufacturer and a wholesaler did not result in a vertically affected market, given that none of the parties attained market shares of more than 25% or more in their respective markets.

**Other jurisdictions**

The parties informed the Commission that the Australian Competition Commission considers the following issues when analysing vertical mergers:

- Whether there are sunk costs and/or barriers to entry at any stage of the production or distribution which might make market foreclosure likely;
- Whether the vertically integrated firm will have control over access to an essential facility;
- Whether vertical integration is likely to facilitate price discrimination;

- Whether vertical integration is likely to facilitate price co-ordination;
- Whether it is likely to facilitate the evasion of regulation over monopoly pricing and access;
- How many independent sources of supply and distribution will remain at each stage subject to the vertical merger;
- Whether the target firm would have been a likely entrant into the primary market.

**Summary**

The parties submit that the proposed transaction would not have any influence on inter-brand competition, since SMH has only ever traded in DCSA products. They submit that intra-brand competition would also not be reduced either, since DCSA would continue to distribute products through all the various retail outlets.

## PROCEDURAL ASPECTS

Steps followed in the investigation/analysis of the merger:

- Determination of whether the transaction is a merger as per definition of the Act;
- Determined the size of the merger in terms of thresholds;
- Assessed the submission for completeness;
- Assessed the parties' market information;
- Defined the market and broken it into two separate markets;
- The Commission requested the parties to furnish it with further information with respect to the relevant market definition;
- Approached DCSA dealerships for their view on the proposed transaction;
- Approached other industry participants (associations);
- Approached DCSA competitors; and
- Considered the Tribunal's findings in previous cases; and
- Considered international jurisdiction.

## COMPETITION ANALYSIS

Despite the fact that the parties did not experience product overlap in that they play different roles in the motor vehicle industry, namely; DCSA is a manufacturer/supplier of vehicles whilst SMH is a dealership in motor vehicles and parts, the Commission concluded that, for purposes of analyzing the proposed transaction, it was necessary to analyze both the market for "dealerships", specifically in respect of DCSA products, and the market for motor car/vehicle manufacture and supply.

For the purpose of evaluating the transaction the following broad markets (not relevant markets from a competition perspective) were considered:

1. The market for the dealership in new DCSA vehicles,
2. The market for the dealership in used DCSA vehicles,

3. The manufacture/supply of passenger cars.

4. The manufacture/supply of commercial vehicles.

The Commission sub-divided the market for the manufacture/supply of passenger cars into the following segments (relevant markets):

- Entry-level cars;
- Small car segment;
- Medium/middle car segment;
- Large cars;
- Luxury car segment;
- Speciality cars;
- Utility vehicles;
- Minivans.

Note that the Commission defined each of the above segments of the passenger car market as separate relevant markets for the purposes of analysing this transaction. However, of the above markets the primary acquiring firm is predominantly active in the large/luxury car segment of the passenger car supply market.

Since mainly the luxury car segment of the passenger car market is applicable to this deal, and this is considered to be a separate relevant market, it is imperative to analyze the dealership market along the same lines, i.e. focus the analysis on the dealership in large/luxury passenger cars. This distinction of segments in the passenger car market is starkly evident from the prices of the vehicles, but is also reflected in the physical features of the vehicles in question. The parties themselves admitted that Mercedes-Benz is a very well established brand worldwide with a good image (see page 27 of the parties' competitiveness report.)

The market for commercial vehicles can also be sub-divided into the following segments (relevant markets):

- Light commercial vehicles (trucks);
- Medium commercial vehicles (trucks);
- Heavy commercial vehicles (trucks); and
- Buses and coaches over ten tons.

Note that the Commission defined each of the above three segments of the commercial vehicles market as separate relevant markets for the purposes of analysing this transaction.

Dealership in the three commercial vehicle categories should thus also be assessed as three distinct markets.

DCSA will post merger have control of SMH (a 75% share) and thus the ability to influence its decisions and day-to-day operation. This is clear from the proposed structure of the deal.

## CONCLUSION AND RECOMMENDATION

The Commission concluded that this proposed transaction would strengthen an existing vertical relationship between the primary acquiring firm and the primary target firm. This relationship does raise strong opposition and concerns in the market place, as is evident from various interviews conducted by the Commission and submissions that it received from participants. These concerns in particular relate to the possibility to discriminate against competitors of the target firm, many of whom are small and medium-sized firms (customers of the primary acquiring firm) and, many are owned by the previously disadvantaged community of South Africa, which gives this analysis an important public interest dimension to consider.

In the analysis of this transaction the Commission had to consider not only the extent to which any proposed deal would affect current competition, but also future competition, as well as the extent to which the proposal could facilitate anticompetitive behaviour post merger, i.e. restrictive practices.

The Commission wishes to submit that the analogy in the Brown case does not apply in the instant case. SMH is not an 'essential facility' for the distribution and sale of motor vehicles for DCSA's competitor manufacturers. SMH only distributes DCSA's vehicles. Other manufacturers have their own distribution outlets.

The Commission recommended that the transaction should be approved without conditions. The Commission's recommendation for unconditional approval is based on the following:

- Other than a new marketing strategy, there is no evidence that DCSA wants to eliminate non-SMH dealers after the merger.

  In any event DCSA does not need the merger to eliminate non-SMH dealers. It can through its franchise dealer agreements do same by simply giving the dealers the required six months dealer termination notice and / or not renew contracts on expiry of the one year dealer term.

  Indications are that DCSA needs a national infrastructure, which includes non-SMH dealers for effective distribution of its vehicles. If DCSA were to close down its non-SMH dealers, then the showroom ambiance associated with its products would surely start to dissipate, which is not in the interest of DCSA.

- The transaction will give DCSA more control over distribution of its own products. With respect to luxury cars, it has the opportunity to invest in showrooms and avoid the free-rider effects associated with non-exclusive distribution of branded products, where image and the pampering of the customer is an integral part of the product.

Finally, the business model represented in the transaction is now widely acceptable, not only in South Africa but also in other parts of the world. As indicated earlier on, both BMW and Ford have employed this model, from which they appear to be retreating. The use of the model by the aforesaid motor manufactures did not bring about adverse consequences for the independent dealers.

The Commission is of the view that the proposed deal should not be prohibited or conditionally approved based on the unsubstantiated allegations that the termination of current and future franchise dealer contracts are directly linked to the transaction. A prohibition or conditional approval of the proposed deal cannot be justified on the basis that current and future termination of contracts as per the terms and conditions of such contracts are / will be a direct result of the transaction.

# The Acquisition of Jumbo Cash & Carry, Browns Cash & Carry and Weirs Cash & Carry from Rebhold Limited and Tiger Foods by Massmart Holdings Limited

*Submited by Lizel Blignaut*
*Competition Commission South Africa*

## I. Summary

At the time of the merger investigation there were three big (publicly listed) companies and many independent players active in the broad wholesale market. The big names in wholesale were Makro (Massmart), Jumbo and Trade Center (Metro). The merger between Massmart and Jumbo would result in only two big players active on a national level. The main issue was whether the smaller independent wholesalers would pose an adequate competitive constraint on the two players.

## II. The factual and legal context

The primary acquiring firm is Massmart Holdings Ltd ("Massmart"), a holding company listed on the JSE Securities Exchange ("the JSE"). Massmart owns and controls several subsidiaries that are active in the retail and wholesale industries of grocery, general merchandise and liquor products. These subsidiaries are: CCW Holdings (Pty) Ltd, Masstores (Pty) Ltd ("Masstores"), a company that operates distribution and wholesale businesses under the name "Makro" in certain provinces of South Africa. Masstores also operates retail businesses through its mass discounters division trading as "Game" and "Dion"; and Shield Buying & Distribution (Pty) Ltd ("Shield"), a voluntary buying association procuring products on behalf of 241 independently (small & medium sized businesses) owned wholesalers and 254 independently owned retail businesses.

The primary target firm is Jumbo Cash & Carry (Pty) Ltd ("Jumbo"), a private company incorporated in the Republic of South Africa. Jumbo is 70% owned and controlled by Rebhold Limited and 30% owned (but not controlled) by Tiger Foods Ltd. Jumbo is currently trading as "Jumbo", "Browns" and "Weirs".

Jumbo Cash & Carry (Pty) Ltd is active in the wholesale cash & carry grocery business and in retail of general merchandise. Jumbo sells its products predominantly in large quantities to general dealers, *spaza shops*, tuck-shops and to convenient stores. Jumbo sometimes sells health and beauty products to small and independent wholesalers. Jumbo also sells its products to end-users who are registered as small businesses that receive buying cards to get access to buy their groceries from Jumbo. Jumbo also serves as a retailer as they sell other items such as non-grocery products as single items to individuals who are members of the public. Browns Cash & Carry (Pty) Ltd ("Browns") and Weirs Cash & Carry (Pty) Ltd ("Weirs") are separate private entities that are 70% owned and controlled by Rebhold and 30% owned Tiger.

## III. Procedural aspects

The parties notified the Competition Commission of the intended transaction as required by the Competition Act. The transaction made the thresholds of a large merger.

A notice was published in the government gazette and the relevant trade unions were informed.

The Commission, or receiving the notification, examined the following documents: the merger agreement, the report on the competitive conditions, both parties' annual reports; business plans, amongst others. After interviews with the parties, suppliers, competitors and customers were interviewed. Some concerns were raised during these interviews and by submissions made to the Commission. These were investigated. The Commission requested further information from the parties, mainly with regard to market shares in geographic markets other than initially supplied.

The Commission also held many telephonic interviews with competitors in the wholesale market in order to establish a profile of these players.

## IV. Competition analysis

### Market definition

In merger analysis market definition appropriately starts with a look at product overlaps between the acquiring and target firms. Massmart is, broadly speaking, involved in the following markets:

| Massmart subsidiaries | Main business |
|---|---|
| Makro | Warehouse outlets that trade in grocery items[2], liquor and general merchandise[3] on a wholesale and retail level. |
| Massdiscounters (Dion, Game) | Retail stores offering a wide range of general merchandise as well as a small range of grocery items to the value-seeking customer. |
| CCW | A peri-urban and rural chain of cash and carry warehouses distributing basic food and groceries to lower income customers. |
| Shield | A buying association assisting independent wholesalers and retailers to procure grocery items more efficiently for resale to lower income consumers. |

[2] Grocery items include food, cigarettes, health and beauty products, detergents and house care products.

[3] General merchandise include appliances, DIY products (tools, paint and hardware) outdoor equipment (camping, braai, pool and garden equipment), house wares (crockery, cutlery, kitchenware), hi tech products (televisions, audio and video equipment), office equipment, cellular telephones, sports equipment, clothing, toys and jewellery.

The targeted stores are, broadly speaking, involved in the following markets:

| Store | Main business |
|---|---|
| Jumbo | Wholesale: grocery items and general merchandise, with a strong focus on health and beauty products, to lower income customers. |
| Browns | Wholesale: grocery items and general merchandise to lower income customers |
| Weirs | Wholesale: grocery items and general merchandise to lower income customers |

From the above the following markets can be identified as a starting point for market definition: wholesale grocery items, wholesale general merchandise, wholesale liquor, retail general merchandise, retail liquor, retail groceries, and procurement and distribution of grocery items (as takes place through Massmart's Shield Buying and Distribution).

The parties are thus generally involved in the wholesale distribution and retail selling of grocery items, general merchandise and liquor.

***Understanding the area of participation: background to the supply chain***

A traditional textbook supply chain looks something like the following:

manufacturer ⇨ wholesaler ⇨ retailer ⇨ consumer

This is particularly true in instances where there are many manufacturers and retailers in an industry or sector and the transaction costs are deemed high enough to warrant a player that can make a profit from giving convenient one-stop supplies to retailers.

In South Africa the textbook supply chain for grocery items is only applicable insofar as the retailers fall outside the mainstream grocery retail outlets. (Mainstream meaning the national supermarket and convenience store chains.) Mainstream supermarkets and convenience stores are national chains or franchised and have their own distribution arms with warehouses and transportation that move products directly from manufacturers to the retail outlets.

Wholesalers are, however, still important in the supply chain to the informal and independent retailers. These retailers include cafes, spaza shops, tuck shops, hawkers, shebeens and taverns.

In South Africa, less than 50 percent of total merchandise sales pass through a traditional supply chain with a wholesaler and retailer, approximately 40 percent of sales bypass the wholesaler moving directly from the manufacturer to the retailer, approximately five percent of sales are from the wholesaler directly to the consumer and the rest is sold directly to the consumer by the manufacturer or importer.[4]

[4] United States Department of Agriculture, Foreign Agricultural Service. 1999. GAIN Report #SF9040. Republic of South Africa, Retail Food Sector Report.

**Finding the product overlaps**

***Shield***

In terms of product overlap it was found that Shield's wholesale members participate independently in the wholesale market, and Shield's business activities are therefore not relevant to the proposed transaction.

***Makro, Game, Dion, CCW, Jumbo, Browns, and Weirs***

From the table below (percentage sales by customer type), it is clear that Makro is mainly a wholesaler, but has a strong presence in the retail market too; Dion and Game stores operate only on the retail level; and CCW, Jumbo, Browns, and Weirs operate mainly on the wholesale level.

**Table 1: Percentage sales by customer type**

| | **Distributor/ commercial users (wholesale)** | **End-consumers/ general public (retail)** |
|---|---|---|
| Makro | 57 | 43 |
| CCW | 95 | 5 |
| Dion, Game | 0 | 100 |
| Shield | 30 | 0 |
| Jumbo | 95 | 5 |
| Browns | 95 | 5 |
| Weirs | 95 | 5 |

*Source: Competitiveness Report: Massmart*

The CCW, Jumbo, Browns and Weirs stores each have approximately 95 percent of their sales in the wholesale sector. The five percent sold to end-consumers should be seen as an indication of the fuzzy distinction between wholesale and retail in South Africa, rather than an indication of the above stores' activity in the retail sector.

Although sales are made to end-consumers the set-ups and layouts of the stores are focused on delivering a service on the wholesale level. Advertising is not aimed at the end-consumer. Their retail sales are incidental to the business and not part of their competitive strategy. Therefore the relevant product markets for these stores are for the purpose of this analysis limited to wholesale.

In terms of product category, Table 2 shows the percentage sales by product category for the wholesale and retail outlets of the parties.

**Table 2: Percentage sales by product category**

| | **Grocery items** | **General merchandise** | **Liquor** |
|---|---|---|---|
| Makro | 51 | 36 | 13 |
| CCW | 92 | 1 | 7 |
| Dion, Game | 9 | 91 | 0 |
| Jumbo | 78 | 22 | 0 |

| | | | |
|---|---|---|---|
| Browns | 86 | 9 | 5 |
| Weirs | 87 | 5 | 8 |
| Total | 47 | 7 | 46 |

*Source: Competitiveness Report: Massmart*

From Table 2 it is clear that only Makro has a significant (more than ten percent) presence in all three categories of products. For the most part CCW focuses on grocery items and has a small presence is the liquor market. Its sales of general merchandise can be disregarded. Dion and Game focus on general merchandise with a small presence in the grocery item market.

Jumbo focuses on grocery items, but its presence in the general merchandise market is significant. Browns and Weirs also focus on grocery items, but with more than ten percent presence in the other two categories combined.

Grocery items and general merchandise cover a wide variety of products. The parties contend and interviews with their customers confirm that the types of grocery items carried by Makro and Jumbo differ markedly. Makro offers a wider variety of products spanning a wider range of consumer income levels, but this is largely aimed at middle-income consumers. Jumbo focuses more on health and beauty products, and is also aimed at lower income groups.

The difference in sales by types of general merchandise Makro, CCW and Jumbo is illustrated by the following: Half of Makro's sales in general merchandise is made up of office supplies, DIY equipment, Hi-tech products and appliances. Game and Dion get half of their turnover from the sales of appliances, Hi-tech products and office supplies. Jumbo, on the other hand, sells more than half their products in the general merchandise category as house wares and clothing. It would thus seem that if the market was to be narrowed further, there would less overlap between the product lines carried by the relevant stores.

However, when dealing with stores that sell a wide range of products it is not necessary to define the market to each level of functionality, i.e. toasters for toasting bread and kettles for boiling water. The collective products can be grouped together to form a market for appliances or to include a much wider variety of goods[5], as in this instance, general merchandise.

The parties also raise the issue of income levels of target markets, contending that the Massmart stores broadly serve the middle class whilst the target firms serves the lower income end of the market. Customer and competitor interviews reveal that this market is very price sensitive and that there may be a difference in the types of products carried by the different stores, but that competition takes place mainly on price.

Breaking the product markets down into smaller categories would diminish the specific product overlaps between the parties. It would seem prudent to rather include the overlaps in the analysis in order to establish whether competitive concerns arise from the merger.

Table three shows the main activities wherein the parties are involved.

[5] By this argument the Competition Tribunal grouped together furniture, bedding, white goods (fridges, etc) and brown goods (TV's, etc) in one "furniture store" market in the JD/Ellerines merger analysis.

**Table 3: Main focus of activities of the parties**

| | Wholesale grocery | Wholesale general | Wholesale liquor | Retail grocery | Retail general | Retail liquor | Shield[6] |
|---|---|---|---|---|---|---|---|
| Makro | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | |
| CCW | ✓ | | ✓ | | | | |
| Dion, Game | | | | ✓ | ✓ | | |
| Shield | | | | | | | ✓ |
| Jumbo | ✓ | ✓ | | | | | |
| Browns | ✓ | ✓ | ✓ | | | | |
| Weirs | ✓ | ✓ | ✓ | | | | |
| **Overlaps** | ✓ | ✓ | ✓ | | | | |

From the above it is clear that the overlap is on the wholesale side in all three the identified categories, i.e. wholesale grocery, wholesale general merchandise and wholesale liquor.

These three areas could thus serve as starting points in establishing the boundaries of the relevant product markets. That is, the markets where the parties face competitive constraints.

***Wholesale grocery items***

When defining the relevant product market three sources of competitive constraints are usually taken into consideration, namely demand side substitution, supply side substitution and imports.

Factors taken into consideration when evaluating demand side substitution are product characteristics, functional interchangeability, intended end use, etc. In the case of wholesale grocery items the product is the service of wholesaling. Grocery wholesaling is the procurement, distribution and selling of grocery items in bulk to firms who intend to resell single items.

Another source of the procurement and distribution of grocery items is buying groups where retailers organize themselves to purchase as a group from manufacturers. Interviews with customers of wholesalers did not directly point to such a solution when faced with price increases.

However, during interviews the independent retailers indicated that price increases would lead them to switch to sourcing directly from manufacturers and to therefore bypass the wholesalers. Some of the smaller independent retailers may find it difficult and time consuming to negotiate with the manufacturers and the price increases by the independent wholesalers will impact hardest at this level.

There is also the argument that retailers could then purchase from the national/ chain store retailers as they sometimes do[7] when these retailers have prices that are more competitive than the wholesalers. This

[6] Procurement and distribution of grocery items.
[7] Retailers (like wholesalers) are very price sensitive and will purchase product from the cheapest source at any level in the supply chain. Large national supermarket chains sometimes negotiate better prices (due to their countervailing power) with manufacturers than wholesalers resulting in lower retail than wholesale prices. In this instance retailers will purchase from retailers to distribute to their own customers.

may be an option for isolated products or specials, but for the most such a purchasing strategy is not sustainable.

***Competitive constraints from retail (grocery items)***

Two types of supply chains are relevant in the distribution of grocery items in South Africa. Independent retailers use the traditional supply chain, i.e. manufacturer, wholesaler, retailer, consumer. The independent wholesalers for the most part do not negotiate on equal footing with the very large manufacturers of grocery items (this sector is concentrated to a degree). To afford themselves of some countervailing power, the independent wholesalers have formed buying groups and associations to negotiate with manufacturers.

The large retailers with national chains and franchised operations do not make use of the wholesalers, but negotiate directly with manufacturers. They have their own warehousing and transport facilities.

Should wholesale prices be inflated, the transfer of these high prices would lead to high retail prices. End consumers could then substitute for retail by the national supermarket chains[8]. This would lead to a decrease in the volumes of wholesalers and independent retailers. Downstream activities could thus pose a competitive constraint on wholesalers.

Alternatively, the increase in prices on the wholesale level could lead to entry into that market by the retail distributors who already have the infrastructure in place to facilitate entry, or independent retailers could approach manufacturers directly, bypassing wholesalers and shortening their supply chain.

***Supply side substitution***

In terms of supply-side substitution a major potential source can be recognised. The large retailers, particularly in grocery items, have their own distribution mechanisms. Should wholesalers increase their prices and abnormal profit be made, they would be in a position to easily enter the markets as they have the infrastructure and expertise within them to do so. The market has relatively low barriers, in particular for a player with the financial backing and distribution experience of a national supermarket chain.

***Market definition: wholesale grocery items***

The relevant product market in the instance of grocery items is limited to wholesale. Although retail does exude some competitive constraint on the market in terms of both demand and supply side substitutability, the options are not open to all the customers of the grocery item wholesalers. Also the effect of price increases will be felt hardest by the customers of the independent retailers in areas where these retail markets do not face the highest levels of competition, i.e. the remoter parts of the country where income levels are low, and customers do not necessarily have adequate transport to "shop around".

[8] It is debatable whether the national supermarket chains and the independent retailers operate within the same markets. The products may be the same, but independent retailers are usually situated closer to consumer residences and also have different trading hours. The convenience of shopping at there retailers comes with a cost in terms of higher prices than usually found with the national supermarket chains.

*Product market: general merchandise*

In practice wholesalers do not buy general merchandise in bulk for resale to retailers. Most retailers active in the general merchandise market source directly from the manufacturer or distributor, particularly for large items. These items usually have guarantees and warranties that the retailers administrate for the distributor.

The market for general merchandise wholesale faces significant competitive constraint from general merchandise on a retail level, from the supply side as noted above, and also from the consumer demand side. These can thus conveniently be grouped together as one relevant product market facing the same competitive constraints.

*Product market: liquor*

Makro is the only store that has a significant presence in the liquor market with 13 percent of its sales to that end. In Makro's business there is no clear distinction between the retail and wholesale liquor trade. Makro does give a standard discount on bulk (i.e. cases of wine and spirits), but this discount is relevant to its commercial and end user customers. For this reason that the party with the highest interest in the market faces that competitive constraints from both ends of the market and also that the liquor manufacturers to a large extent manage their own distribution, the wholesale and retail markets can thus conveniently be grouped together as one relevant product market facing the same competitive constraints.

**The Geographic Market**

The geographic market establishes the area over which an entity faces competitive constraints. In terms of geography, demand side substitutability usually pertain more to retailing and supply-side substitutability ultimately determine the geographic boundaries of wholesale and manufacturing markets.

In geographic market definition the hypothetical monopolist test is also used to determine the sources of competition. It is appropriate to start with a very narrow geographic area, such as a local market and to then consider whether customers will switch to suppliers in neighbouring areas in response to a small increase in price. If the potential substitution constrains price increases the area of potential substitution should be included in the relevant geographic market.

In this instance it would be appropriate to start with a rural local market where the acquiring and target firms are present. Customers of wholesalers indicated in interviews that they look at a relatively large geographic area for the best prices. As discussed above, these players are very price sensitive.

Most of the customers of wholesalers indicated that they currently source from an area within a radius of 170 – 200 km, but that they would be willing and are able to travel further should prices be more competitive in other areas.

The value of product in relation to the transport cost incurred to source it from removed markets is important in determining the relevant geographic market. The transport of products in bulk dilute the transport cost per unit and therefore may make it worthwhile to source from other geographic areas. Also, most customers of wholesalers and the wholesalers themselves have access to the necessary transport.

Although individual customers of wholesalers may only source from an area within a radius of 170 – 200 km, the catchment areas overlap leading to the relevant geographic market to include all markets in the chain of substitution. A chain of substitution could cover the whole national area, although chains often break down in the rural areas.

In terms of the relevant geographic market for this merger analysis it was deemed appropriate to use a rural, local market as a starting point. Particularly CCW, Browns and Weirs stores are present in rural areas that could easily be seen as separate from other geographic markets. Interviews with wholesalers and customers brought to light that, even with high transport costs and "bad" roads in South Africa, businesses are prepared to travel significant distances for competitive prices. The market is very price sensitive.

The geographic market can therefore be extended from local to regional. The large catchment areas (170 – 200 km radius) and the relatively short distances between centers, indicate that there are no breaks in the chain of substitution and the market could easily be extended to the national market.

Massmart's business model[9] promotes a strategic focus by the group on growth through focused chains and profit through, amongst others, co-coordinated retailing, indicating a national retail strategy (and thus a national market). However, the parties' differing levels of exposure in provincial markets may be an indication of differing competitive forces in these markets and that each one should be analysed separately. Also it seems prudent to rather err on the side of caution with a narrower geographic market.

Therefore the relevant geographic markets are the provinces where the parties have overlaps, i.e. Gauteng, Kwa-Zulu Natal, the Northern Province and the Eastern Cape.

[9] Source: Massmart Annual Report 2000

**Market structure**

**Market shares according to relevant markets based on turnover figures**

| Geographic | Product | Massmart: Pre-merger market shares (%)[10] | Target: Pre-merger market shares(%) | Massmart: Post-merger market shares (%) | Change in HHI |
|---|---|---|---|---|---|
| Gauteng | Grocery | 10.40 | 6.15 | 16.56 | 128.05 |
| | GM[11] | 8.00 | 8.65 | 16.65 | 138.40 |
| | Liquor | 5.39 | 0.00 | 5.39 | 0 |
| Kwa-Zulu Natal | Grocery | 9.49 | 3.35 | 12.84 | 63.62 |
| | GM | 7.76 | 0.34 | 8.11 | 5.31 |
| | Liquor | 6.31 | 0.58 | 6.88 | 7.28 |
| Eastern Cape | Grocery | 8.88 | 23.81 | 32.69 | 422.67 |
| | GM | 3.80 | 0.70 | 4.5 | 5.34 |
| | Liquor | 2.00 | 2.95 | 4.95 | 11.82 |
| Northern Province[12] | Grocery | 9.21 | 10.50 | 19.71 | 193.32 |
| | GM | 10.01 | 2.08 | 12.09 | 41.59 |
| | Liquor | 0.00 | 0.00 | 0.00 | 0.00 |
| Total SA | Grocery | 9.51 | 5.01 | 14.52 | 95.32 |
| | GM | 6.28 | 0.41 | 6.69 | 5.16 |
| | Liquor | 3.07 | 0.44 | 3.51 | 2.72 |

*Sources: Massmart Competitiveness Report, AC Nielsons and own calculations*

**Barriers to entry**

The barriers to entry into the relevant markets seem to be very low, which is founded on the following:

1. *Startup Costs and Finance*

The initial costs of setting up a wholesaling business are generally deemed to be low. Parties submitted that suppliers generally provide terms for store openings that exceed the stock turnover rate of the outlet thus preventing the requirement for initial working capital. The supply of appropriate premises for hire often exceeds demand and fittings and fixtures are readily financed. Furthermore, the products sold are readily available from the suppliers and immediately recognizable by customers, obviating the need for high investment in marketing and advertising.

2. *Sunk Costs*

Customers of wholesalers are very sensitive to price differences and there seem to be very little brand loyalty. Contrary to the situation in the JD/Ellerines case, new entrants would not have to establish a "name" for themselves to attract customers. Customers will go to the best prices.

[10] Source: AC Nielson, based on June 2000 ratios.
[11] General merchandise
[12] Data only available for Pietersburg.

**3.** *Expertise*

New entrants may find it difficult to acquire skilled personnel. Metro Cash and Carry state that expertise and good positioning of the business are important.

The proliferation of small to medium size independently owned distribution businesses/wholesales in the Republic of South Africa is strong evidence of low barriers. There are no regulatory or artificial barriers to entry. The entry into the relevant markets is therefore easy.

**V. The outcome**

The merger was found not likely to substantially prevent or lessen competition in all of the relevant markets. The parties will not have market power, as their combined market shares, post merger, are relatively low. The only area that raises an eyebrow is in the grocery market in the Eastern Cape. The parties are unlikely to have market power, as customers have countervailing power, and ability to discipline price. Furthermore barriers to entry are low.

No public interest issues arise from the merger and no jobs will be lost as a result of the merger. SACCAWU indicated that it has no objection to the merger.

It was recommended that the transaction be approved without conditions.

The Competition Tribunal subsequently also approved the merger without conditions.

*Prepared by Lizél Blignaut, Policy and Research Division*

# Case Study: Avery Dennison/Jackstadt Merger

*Submitted by Seema Nunkoo*
*Competition Commission South Africa*

## 1. Summary

The merged entity would have a very high market share in a concentrated market if the market is narrowly defined and may pose serious competition concerns. In a broader market, the parties do not have a significant share of the market. The problem is of defining the relevant market and assessing whether any serious competition concerns arise.

## 2. The Factual and Legal Context

The primary acquiring firm is Avery Dennison Holding GmbH, a company incorporated in Germany and the primary target firm is Jackstadt Vermogensverwaltungs GmbH (Jackstadt). Avery is to purchase all the shares in Jackstadt. The merger is an international transaction and hence Avery is buying off the Jackstadt business worldwide. The merging parties had notified the Commission of the merger in terms of Section 13A of the Act. In terms of Section 11(4)(c), the merger has been classified as intermediate and the relevant filing fees were paid.

## 3. Procedural Aspects

The commission conducted an analysis of the competitive report submitted by both parties to the transaction. The investigating team took this information into consideration, but conducted its own independent investigation. The investigation involved telephonic interviews with competitors, customers, and product manufactures. The facts obtained were then presented to the parties and their attorney's for comments and further clarification. Interviews with industry experts were also conducted.

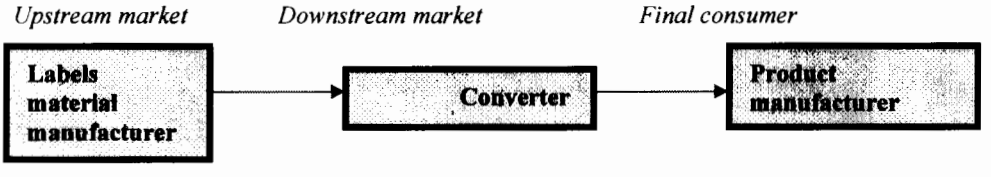
## 4. Competition Analysis: Mergers

### 1. Market definition (product and geographic dimensions)

### Label Market

Both parties manufacture and supply self-adhesive label materials called labelstock, to converters or printers for conversion into product labels. They operate in the upper stream of the market and are not involved in any other type of labeling technology.

INDUSTRY PROCESS DIAGRAM



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In the upstream market, the labeling materials manufacturers obtain paper, film, release liners, adhesives, silicones and other materials for the production of label material. The downstream market involves the further processing of the label material into finished products or labels. The converter purchases the label stock from manufacturers like Avery and Jackstadt, and prints or converts the material into a label according to the product manufacturer's specification. The product is then supplied to the product manufacturer in large rolls or sheets. The upstream and downstream market can be seen as a two-stage manufacturing process. Demand in the label market, is determined by the product manufacturers who are the final consumers.

**Broad Product Labeling Market**

There are various labeling technologies ranging from wet glue labeling to stretch sleeving, in-mould labeling and dry gum labeling. In deciding which technology to use, product manufacturers consider certain factors such as: speed of label application, purpose of the label, mass market vs. niche market, convenience, durability, aesthetic appeal, moisture resistance, product image, etc. Each labeling technology is different and has a different application technology.

**Demand Side Substitution**

The information submitted indicated the ease at which product manufacturers could switch between different labeling technologies. For example, Clover, a manufacturer of milk products, requires the label to be moisture resistant, recently switched from using self-adhesive labels to shrink-stretch sleeving for its milk products. This was one among many examples cited by product manufacturers of switching between label technologies. It showed that demand side substitution does exit.

During the commission's investigation it was initially found that demand side substitution is not strong in all cases, while it was recognised that it does exist. The reason being that, product manufacturers consider the abovementioned factors when deciding on a label technology. For example, a product manufacturer marketing a high-end market product would want a label that provides a specific image. It was found that all labels could provide these functions. The various labels come in different grades and hence an expensive self-adhesive label competes with an expensive wet glue or dry gum label.

Further it was found that certain types of labels were not suitable for certain products, such as wet glue labels that are not moisture friendly and hence not conducive to moisture surfaces. On closer examination it was found that while wet glue labels were not moisture friendly, they could still be used on refrigerated products. The ultimate choice depended on the product manufacturer and the market segment he was trying to target. For example certain ice cream containers have wet glue labels even though they are not moisture resistant. Demand side substitution could not be ruled out on this basis.

**Application of Labels**

It was initially thought that since each labeling technology is unique they would each require a unique application method onto a product. This would hamper the ease with which product manufacturers could switch between labeling technologies and hence limit demand side substitution. On further investigation, the commission found that switching to another label technology would require the product manufacturer to adapt the existing machinery. For example, product manufacturers would require minor changes such as software replacement, which could be operational within a period of two weeks. This did not pose much of a constraint or limit the ability of the product manufacturer to switch between technologies.

Some product manufacturers apply labels manually onto products. In this context the product manufacturer can switch between different types of labels with relative ease.

**Function**

It was found that the various labeling technologies serve generally the same function, that is, to inform customers about a product, provide aesthetic appeal, etc. All labeling technologies could provide the same function to the product. In terms of product image, again different types of labels have various grades to cater for all grades and images of products.

**Price Information**

It has been expressed that a self-adhesive label is more expensive than a wet glue label. However, it was found that within each type of label, there is a high grade and high priced label and a low grade and low priced label. This creates an overlap in terms of prices. The cheaper products compete with each other across the board while the more expensive labels compete with each other.

**Industry View**

This was somewhat mixed. Competitors to the parties indicated that they compete with a wider market, while customers indicated that they compete within the self-adhesive label market. The various labeling technologies are consistently trying to sell their label technology to a product manufacturer. Hence they are all competing to get the business of a product manufacturer. While the converters within the self-adhesive label market compete with each other to get contracts from product manufacturers.

**Supply Side Substitution**

Initially it was found that the equipment used to produce a certain type of label could not be used to produce other types of labels. However, certain machinery could be adapted to manufacture other types of labels, even though this was an expensive undertaking and is very limited. Supply side substitution appears to be limited, however, in our analysis it should be viewed as a secondary consideration in comparison to demand side substitution, which is very high in this case.

In light of the above, the relevant market is viewed as the product labeling market.

**Geographic Market**

The parties have distribution centers in Johannesburg, Cape Town and Durban. They distribute around the country. On this basis it was found that the relevant market is national.

## 2. Structure of the Market

**TABLE 1: ESTIMATE MARKET SHARES OF MANUFACTURERS OF SELF ADHESIVE MATERIALS**

| Company | Market Range | Estimate Market Share |
|---|---|---|
| ***Avery Dennison*** | ***30 – 35%*** | ***32.5 %*** |
| ***Jackstadt*** | ***25 – 30%*** | ***27.5 %*** |
| Raflatac | 15 – 20% | 17.5 % |
| Ozalid | 10 – 15% | 12.5 % |
| Labelcote | 5 - 10% | 7.5 % |
| Direct Imports | 5 – 10% | 7.5 % |

The combined market share, post merger, for the merged entity would be approximately 60%. These market shares are high and could raise serious competition concerns. The top three players in the market will account for 77.5% of the market, post-merger.

## Market Shares for a Product Labeling Market

| Labeling technology | Market share % | Estimated Turnover |
|---|---|---|
| Wet glue labeling | 24.2% | 420 |
| Dry gum | 4.5% | 74 |
| In-mould labeling | 12% | 200 |
| Shrink/stretch sleeving | 4% | 63 |
| Wrap around | 15.6% | 258 |
| Direct printing | 18.1% | 300 |
| Self-adhesive labeling | 21.7% | 360 |

The parties stated that a combined turnover of Avery SA and Jackstadt SA for the product labeling market is approximately R248 million. This represents an estimate market share of 14% for both parties in the product labeling market with Avery SA presently holding 8.6% and Jackstadt SA 5.4% respectively. As appears, the estimated market shares of the merging parties on the product labeling market are not high and do not raise appreciable competition concerns.

**3. Barriers to Entry**

There are no significant barriers to entry. The cost of machinery required to manufacture the labelstock may amount to R10 million. However, there are good quality second hand machines that can be purchased from secondary markets at a cost of R5million. There are also local manufacturers of machinery and raw materials from which inputs can be attained. The parties have indicated that most of their machinery was sourced locally and are second-hand. They are capable of producing the same quality and volumes as a brand new machine. Sunk costs are not significant as the machinery once, purchased can be resold in a secondary market at a cost of R5 million. Recovery costs through resale will amount to approximately 5 million.

Further, it is not required that a business have an expensive operation. A business can set up a low cost operation with low-cost, low skilled labour using low cost machinery and produce the same volumes as the larger businesses. It is a semi-skilled job and, no expertise is necessary. There is a very successful example of such an operation in the market.

Branding is not considered to be an important issue. A product manufacturer that determines the demand in a market does not adhere to a specific brand of label. They can switch to different types of labels and obtain the same quality and functions that it is required.

**4. Effect of the Merger**

It was decided that the merger would not have any significant effects on competition in the broad product label market or the self-adhesive label market. This conclusion was reached after further consideration of import competition and countervailing power. Because of the ease with which product manufacturers can switch between labeling technologies, countervailing power exists. If the parties had to raise prices post-merger, the product manufacturers would be in a position to switch to competing technologies. As long as there are a fair number of product manufacturers that switch between technologies, they can keep prices in check.

The market is characterised by high levels of imports with about 30% of direct imports going straight into the self-adhesive labeling market. If prices had to increase, converters could source products directly from importers. A fair number already do this and many have indicated that they would import directly. All importers import at a 19% tariff and any manufacturers wishing to import will have to pay the same tariffs. The tariff does not pose as a barrier.

**5. The Outcome**

In light of the above, it was decided that the merger would not pose any significant competition concerns and should be approved.

**Enforcement and Exemptions Final Report: XYZ Packaging vs ABC and Others**
**Case Number: 2001Jun5**

*INVESTIGATING TEAM:*
*Beverly Rikhotso*
*Wouter Meyer*

*06 November 2001*

# SUMMARY OF COMPLAINT

| | |
|---|---|
| **Case Number** | 2001Jun5 |
| **Complainant** | X |
| **First Respondent** | |
| **Second Respondent** | |
| **Third Respondent** | |
| **Fourth Respondent** | |
| **Fifth Respondent** | |
| **Sixth Respondent** | |
| **Seventh Respondent** | |
| **Eighth Respondent** | |
| **Product Grouping** | Plastic Packaging Material |
| **Section of the Act** | Alleged contravention of Section 8 (c) and (d) of the Act |
| **Date of notification to EXCO** | 11 June 2001 |
| **Notification to the Competition Tribunal** | No |
| **Is complaint the subject of an application for interim relief?** | No |

| | |
|---|---|
| **Notice in Gazette [Rule 17(1)]** | No |
| **Has the respondent been the subject to completed proceedings in the Tribunal under the same or another section of the Act relating to substantially the same conduct [Section 67(2)]?** | No |
| **Date of this submission to EXCO** | 13 November 2001 |
| **Recommendation(s)** | Issue a notice of non-referral |
| **Staff responsible for Report** | Beverly Rikhotso<br>Wouter Meyer |

## 1. THE PARTIES

### 1.1. The Complainant

The Complainant is XYZ (hereinafter referred to as the Complainant), a company involved in the business of supplying plastic packaging material, with its registered place of business in Sea Point, Cape Town.

### 1.2. The Respondents

The Respondents are ABC. Most of the Respondents are involved in the business of manufacturing and supplying of plastic packaging material in Cape Town.

## 2. NATURE OF COMPLAINT

The Complainant alleges that the Respondents entered into an agreement to refuse to deal with her company, in that they refuse to supply her company with some packaging material.

This apparent refusal to deal stems from the fact that the Complainant's husband was previously employed by a packaging company, CDE Packaging. There were apparently problems between the Complainant's husband and his company, and the former left. The Complainant then decided to open a company, which is a competitor of CDE Packaging.

## 3. EVALUATION

Staff contacted all the Respondents, and it transpired that the Complainant's husband owed some money to his former company. All had one thing to say, that is, they were skeptical to deal with the Complainant because they believed that the company (XYZ Packaging) was registered in the Complainant's name only in paper, but the actual person who was running it is her husband. Most pointed out that they had bad business dealings with the Complainant's husband whilst he was still a partner in CDE Packaging (which he apparently still owes some money).

However, all pointed out that they are prepared to deal with the Complainant on cash on delivery or pre-paid basis, provided that they have enough stock.

## 4. RECOMMENDATION

It is recommended that a notice of non-referral be issued in this case.

# Case study: A merger Between Iscor Limited & Saldanha Steel Limited

*Presenter: Maarten Van Hoven*
*Investigator, Competition Commission South Africa*

## 1. Summary

The major challenge faced by the Competition Commission in the analysis of the merger was on defining the relevant geographic market. Both parties are major exporters of steel; the price of steel locally is affected by the international price of steel, which is in US dollar. The parties' submission to the Commission was that it was competing in a global market, and that the parties market shares globally is insignificant compared to other primary steel manufacturers in the rest of the world.

## 2. The factual and legal context

Saldanha Steel (Pty) Limited ("Salhanha") is a company that was formed during 1995 through a joint initiative between Iscor Limited ("Iscor") the major steel producer in South Africa and the Industrial Development Corporation of South Africa Limited ("IDC"). Iscor and the IDC each held 50% shareholding in the newly formed steel producer.

Saldanha is situated on the west coast of the Republic of South Africa next to an international port. The object of creating Saldanha is to manufacture and sell steel products, which are sold in world markets, based on competitive advantages arising out of raw material quality, and a state of the art facility.

Notwithstanding the noble objectives no profits were forthcoming from Saldanha and it was costing its shareholders billions of Rands to operate.

The shareholders of Saldanha took a decision that as part of a restructuring process of Iscor whereby Iscor would focus solely on the manufacturing of steel products and divest its mining interests to Kumba Resources Limited, that Iscor would acquire sole control of Salhanha.

The transaction would cause Iscor to acquire IDC's 50% shareholding in Saldanha, which would result in Saldanha to become a wholly owned subsidiary of Iscor upon completion of the transaction. In return IDC would obtain an increased shareholding in Iscor.

In terms of the South African Competition Act the parties may not implement a merger if approval or conditional approval thereof has not been received from the Competition Authorities to a merger. The transaction between Iscor and Saldanha constitutes a merger as defined in the Act and exceed the large merger thresholds as set out in the latest determination of thresholds. The parties accordingly notified the transaction to the Competition Commission through its legal representatives.

The Competition Commission investigated the transaction and due to the fact that the transaction was classified as a large merger made only a recommendation to the Competition Tribunal of South Africa, which has the authority to make a rulings on large mergers.

## 3. Procedural aspects

On receipt of the parties' notification to the Competition Commission all the documentation received was analysed. These documents included answers to specific questions relating to the transaction and the products of the parties, and other documents such as the most recent annual reports and financial statements, business plans, the merger agreement and minutes of board meetings.

The Commission further contacted the major customers and competitors of the parties in order to obtain their views on the transaction and in particular on the structure of the market in which they are active. Of particular importance are there views on the product and geographic markets.

Another useful source of information was the South African Iron and Steel Institute, an orginisation created by the Iron and Steel manufactures of South Africa. The Department of Trade and Industry was also approached to furnish its views on the transaction.

Finally the Commission researched local precedents from the Competition Tribunal of merger transactions in the steel and related product industries.

All the above-mentioned entities contributed to the ultimate recommendation of the Commission to the Tribunal.

## 4. Competition Analysis

### 4.1. Relevant market definition

#### 4.1.1. Relevant product market

Iscor manufactures a magnitude of steel product, whereas Saldanha only manufactures two products namely Hot Rolled Coil and Ultra Thin Hot Rolled Coil. The Ultra Thin Hot Rolled Coil manufactured by Saldanha is a unique product, which is not manufactured by Iscor. Accordingly a product market overlap only occurs in the manufacturing of Hot Rolled Coil.

#### 4.1.2. Relevant Geographic market

Both Iscor and Saldanha export steel to countries in the Far East, Europe, South America and North America. Saldanha does not supply the local market as Iscor as a competitor and 50% shareholder of Saldanha refused to assist in creating a competitor to compete with it locally. Factors considered in determining the relevant geographic market are:

- Imports
- Import tariffs
- Transport costs
- Exchange rate

Imports

According to a survey done up to March 2001 the total amount of hot rolled coil steel consumed nationally, which is imported, amounts to 7%. Iscor supplies the bulk of the national demand for steel.

Import tariffs

The tariff on the importation of steel is set at 5%, which is relatively low compared to other developing countries. The higher the import tariffs the more likely the relevant geographic market is narrow.

Transport cost

Transport cost for steel is exceptionally high, due to the very nature of the product. This limits the financial viability to import the products at competitive rates. The more expensive the transport cost the more likely the relevant geographic market is narrow.

Exchange rate

The international price of steel is set in US Dollars, South African importers of steel needs to pay suppliers in US Dollars. In the event that the Rand depreciates the price of steel becomes naturally more expensive, and accordingly makes it to expensive to import steel.

Since March 2001 to December 2001 the South African Rand has depreciated approximately 60% against the US Dollar. This depreciation of the Rand has caused that the small amount of imports (7%) has decreased to even less. Accordingly the more the Rand depreciates against the Dollar the less importation of steel becomes viable.

Taken all of the above into consideration the Commission concluded that the relevant geographic market was more likely to be national than international, however would take into consideration the effects of imports.

### 4.1.3. Conclusion of the relevant market

The Commission accordingly concluded that the relevant market was the manufacturing of hot rolled coil in the national market.

## 4.2. Structure of the market

Only two steel manufacturers are active in the above-mentioned relevant product market, being:

- Iscor and
- Highveld Steel and Vanadium Corporation Limited ("Highveld")

Due to the fact that Saldanha is not active in the national market, no geographic market overlap occurs. This is quite a unique situation where a local manufacturer does not supply the local market. In view of

the fact that no geographic market overlap occurs no market share analysis is necessary, as the merger will not change the competitive sphere in the relevant market.

### 4.3. Effect of the merger

The merger will not substantially prevent or lessen competition due to the fact that Saldanha does not compete in the national market.

## 5. Outcome

The Commission accordingly made a recommendation on the 28th of January 2002 to the Competition Tribunal to approve the proposed transaction unconditionally.

The Competition Tribunal hearing has been set down to take place on Wednesday the 13th of February 2002. The final decision regarding this transaction would accordingly only be shared at the presentation of this paper.

*Date: 6 February 2002*

# Merger: ADT Security Services (Pty) Ltd/ Sentry Group Limited (Case No: 2001May4)

*Prepared By: Charles Mabuza*
*Division: Policy And Research*
*Competition Commission South Africa*

**I. Main competition problems**

- Product overlaps between the products of the parties
- Issues of high market shares (Target firm)
- Levels of concentrations
- Complaints from small installation companies

**II. The merger** occurred within the security industry and it involved two security companies, which are Sentry (Acquiring Firm) and ADT (Target Firm). According to the Competition Act of 1998, section 12 (1) (a), a merger occurs when one or more firms directly or indirectly acquire or establish direct or indirect control over the whole or part of the business of another firm. Therefore, the transactions constitute a merger since it meets the requirements of Section 12 (1) (a).

**III. The various information/documents** submitted by the different parties were considered. The investigation included the following:

- Talking to competitors
- Calling customers
- Labour movements-verify employment issues
- Some Internet searches were also done regarding the industry
- Meeting with various parties of the transaction.

**IV. The commission came to a conclusion that the merger raises no competition concerns.** Though the target firm's market shares were considered high, there was no cause for concern since the acquiring firm was a newly formed company, which started operating recently. Its market share on the overlapping product was below 2%. Therefore, the transaction was not going to substantially lessen competition in the market. The analysis is fully discussed in the relevant topics below:

## Market Definition

***Primary acquiring firm***

***ADT Security***

ADT Security only commenced trading on 1 March 2001. Their main business focus is on installation of security equipment and monitoring and response services.

*Tyco Group*

| Subsidiaries | Activities |
|---|---|
| Belglcast SA (Pty) Ltd | Maintenance and control of water flow equipment |
| Transcast (Pty) Ltd | Designs engineer and maintains undersea cables |
| Tyco Healthcare | Supply healthcare products |
| Kendall Company of SA (Pty) Ltd | Dormant |
| Intersalve (Pty) Ltd | Supply valves and water control equipment |
| AMP Products (Pty) Ltd | Supply electronics for telecommunication services |
| Raychem SA (Pty) Ltd | Supply electronics for undersea cable systems |
| A&E Products (SA) (Pty) Ltd | Manufactures and supplies garments hangers |

These business activities are not related to the installation of security equipment and monitoring and armed response services.

***Primary target firm***

***Sentry Group***

Sentry Group through its subsidiaries provides installation of security equipment, guarding, and monitoring and armed response services.

**Product overlap**

There is product overlap between the merging firms in respect of installation of security equipment and monitoring and armed response services. The relevant product market is, therefore, the market for the provision of installation of security equipment and monitoring and armed response services.

- ***Installation of security equipment***

This comprises the installation and servicing of intruder detection and access control equipment such as alarms systems, CCTV systems and access control systems.

- ***Monitoring and armed response services***

Monitoring and armed response services comprise the monitoring of intruder alarm signals received by radio transmitter into a central control room and physical response by vehicle, by trained security personnel to such intruder alarm activations.

**Geographic Market**

***Installation of security equipment***

ADT Security renders installation of security equipment in the Greater Cape town only and the sentry Group renders the same services throughout South Africa. The geographic overlap is therefore in Greater Cape Town. The geographic market for installation of security equipment services is local, since customers look in their local areas when they need installation of security equipment services.

- ***Monitoring and armed response services***

ADT Security renders monitoring and armed response services in the Greater Cape Town only and the Sentry Group renders the same services throughout South Africa. The geographic overlap is therefore in the Greater Cape Town. The geographic market for monitoring and armed response services is local, because a service provider should be based within a reasonable proximity to the customers' premises to be able to respond immediately when an alarm signal is activated.

**Structure of the market, e.g., market shares**

The parties provided us with the estimated market shares for the installation of security equipment services market, and for monitoring and armed response services market in the Greater Cape Town as shown below:

***(i) Installation***

| *Company* | *Market shares* |
|---|---|
| Chubb/BBR | 25% |
| ***Sentry Group*** | ***20%*** |
| CSM | 3% |
| Secureco | 2% |
| Secrupo | 2% |
| ***ADT Security*** | ***<1%*** |
| Others | 47% |
| **Total** | **100%** |

The parties' combined estimate market shares will be 21% post merger for installation of security equipment services in the Greater Cape Town. These combined estimate market shares are slightly higher than the Commission's benchmark of 15% and are unlikely to raise competition concern for the reason stated in paragraph 5 below.

The parties state that there are approximately 45 smaller installation companies which share the balance of the market shares for installation of security equipment services market.

The acquisition by ADT Security of Sentry Group's business activities will not change the existing competition in this market, as the delta change in HHI is approximately less than 50 points. The combined estimate market shares of the merger entity are unlikely to raise competition concerns in the installation of security equipment services market in the Greater Cape Town.

**(ii) Monitoring and armed response services**

| *Company* | *Market shares* |
|---|---|
| ***Sentry Group*** | ***40%*** |
| Chubb/BBR | 28% |
| ***ADT Security*** | ***4%*** |
| Secureco | 3% |

| | |
|---|---|
| Secrupo | 3% |
| CSM | 3% |
| Others | 19% |
| **Total** | **100%** |

The parties' combined estimate market shares post merger will be 44% in the market for monitoring and armed response services in the Greater Cape Town. This estimate combined market shares are high. However, this combined estimate market shares are unlikely to raise competition concerns for the reasons stated in paragraph 5 below.

The level of concentration is high in this geographic market. However, these high concentration levels are not as a result of the merger, since the acquiring firm, ADT Security have 4% estimate market shares. Furthermore, it should be noted that there is a number of small monitoring and armed response companies, which their respective market shares have been added collectively to form an estimate market share of 19%, due to the lack of individual firm's market shares.

## Barriers to entry

**(i) Monitoring and response services.**

Barriers to entry into the monitoring and response market are low. There are no government regulations that prevent entry or make it difficult to enter the monitoring and response market. The only government regulation is that, no person shall render security services unless they are registered with the Security Officers Interim Board ("the SOIB").

From our investigations, we discovered that one could buy a franchise business of monitoring and response for a capital investment of R 85 000,00. We discovered this information from Franchise South Africa website[13].

Furthermore, as mentioned above, there are approximately five thousands (5000) security firms registered with the SOIB of which, 1010 companies provide monitoring and response services.

In the light of the above, barriers to entry into the monitoring and response market are low.

**(ii) Installation services.**

Like in the Monitoring and response market, barriers to entry into the installation are low. There are no government regulations that prevent entry or make it difficult to enter the monitoring and response market. The only government regulation is that, no person shall render security services unless they are registered with the SOIB.

This is evident by the fact that there are many installation companies in the market and some of them do not necessarily offered complementary security services such as monitoring and armed response services. They specialize with installation services only. Accordingly, barriers to entry in the installation market are low.

[13] Http://www.bizforsale.co.za

**Recommendation and conclusion.**

The proposed transaction is not like to substantially prevent or lessen competition in the markets for the provision of installation of security equipment and monitoring and armed response services and therefore should be approved without conditions for the following reasons:

a) There are big and reputable security companies in the Greater Cape Town region which have the ability to expand and as a result, are likely to discipline prices;

b) There are also approximately 5000 security firms registered with the SOIB, which are competing with the merging firms;

c) Furthermore, barriers to entry into the relevant product markets are low; and,

d) The merger does not raise significant public interest concerns.

# Commission's Recommendation and Reasons in the "Large" Merger Between: Shell South Africa (Proprietary) Limited, BP Southern Africa (Proprietary) Limited, and Caltex Oil (SA) (Proprietary) Limited *and* Trident Logistics (Proprietary) Limited

**Case No: 2000 Aug 10**

*Competition Commission South Africa*

## EXECUTIVE SUMMARY

*(Note: The full Commission Recommendation and Reasons were submitted to this seminar, but were too voluminous to reproduce here. Hence, the Executive Summary and an excerpt from a South African contribution to an OECD Global Forum in October 2001 are reproduced here.)*

The proposed transaction involves the consolidation of certain services of three major oil companies in South Africa: Shell, Caltex, and BP. Via a joint venture, the parties will form Trident, a company designed to manage, contract, and provide logistical services on their behalf. Trident will provide these services with respect to supply and distribution services that include those associated with refining, storage, pipeline, rail, ship, and road transportation.

The principal focus of the Commission's investigation has been on the extent to which the joint venture will harm competition at the wholesale and retail levels in both the current, regulated environment and in the future, deregulated environment. The Commission also focused on the harm to public interest in assessing the transaction. The harm to competition in the current environment consists of the ability of the parties to raise prices at the depot level and the increased likelihood of collusion. Nevertheless, the expectation is that the harm to competition after deregulation will be even more significant. The public interest concerns are intertwined with the competitive concerns. The transaction's restriction on the ability of smaller, black empowerment companies to compete in the oil industry is specifically addressed in the Commission's report.

Currently, the government regulates wholesale and retail prices for petroleum products throughout South Africa. Nevertheless, the parties' proposed joint venture would have an impact on competition because of the ability of the refiners to raise prices and restrict supply at the depot (storage) level. These storage services are necessary for refiners to move their product from the refineries to the end customer at the retail station. The parties provide in-house and third party storage services. Smaller industry participants, i.e. the black empowerment companies, do not have the necessary funds to acquire and maintain their own network of storage facilities. They rely on the storage services provided by the parties. Without access to storage facilities, independent, smaller black empowerment companies will not be able to supply their stations with fuel and, therefore, will not be able to build market share. In the Commission's opinion the parties have the incentive to prevent the smaller, independent refineries from expanding their market share by restricting their ability to supply their fledgling stations.

If the parties consolidate management, logistics, and contracting powers of all of their depots, effectively, the majority of the storage facilities throughout South Africa will end up under the control of a single entity. In the Commission's view allow the parties to hinder competition.

The proposed transaction also affects future competition within the oil industry in South Africa. The government intends to deregulate the industry. Deregulation presents the opportunity for increased competition in the oil industry by existing, local refiners and new entrants. However, the ability of existing refiners to expand their market share and new entrants to begin serving the market depends on the availability of storage facilities. It is financially impossible to move product directly from the refineries to all of the end users without running it through depots along the route. The proposed transaction will allow the parties to control most of the available storage facilities throughout South Africa and thereby prevent or significantly lessen competition through either increased prices for depot services or outright restricted access.

In addition, the proposed transaction raises concerns about the potential for collusion between the parties. For example, the parties will have an incentive to collude at the production level. Trident will be managing the logistics of the parties' refineries. It will have access to information regarding the three parties' planned and unplanned outages and production and supply levels. In a deregulated industry, the ability to manipulate supply affects both wholesale and retail prices. If the parties have information about each other's supply levels, they could make output-pricing decisions based on their knowledge of existing supply in the market. The parties could collectively restrict or increase supply to affect prices and hinder any attempt by independents to compete. Accordingly, the increased possibility for collusion that arises from the proposed transaction makes competition by the remaining few competitors difficult.

Despite the parties' efficiency claims regarding the joint venture, the Commission finds that the proposed transaction presents current and future anticompetitive concerns, as well as public interest concerns. For the reasons discussed below, the Commission recommends that the Tribunal prohibit the proposed joint venture.

**Excerpt from Contribution of South Africa to OECD Global Forum on Competition, October 2001, CCNM/GF/COMP/WD(2001)11**

On 15 December 2000, the Commission submitted its recommendation to the Tribunal to prohibit the proposed supply and distribution joint venture between Shell SA (Proprietary) Limited (Shell), BP Southern Africa (Proprietary) Limited (BP), Caltex Oil (SA) (Proprietary) Limited (Caltex) and Trident Logistics Proprietary) Limited (Trident). On 22 January 2001 the parties withdrew their application from the Tribunal. In light of this withdrawal, the Competition Commission's recommendation to prohibit the proposed joint venture remains in force.

The proposed transaction involved the consolidation of certain services and assets of three major oil companies in South Africa, i.e. Shell, Caltex, and BP. Through the joint venture, the three parties would form Trident, to manage, contract, and provide logistical services on their behalf. Trident would provide these services with respect to supply and distribution, including services associated with refining, storage, and handling at depots, pipeline, rail, ship, and road transportation.

The proposed merger would substantially have lessened competition between the parties. More specifically, the Commission believed that it would have had the effect of substantially lessening competition in the markets for product exchange and hospitality services.

Refiners enter into agreements with other refiners, called product exchange agreements, as an alternative to producing the product themselves. Through the agreements, the refiners may exchange product or pay cash for product. However, the majority of transactions, both by volume and value, are

settled in product rather than in cash. These agreements allow them to receive product in areas where they may have shortfalls and give product in areas where they have surpluses. This helps cut down on uneconomical and unnecessary transportation throughout the country.

The owners of the crude refiners have longstanding product exchange agreements with each other, essentially *to reduce the cost of product transportation*. These exchange agreements are between the four crude oil refineries in Durban (Shell/ BP and Engen), Cape Town (Caltex) and Sasolburg (Sasol/Total).

For example, there is a Durban/Cape Town product exchange agreement between Caltex, Shell, BP and Engen. In terms of that agreement, the parties communicate their requirements for products in the Cape Town and Durban product markets. As far as possible, Caltex supplies the Cape Town market requirements of Shell, BP and Engen. These parties deliver equivalent products to Caltex in Durban to meet Caltex's requirements for the Durban area and the hinterland. The effect is that each party saves the transportation cost of delivering the product volume in question between Durban and Cape Town. That saving is shared equally between the two parties having exchanged products.

Like product exchange agreements, hospitality agreements are mainly entered into for efficiency reasons. The main savings resulting from hospitality agreements are:

A reduction in depot numbers, and

The transport cost savings.

These services are thus offered both for convenience and to save costs. To minimise distribution costs, the major marketers of petroleum products have entered into hospitality agreements on a case-by-case basis at various depots. These arrangements are common worldwide and have been in place for decades. Hospitality arrangements are willingly entered into between oil companies.

Invariably hospitality agreements are recorded in writing. Generally these agreements have six months or greater notice of termination periods.

The essence of a hospitality agreement is that a depot operator (e.g. Shell – the operator) agrees to provide another oil company (e.g. BP – the guest) with product at a Shell depot (e.g. Ladysmith). The purpose of these negotiated agreements is to save the cost of duplicating facilities in the same vicinity. Both host and guest benefit from economies of scale.

Insofar as hospitality involves a product exchange (i.e. it is not settled in cash) this is referred to as a *"borrow/loan" arrangement*. In the above example Shell is deemed to have loaned Shell product to BP and BP is deemed to have borrowed that Shell product from Shell. The borrow/loan balances are settled either by the guest placing product into the depot in advance or by repaying in product, either at the depot or at the coast.

In addition to settling the loan with product the guest would pay the host:

1. The primary transport cost of delivery from coastal refinery to the depot (normally the zone differential), if applicable; and

2. An agreed rate for storage and handling; and

3. An agreed rate for delivery to customer, if applicable.

4. The requirements for participation in hospitality and product exchange arrangements are:

5. Storage facilities;

6. Transport facilities; and

7. A supply of product.

The joint venture, in the Commission's view, would also essentially reduce the incentives for vigorous future competition, once momentum was given to the deregulation of the industry. Furthermore, no efficiency, technology or other pro-competitive gains would result from the joint venture that would outweigh or offset the potentially anti-competitive effects. The Commission found that the parties had failed to demonstrate which efficiencies were unique to the merger as opposed to gains that the parties would achieve without the joint venture. More importantly, they had failed to convincingly show that the efficiencies would benefit consumers in any manner. The Commission, therefore, was of the view that the parties had failed to demonstrate that efficiency gains that arose from the proposed venture outweigh the potential anti-competitive effects of the proposed venture.

The proposed joint venture also raised certain public interest concerns, specifically regarding employment and empowerment issues, within the context of the oil industry and the overall restructuring vision of Government. While the merger would benefit the parties in terms of one time cost savings, it would not contribute to the overall competitiveness of the South African oil industry.

One of the eleven cornerstones of future government policy on the liquid fuels industry is that black economic empowerment should be reflected in the composition of the industry at all levels, and significant domestic black ownership, or control, in all facets of the industry.

The aim of competition legislation is not to protect competitors, but the competitive process. The effect of the proposed transaction on empowerment firms in the liquid fuel industry raised concerns within the context of the broader aims of the legislation, i.e. ensuring small and medium-sized enterprises have an *equitable opportunity* to participate in the economy, and the promotion of a greater spread of ownership, in particular the ownership stakes of historically disadvantaged persons.

The oil industry needs storage facilities to facilitate the economic movement of product from refinery to end consumer. Access to these facilities is particularly important to the BEE companies. The smaller, empowerment firms in the liquid fuels market are dependant on the other industry participants for both product exchange services and hospitality services, since they do not own any refineries or depots themselves. Similarly, access to these facilities and services would be crucial to any future new entrant into the industry. Within this context, the Commission found that the proposed joint venture would not facilitate the achievement of the proposed empowerment goals of Government and, furthermore, would not contribute to an overall competitive industry.

After due consideration the Commission concluded that there were no mitigating factors that would lessen the anti-competitive effects of the joint venture and also no public interest grounds on which the venture could be approved.

# 1: Mergers: The Takeover of Zambia Bottlers Limited by Zambian Breweries PLC

*Zambia Competition Commission*

1.1 **Summary**

1.1.1 On the 18th July, 2001 officials from the Zambian Breweries PLC(ZB) and the Coca-Cola Company(TCCC) Southern Africa Division, had a meeting with ZCC to announce the intended transaction in which the ZB would acquire the 100% shares of ZBL. Currently the ZBL shares are owned by TCCC and ZBB, a subsidiary of T J C Holdings of South Africa. Further the officials sought advice of ZCC on the matter. The parties filed a notification for approval on the 28th November, 2001.

**1.2 The factual and legal context**

1.2.1 The Competition and Fair Trading Act (the Act) makes it mandatory for mergers and acquisitions between independent enterprises that manufacture and distribute substantially similar goods and services to be notified with the Commission for approval. Further, that failure to do so is an offence and that such transactions shall not have any legal effect and no rights or obligations imposed on the participating parties by any agreement in respect of the merger or takeover shall be legally enforceable in Zambia.

1.2.1 The issue for decision was on whether or not the proposed takeover of ZBL by ZB has the likely effect of restricting, distorting or preventing competition to an appreciable extent or substantial part of the market in Zambia in violation of section 7 of the Act.

1.3 **Competition analysis:**

1.3.1 **Market definition**

(i) The Commission determined that whereas ZB is a manufacturer and distributor of clear beer, ZBL is a manufacturer and distributor of Carbonated soft drinks and Still soft drinks( non-alcoholic beverages), and that both carryout their businesses in the Republic of Zambia. On this basis the Commission determined that the transaction is not a horizontal acquisition because the parties are not direct competitors and that there will be no reduction in the numbers of players in the relevant markets.

1.3.2 **Market structure**

(i) ZB controls 98% of the clear beer market in Zambia. ZBL controls 98% of the carbonated soft drinks market and 59% of the non-carbonated soft drinks market. The two firms are therefore monopoly undertakings as defined by the Act. There are numerous suppliers of non-CSDs who have come up during the last 5-6 years.

1.3.3 **Market entry**

(i) Entry of the CSD market has been very difficult as evidenced by the lack of any recent entry. This seems to arise from several factors: high brand differentiation, the need to have a full range brand presentation, strong and comprehensive distribution network to

push through the brands, and existence of excess capacity which enough to put off potential entrants as minimum scale efficiencies may be almost impossible to attain..

1.3.4 **Effect of the merger**

(i) The **purpose and motive** of the acquisition is of a conglomerate nature and seeks to achieve synergies in production, distribution and enhance consumer choice given a wider product portfolio to be on offer.

**(ii)** ZCC has observed that ZBL is partly owned by the Cooks Family (T J C Holdings of the RSA) have decided to divest from the bottling business. The other shareholder is the TCCC who wish to withdraw from a vertical involvement in the downstream bottling by retaining its role as a brand owner and in the business of selling concentrates and not bottling.

**(iii)** ZCC has also observed that the Cooks family, and probably out of the desire to divest from the sector, have not made substantial investment in the business and the business needs this investment especially the distribution infrastructure. This gap can be easily filled by ZB being a member of the financially sound SAB and indeed on its own.

**(iv)** Globalisation has brought with it intense import competition and ZB is likely to withstand this by achieving better economies of scale from the synergies cited above. It therefore becomes certain that while price reductions cannot be promised, cost containment becomes possible and hence also the maintenance of current consumer prices for longer periods despite competitive pressures.

**(v)** On the matter of **likely abuse of market position**, the Board recalled that both ZBL and ZB are currently implementing compliance programmes on the undertakings made with the ZCC and this transaction will not change the status of their monitoring by ZCC. ZCC is happy with the levels of compliance achieved so far by the two firms as seen by the voluntary notification of this transaction.

**(vi)** In **conclusion** short and based on the face value of the transaction, there are no sufficient grounds to reject the application for authorisation because the transaction does not raise substantive competition concerns.

**(vii) On the other hand** the Commission has observed that this transaction as submitted by the parties, sort of sidelines the role/s to be played by the **second franchised bottler of TCCC,** namely Invesco/Gold Spot Bottling Company. Invesco has complained to the Commission indicating that its future role in the sector is being made uncertain arising from this transaction and yet huge investments have been made in PET plant and equipment in the sum of $1.3 million this year, 2001. Invesco fears that ZB may usurp its privileges and rights in the Zambian market and become subservient to ZB. This view point is supported by factors such as the following:

a. Following the takeover of Cadbury Sweppes brands by TCCC, Invesco has been performing certain functions within the franchise agreement including: production of plastic bottles (,PETs), the bottling of 500ml, 1 and 2 litre of the TCCC core brands and 330ml secondary brands. Further Invesco

manufactures the mazoe and other cordial brands while distribution is done by ZBL. Apart from the issue of remuneration for this role at 14% margin, ZBL is getting 25% margin and hence it is felt the value chain is rather distorted and unfair to the consumer as the product passes through many hands.

**b.** Currently Invesco has an agreement with TCCC to produce, market, sell and distribute its brands in Zambia. Within this framework Invesco has been apportioned the PET bottling and ZBL does the glass bottling. This arrangement is likely to change with the coming in of ZB who want to set up their own PET plant in Lusaka. The issue then is what will happen to the plant and machinery that Invesco has installed. The second issue concerns the likely socio-economic adverse effects of closing down the Invesco business in Ndola and indeed the impact on associated enterprises country wide. Already Invesco has 250 employees whose future is bleak on account of this transaction if safeguard measures are not put in place.

**c.** TCCC bought the Cadbury Sweppes Production facilities in Zimbabwe and it feared that the cordials may be sourced from there for sell in Zambia and Invesco may close down. Already Invesco has observed that TCCC has date coded the Zimbabwe PETs a six months shelf life while that of Invesco has been pegged at 6 weeks. Technically the PETs are the same and hence the motive is to eliminate competition from Invesco because after the said date the products are supposed to be declared expired. The Invesco PETs are shaped differently and this has been taken to be the reason for a different date code. This is a flimsy reason.

**d.** For the non-carbonated soft drinks, Invesco produces and bottles and ZBL does the distribution. This entails that Invesco has not been allowed to create its own distribution system in Zambia and be able maximise its earnings in the longer value chain other than just receiving the 14% margin allowed by TCCC.

**e.** In short it would appear ZB and TCCC are courting a course of action that advocates the existence of a single bottler for Zambia. This would materially go against the competition rules in Zambia. In fact TCCC itself has suggested that Invesco should consider taking equity or merge with ZBL instead of going it alone. These plans are likely to result in Invesco probably remaining as a PET bottle producer and supplier and not a TCCC franchised bottler. It is also possible that PET production facilities may end up as stranded investment. This will not only be anti-competitive but also go against public interests as the economy in general is to be adversely affected.

(viii) Further, ZCC has taken note of the parties claims of **some benefits** associated with the consummation of this transaction as follows:

a. A Zambian firm will now own ZBL as the two foreign owners are to divest their interests.

b. ZB has undertaken to sell 37% of ZBL shares to the Zambian public through a rights issue and ultimately ZB will be 25% owned by the local persons and institutions. Currently ZB is 10% owned by the public.

c. New Product Developments for 2002

ZB intends to introduce a 1 litre returnable bottle, covering the Fanta, Coke and Sprite range, and this will take some major plant and equipment investment. Secondly ZB will introduce a large volume PET (non returnable bottle) in 1 or 2 litre packs and this take some major plant and equipment investment. Thirdly ZB will introduce an additional five products and flavours which would most likely include:

- Coke Light (diet type)
- Granadilla
- Sparletta Lemon twist
- Grape
- Minute Maid Fresh Orange

And lastly ZB will introduce bottled mineral water (still) in 500 ml or 1 litre packs.

d. ZB undertakes to enhance Product availability on the basis of the following: the acquisition of 4 – 6 new delivery vehicles of various sizes, 200 – 300 new Coolers into the trade, an additional new bottles and crates in excess of 2 million bottles and 50,000 crates, Upgrade and overhaul of packaging machines to eliminate stoppages and breakdowns so as to prevent stock shortages.

e. How or why will more "users" have access to both soft drinks and beer?

- ZBL products will be carried by the vast network of ZB distributors and transporters.
- ZB products will have access to the wide network of the ZBL distribution systems.
- ZBL will be carried by ZB's successful refrigerated container net work.

- ZB and ZBL combined have 18 depots which cover Zambia well, ie., the whole significantly greater than the parts.

- Currently ZBL fleet is somewhat poorly utilised because of the nature of their route sales. The addition of beer makes it feasible and viable to implement a modern route to market computerised system of pre-sell which will greatly improve distribution, efficiency, customer access, and service.

- Being able to move ZB and ZBL products concurrently, it now becomes viable to move products into very remote previously non viable markets areas.

- The above will to an extent enable ZB to contain costs.

f. Localisation of bottling expertise from SAB is likely to filter into the rest of the economy and hence the likelihood of entrepreneurial spin-offs into the use of local raw materials for soft drinks making in the regional markets.

## 1.4 Recommendations.

1.4.1 One the basis of the foregoing, it was recommended that the Board of Commissioners approves the takeover of ZBL by ZB subject to the following conditions:

a. the parties have undertaken to promote and enhance the local participation in the ownership of ZB through the flotation on the Lusaka Stock Exchange (LUSE) of additional shares such that ultimately ZB will be 25% locally owned. To do this, ZBL will be owned locally by 37% and SABI will own 63%. On the basis of the existing ZB ownership structure where SABI owns 90% and the public 10%, the combined shareholding gives the 75% : 25% share split. The understanding is that above results from a financing plan to acquire ZBL at a consideration of $16.5million, of which $5 million will be through a debt finance and the balance through the rights issue. Please refer to the ZB proposed rights issue chart as attached.

b. the parties have undertaken to maintain their core businesses as before the takeover ie. Clear beer and non-alcoholic beverages. That the transaction will in no way prejudice the core businesses.

c. there shall be no interlocking directorships between the two firms, and that both management and books of accounts will be maintained separately.

d. the parties will be subject to the existing and separate compliance programmes with the ZCC whose main objective is to sustain and enhance the competitive conditions in the respective relevant markets.

e. The parties have undertaken to honour in totality the current franchise agreement between Invesco Limited and TCCC. It is also agreed that any changes or modifications to the agreement or any part of the agreement must be notified for authorisation with the ZCC.

f. That ZB will implement the 2002 new product development as set out above.

g. That ZB will enhance product availability through tangible new investments into the ZBL distribution system, plant and machinery.

1.4.2 The majority of the Board members accepted the recommendations. Dissensions raised expressed the feeling that Zambians were not being empowered adequately through this transaction. The majority felt that this need was beyond the mandate of the Commission and therefore decided to conditionally authorise the transaction as recommended.

## 2. Vertical Agreements: Hybrid Poultry Farm Limited Exclusive Dealing Arrangements with Galaunia Farms Limited

*Zambia Competition Commission*

### 2.1 Summary

2.1.1 The case arose from a revelation during a meeting between management of Hybrid Poultry Farm (HPF), Zambia Association of Manufacturers (ZAM) and Zambia Competition Commission (ZCC) that HPF and Galaunia Holdings Limited (GH) had earlier agreed to effect a sale of Mariandale Farm and the poultry processing factory to Galaunia Holdings subject to agreed exclusive dealing clauses and conditions. In turn ZCC advised the parties to notify the said exclusive agreements as required under the Competition and Fair Trading Act Cap 417 of the Laws of Zambia.

### 2.2 The factual and legal context

2.2.1 During the investigations it was determined that in the sale of Mariandale Farm, which specializes in the raising of Day Old Chicks (DOC) into table birds, HPF required GH to only purchase DOC from itself. Further GH was also required to consider HPF's right of first refusal should it intend to resell Mariandale Farm. GH was also not allowed to raise any type of poultry, at the farm, apart from broiler chickens, including the provision not to go into business of a chicken hatchery. The parties also agreed that GH should be accorded the right of first refusal should HPF intend to sell some of its shares and that HPF should be given the first right of refusal to participate in a out growers scheme should GH come up with one.

#### 2.2.3 Procedural aspects

(i) The information regarding the existence of an exclusive dealing arrangement between HPF and GF was made available to the ZCC through a tip-off from the business community during a meeting. The matter arose from a revelation during a meeting between management of Hybrid Poultry Farm (HPF), Zambia Association of Manufacturers (ZAM) and Zambia Competition Commission (ZCC). In the meeting it was revealed that HPF and Galaunia Holdings Limited (GH) had earlier agreed to effect the sale of Mariandale Farm and the poultry processing factory to Galaunia Holdings subject to agreed exclusive dealing clauses and conditions. At this point ZCC got concerned that by nature exclusive dealing arrangements are anti-competitive unless authorised by the Commission. In this particular case ZCC observed that the arrangement had not been notified and cleared by it. In turn ZCC advised the parties to notify the said exclusive agreements as required under the Competition and Fair Trading Act Cap 417 of the Laws of Zambia. On 31st January, 2000 HPF notified the said agreements. ZCC instituted investigations drawing heavily on the parallel investigations on the intended takeover of Tamba Chicks Ltd. GH management was interviewed on the same.

#### 2.2.4 Competition Analysis

(i) **Market definition.**

ZCC has determined that parties to this transaction are the two leading players in the poultry sector's upstream (HPF) and downstream (GH) sub sectors. HPF is the dominant producer of DOC in Zambia with a 60% market share. GH with its Mariandale and Diamondale Farms has an uptake of 42,000 DOC per week and hence the largest buyer in the poultry sector.

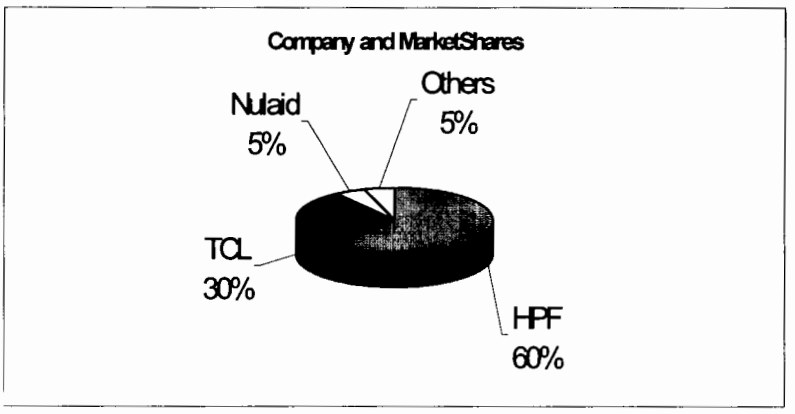
**The relevant market** is the poultry farmers who are both commercial and small-scale poultry rearing farmers and households mainly along the line of rail. The market or customers comprises 25% commercial farmers and 65% small-scale farmers and 10% exports.

**The product market** comprises the broiler day old chicks(DOC) market. HPF on the other hand are producers of Arbor Acres broiler breeders under franchise. Nulaid Farms in South Africa has Ross Breed franchise but in Zambia they have the Hybro franchise from Holland. Caledonian Hatchery is a small hatchery and are "Cobb breeder" franchisee. Cobb breed is a close substitute of Ross breed.

**The Geographic market** definition is mainly the urban areas in Zambia along the line of rail, with major concentrations in Lusaka and the Copperbelt Province. There are, however, smaller amounts of provincial sales of DOC in Chipata in Eastern Province, Monze in Southern Province and other isolated sales scattered throughout rural Zambia.

**(ii) Market structure**

a. There are three significant companies producing day old chicks operating in Zambia with a national coverage. The major companies with market shares are HPF the largest with approximately 60% of day old chicks market, TCL 30%, Nulaid Farm 5% market share and others supplying only 5% of the market. In the last one year, HPF has gained some market share at the expense of TCL which has been experiencing difficulties during the same period. The pictorial presentation of companies and market shares is given below:



b. The broiler DOC from various companies are close substitutes in the market. HPF is the dominant player in the market and would be a countervailing power in the market in an event that the proposed takeover by CBI is authorised. HPF is expected to be further entrenched in the market controlling about 90% of the market if it is authorised to take over TCL.

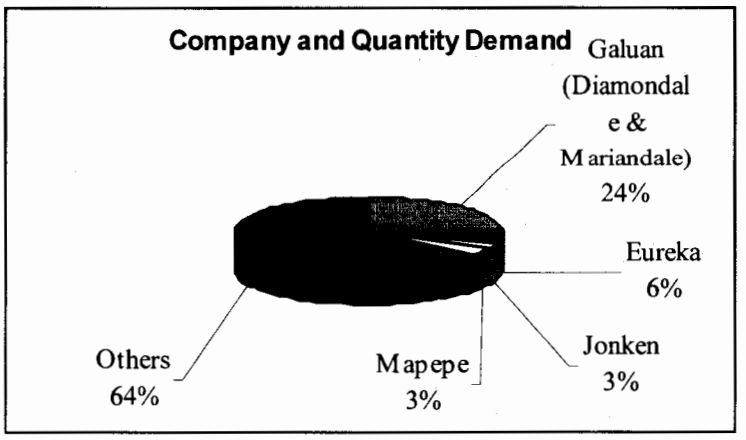
c. The industry has not been dynamic to a point of being static because of the current market incumbents namely, HPF and TCL. The proposed acquisition by CBI is likely to rejuvenate the industry and stimulate demand for chicken consumption. Currently, the price of day old chicks is reported to be too high to stimulate demand at K1400.

d. The major customers in the market are Diamondale and Mariandale Farms of Lusaka owned by Galuan Holdings with a combined demand of 42,000 DOC per week; Eureka Farm of Lusaka 10,000 DOC per week; Jonken Farm of Lusaka with 5000 DOC per week, Mapepe with 5000 DOC, and others demanding less than 5000 DOC per week.

   i. The total market demand for broiler DOC per week may be tabulated as below:-

| Company | % | Quantity Demand |
|---|---|---|
| Galuan (Diamondale & Mariandale | 24 | 42,000 |
| Eureka | 6 | 10,000 |
| Jonken | 3 | 5,000 |
| Mapepe | 3 | 5,000 |
| Others | 64 | 115,200 |
| **TOTAL** | **100** | **177,000** |

e. Mariandale and Eureka are the major customers of HPF while, Jonken and Mapepe




Farms buy their DOC from TCL and Nulaid Farm. Mariandale and Eureka Farms are unable to change their supplier because of fear of blackmail from HPF. They both complained against HPF's business practices.

f. The Mariandale Farm was bought by Galaun Holdings from HPF. Under the sales agreement, the parties agreed that Mariandale Farm shall buy all its DOC requirements from HPF and this has been in force up to-date. The other exclusionary provision in the sales agreement is that should either party decide to sell, either party shall have right of first refusal.

g. **The demand for table chickens and eggs remains depressed because the price of these poultry products is perceived to be very high. This is influenced by prices of DOC which remain very high in Zambia at 0.49 cents compared to Zimbabwe (.30 cents) and RSA at .25 cents. The high price and poor quality of poultry feed has had negative effects on the final price of eggs and chickens.**

**2.2.5 Market entry**

(i) In the last three years Nulaid Farm has entered the market. The market share of Nulaid Farm is approximately 5% and has failed to attract major customers of DOC due to its low capacity. Nulaid produces only 15 – 20,000 DOC per week and is not able to meet the orders of big customers. HPF is under new investors who took over the company in 1994.

(ii) There is no company that has exited the market in the last three years except that Caledonian Hatcheries and TCL experienced severe financial difficulties. Caledonian Hatcheries at one time stopped operations.

(iii) There are no legal impediments to entry except the requirement for a clearance with the Department of Veterinary Services and usual registration requirements. Financial requirements remain the only barrier to entry to develop a hatchery of the size of TCL, which is approximately US$1.5 million. The average cost of establishing an average hatchery is about US$1 million.

(iv) Property Rights to breeding stock are controlled by international breeder companies. Agreement with one of these companies is required before a breeding operation can be established to supply the hatchery with hatching eggs hence an entry barrier.

(v) The largest player in the market, HPF, has shown hostility to the proposed takeover of TCL assets by CBI because they are also bidding to acquire TCL. Their fear is that the entry of CBI would destroy the local market. HPF suggests that it should takeover TCL to consolidate its position in the market and be able to defend the domestic market when the COMESA Zero Tariff takes effect.

(vi) **The GRZ Ban on the Import of Poultry and Poultry Products.** The GRZ has since 1994 imposed a Zoo-Sanitary ban on imports of poultry and poultry products from Zimbabwe and South Africa. At the time there was a disease outbreak in the said countries. This is currently the major barrier to import competition. In January 2000, the Department of Veterinary Services destroyed 18,000 DOC imported from USA without a permit and 20,000 dressed chickens from Belgium worth K300 million were also destroyed on 7th May, 2000.

### 2.2.6 Nature of the agreement

(i) Some of the anti-competitive Clauses in the Sale of Business Agreements included the following:

Clause 13: That GFL would not raise any type of poultry on Mariandale Farm other than broiler chickens.

Clause 14: That GFL and any subsidiary or associate company would not enter into the business of a chicken hatchery or breeder broiler production in Zambia.

Clause 15: That GFL would only procure its DOC requirements exclusively from HPF.

Clause 17: That GFL shall have the exclusive right to collect all chicken manure from HPF chicken houses located in the Lusaka/Chisamba area at a cost of US$0.30 per 90kg bag.

Clause 19: That GFL should give HPF the right to first refusal to purchase, within five years of completion date, should it decide to sell the business and vice versa.

Clause 21: Should GFL develop and implement an out-grower scheme to grow broiler chickens, HPF shall be given the first refusal to participate in the scheme.

### 2.2.7 Effect of the agreement

(i) On the basis of the foregoing findings, it is evident that the parties had contravened the Act. The exclusive dealing arrangements appear to have been over and above the offers each party made and hence the considerations made by the other.

(ii) The excesses hinge on the ulterior motives of the parties in as far as the poultry sector is concerned. The parties seem to have taken advantage of their dominant market positions upstream and downstream – where each party was dominant. The parties were, both by motive and concerted practices, foreclosing competition both in the DOC, table birds (broiler) and frozen chicken.

(iii) HPF and GH also entered into another agreement for sale and purchase of the Poultry Processing Company (PPC) with similar restrictive clauses.

(iv) These practices are in direct contravention of Section 7 of the Act.

(v) The Board of Commissioners found all the exclusive dealing provisions in the sale and purchase agreements by the parties anti-competitive and nullified them forthwith.

# 3: Abuse of Dominance: Zambia Breweries PLC and the Loyalty Rebates with Its Distributors

*Zambia Competition Commission*

## 1. Introduction

- On 1st February, 1999 Zambian Breweries Plc (ZB Plc) undertook to comply with several undertakings with ZCC with a view to sustaining and/or enhancing a system of workable competition and that market entry remains unhindered by anti-competitive practices. This was on occasion of the takeover of Northern Breweries Plc by ZB Plc.

- During the 1999/2000 festive period, ZCC observed that one ZB Plc distributor - RS Distributors, was conducting its sales of the competing products separately.

- Prior to the notification done on the 16th May, 2000 the details of scheme revealed that all those distributors who carried competing brands were excluded from the Incentives scheme. This was of concern to the Commission by ZB Plc favouring only its loyal distributors in the award of rebates.

## 2. Legal Contravention

- ZB Plc was operating a Loyalty Rebate system with its selected distributors. Section 7 of the Competition and Fair Trading Act stipulates that an enterprise such as ZB Plc must not engage in concerted practices whose object is to prevent, restrict or distort competition to an appreciable extent in Zambia.

## 3. Findings

### 3.1 A scrutiny of the incentive scheme by ZB Plc with its distributors found it to be structured as follows:

- based on sales volume target achievements by distributors.

- Volume targets are matched up with brand targets e.g. Mosi sales plus Castle Milk Stout volume target.

- Includes only about 20 top distributors/agents out of a total of about 50 country wide on discretionary basis by management.

- Higher volume sales attract higher incentives paid per week case sold, over and above the normal commission of K600 or K650 for Mosi and Castle respectively.



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- Inclusion on the incentive scheme is only for those distributors who do not carry competing products.

### 3.2 The Clear Beer Industry in Zambia

- The *Relevant Product Market* is the Clear Beer Market, with Mosi Lager being the mass/ mainstream product. The other brands seem to be niche market products or medium to high-income offerings.

- The *Relevant Geographic Market* is mainly the Copperbelt, Midlands and Lusaka; and the peri-urban provincial centres.

### 3.3 The Market Structure and Shares

- 98% of the clear beer market in Zambia following the takeover of the NB Plc in 1999.

- Zikomo Breweries of Lusaka used to produce clear beer and had a market presence of about 0.1%. Zikomo is now closed and on sale.
- Imports have accounted for about 1.9% of the balance market share.

- ZB Plc is a monopoly, wields considerable market power and has often acted unilaterally in determining prices without significant cross elasticities in demand as the new prices have always been below those of the competition.

### 3.4 The ZB Plc Dominance and Market Power

- The clear beer market is imperfect and highly concentrated. The market dominance by ZB Plc is evident from the foregoing mainly arising from its high market share in the domestic market.

- The competition is extremely negligible including import competition.

- There is no countervailing power in the market all round; has access to cheaper inputs internally or from suppliers as SAB procures for the group

- Entry Barriers: Higher wages being paid to employees are likely entry barriers; incurs huge advertising sunk costs which rivals may not meet as was the case with the former owners of NB Plc;entry is very unlikely: setting up a small plant of 192,000 HL/pa would cost a minimum of US$200 million and another US$100 million in distribution infrastructure.

- Accordingly the dominance of ZB Plc is heavily entrenched in Zambia, market forces have been weakened and only intervention can work towards effective competition.

## 4. Assessment of the Incentive Scheme or Loyalty Rebates System

- The Commission is skeptical as to the use of loyalty rebates by dominant undertakings because such rebates are apt to lock in customers with the result being reduced competition. When corresponding schemes are used by non-dominant undertakings in a market with effective competition, the same type of scheme may stimulate competition.

- When such schemes are implemented by dominant undertakings, they represent a hindrance for existing or potential competitors to gain a footing in the markets or compete effectively. In the long term the rebate schemes may thus be detrimental to the customers that benefit from them in the short term.

- Parallel arrangements may also have similar effects, even if the undertaking offering the rebate does not hold a dominant market position and acts independently of others. This applies when undertakings, combined, become dominant.

- A dominant supplier may use loyalty rebates to achieve the same objectives as those of agreements stipulating that customers do not have the right to buy form other suppliers. This leads to creation of dominance by effectively barring competitors from supplying to the customers of a particular supplier.

- The incentive system in force at ZB Plc can be interpreted as one called the volume rebates, which are offered on the basis of the quantity of a product a customer buys or is assumed to buy in a given period. It is a progressive one in that a higher rebate rate is obtained if the volume purchased is higher in the period. Such arrangements are incompatible with the Act in that the purpose or effect is that of restricting or liable to restrict competition under Section 7 of the Act.

- The loyalty rebates therefore need to be seen within the context of whether or not they create, or maintain or strengthen a dominant position in a market by barring competitors.

- ZB Plc has about 50 distributors country-wide. It has chosen the top 20 or so distributors to be on the incentive scheme. Their choice has so far been based on whether or not they carry competing brands to those of ZB Plc. However, when loyalty rebates become part of the concerted practices of a dominant undertaking, they become suspect competitively as they effectively lock-in customers resulting in reduced competition.

- The Incentive is targeted at the top 20 distributors and their combined sales volume takes up 70% of national sales. Access to these distributors is critical if the competition is to be effective as the alternative channels would be very costly to the competition.

- Mosi, is a must-stock product and no other supplier supplies a close substitute in terms of taste and price. The product is a demand puller and then can products be sought after in the main-stream markets.

- Refusal to Deal on Incentives: Finally, the most worrying condition precedent for inclusion on the incentive is that a distributor does not carry competing products. This is nakedly anti-competitive and prohibited under Section 7 of the Act and has a place in the undertakings.

## 5. Conclusions and Recommendation

- On the basis of the foregoing, its clear that since the ZB Plc merchandise has to be paid for before delivery/collection, the high volume targets entail high working capital investments. This has not been easy to come by on the party of most distributors. By implication, given the high profit expectations from the scheme and financial commitments, the distributors rarely have time and resources for other suppliers. This entrenches the dominance and enhances monopolisation in the sector.

- ZB Plc in their submission to ZCC disclosed that it no longer placed any restrictions as regards competing products as follows:

> "As discussed telephonically this afternoon, herewith written confirmation that, with respect to qualifying for our Incentive programme, there is no restriction, explicit or implied, on distributors selling competing products."

On the basis of the confirmation by ZB Plc not to put any restrictions in the implementation of the Incentives programme, it is hereby recommended that the case be closed.

Further, it is recommended that ZB Plc be required to, in future, consult with ZCC before any changes are made in their dealings with distributors as regards terms and conditions of distributorships as it takes time to correct or re-track from anti-competitive conducts already in force.

Further, ZB Plc should be told not to make it as a requirement for dealership, the exclusion of competing products from being sold in the same premises as its brands, e.g. Whisky Black. This negates the spirit of the Undertakings which were given to the ZCC.

# 4: Horizontal Agreements: Hybrid Poultry Farm (Z) Limited and Tamba Chicks Limited

*Zambia Competition Commission*

## 4.1 Summary:

4.1.1 This case is a classic example of how a well planned and orchestrated horizontal agreement can be used to entrench dominance and foreclose any likely future competition. Here is a situation where both Hybrid Poultry Farm(HPF) and Tamba chicks Limited(TCL) are the two major poultry breeding and hatchery operators in Zambia and both produce Day Old Chicks(DOC) for sale to commercial poultry farmers. HPF has a market share of 60%; TCL has a 30% share and the rest have 10%. A signed agreement between HPF and TCL in 1996 provided that should either party decide to sell shares or the business, the other party would be accorded the "**right of first of refusal**". The two firms wanted to retain their dominance over the sector, however TCL became a failing firm and a decision was made to sell the business to avoid being placed under receivership and liquidation. The said agreement became a bottleneck to TCL in trying to sell the business in the market and the Competition Act would not let the sale be made to HPF and the agreement was nullified.

## 4.2 Factual and legal context

4.2.1 On 29th October 1999 the Executive Chairman of Tamba Chicks Limited and the major creditor of Tamba Chicks Limited, Holt Whitney and Company of the UK informed the Commission that Hybrid Poultry Farms (HPF) a direct competitor, planned to takeover TCL. TCL had not paid its creditors for sometime and the creditors wished to place the company on receivership in order to recover their money. At the same meeting, it was reported that TCL was compelled to sell only to HPF under the terms of agreement entered into on 5th September 1998 between TCL, Tamba Farms Limited, Five Aces Limited on one hand and HPF on the other hand.

4.2.2 On 23rd June, 1999 HPF made an offer to acquire TCL at US$1.445 million in cognisance of the letter of understanding signed between TCL and HPF of 5th September 1998. TCL did not wish to sell its assets to HPF but felt compelled because of the agreement. On 29th November, 1999 at a meeting with Livestock Services Cooperative Society (LSCS) management, the Commission was advised that LSCS wanted to purchase TCL but were prevented by the Clause in the agreement between TCL and HPF of "right of first refusal". ". This clause precluded LSCS from bidding for the purchase of TCL. ZCC advised LSCS that the agreement in question was null and void and had no legal effect in Zambia. LSCS came to know about the clause when they made an offer to purchase TCL at US$1.7 million on 28th October, 1999. LSCS were advised to notify their intention to takeover TCL since nothing prevented them from bidding for the company. On 1st December, 1999, ZCC nullified the agreement between TCL and HPF of 5th September, 1998.

4.2.3 On 8th December 1999, LSCS submitted their notification with the Commission to takeover all the assets TCL in order to continue TCL as a viable hatchery.

4.2.4 The Competition and Fair Trading Act, makes it mandatory that parties obtain the

ZCC authorisation under the following circumstances:

a. Under Section 7, where an agreement or concerted practice between enterprises have the object of preventing, restricting or distorting competition to an appreciable extent in Zambia or any substantial part of it. Despite this provision, parties to a transaction may seek exemption under certain circumstances where it is felt justifiable reasons do exist to engage in the said conduct such as where full competition may not deliver the most desirable outcome, or where immunity form prosecution is needed or public benefits outweigh the adverse effects on competition. The exemption or the authorisation of allowable acts is done under Section 13 of the Act.

b. Section 8(1) of the Competition and Fair Trading Act calls for notification for authorisation by the Commission of all mergers or takeovers between two or more independent enterprises engaged in the manufacture or distribution of substantially similar goods or in providing substantially similar services. Without the Commission's authorisation, Section 8(2) nullifies such mergers or takeovers. Further that such transactions shall not have any legal effect and no rights or obligations imposed on the participating parties by any agreement in respect of the merger or takeover shall be legally enforceable.

### 4.3 The Competition analysis

#### 4.3.1 Market definition

**a. The product market**

TCL is operationally integrated by raising grandparents from the imported Ross DOC. These DOC are reared to produce hatching eggs into parent stock which in turn produce hatching eggs at both Chainda and Mimosa farms. The hatching eggs from both farms are then transferred to the Mimosa hatchery. The Mimosa hatchery has a total installed capacity of 9,584,640 DOC per annum. The Hatchery specializes in the production of parent Ross DOC for the Chainda and Mimosa parent stock farms and commercial Ross DOC for farmers who then raise table chickens for wholesale and retail purposes.

Tamba Chicks is focused on supplying the local market although some sales have been made to DR Congo. Production is in the region of 70,000 DOC's (mainly Broiler) per week. This is below 30% of the Hatchery's capacity. There are four modes of sale:

- Commercial Producers - deliver/collect from the hatchery
- Small Scale Producers - collect from the Hatchery
- Own Retail Outlets - deliveries twice a week
- Retail Agents - deliveries twice a week

(iii) HPF has the largest poultry breeding and hatchery operation in Zambia. It has hatchery and breeding farms in Lusaka and Kitwe on the Copperbelt. The company controls approximately 60 - 70% of the Zambian poultry market. HPF is a producer of DOC based on the following breeds of birds:

- Arbor Acres - stocks for production of broilers (processed chickens)
- ISA Brown - stocks for commercial layers (table eggs)

- Harco - stocks for commercial layers (table eggs)

(iv) Arbor Acres is controlled by Avian group in the USA, Harco controlled from Hungary and ISA Brown from UK. These breeds are independent of each other.

b. **The relevant geographic market**
The relevant geographic market for HPF is national and especially along the line of rail towns and peri-urban provincial centres. It is only TCL that is also a national supplier of DOC in Zambia.

**4.3.3 The market structure**

Apart from HPF, DOC can also be procured by farmers including Galaunia Holdings/Miriandale, from other suppliers namely: Tamba Chicks Limited (Lusaka); Nulaid (Lusaka); Flamingo (Luanshya); and others for the regional markets. The market structure is accordingly dominated by HPF and Tamba as follows in terms of market shares:

| | |
|---|---|
| HPF | 60% |
| Tamba | 30% |
| Others | 10% |
| | 100% |

**4.3.4 Entry and Exit Barriers to the Market**

**(i) The industry is highly concentrated and entry is practically very difficult on account of the following factors:**

a. heavy investment requirements

b. production process, very technical coupled with intensive bio-security requirements

c. Zambia has placed a ban on the import of poultry and poultry products from Zimbabwe and RSA. Imports from elsewhere are costly due to distance/costs.

d. Apparent restrictive business practices by the dominant player, HPF, as contained in the exclusive agreement with Galaunia Holdings.

In the last three years Nulaid Farm has entered the market. The market share of Nulaid Farm is approximately 5% and has failed to attract major customers of DOC due to its low capacity. Nulaid produces only 15 – 20,000 DOC per week and is not able to meet the orders of big customers. HPF is under new investors who took over the company in 1994.

There is no company that has exited the market in the last three years except that Caledonian Hatcheries and TCL experienced severe financial difficulties. Caledonian Hatcheries at one time stopped operations.

There are no legal impediments to entry except the requirement for a clearance with the Department of Veterinary Services and usual registration requirements. Financial requirements remain the only barrier to entry to develop a hatchery of the size of TCL, which is approximately US$1.5 million. The average cost of establishing an average hatchery is about US$1 million.

Property Rights to breeding stock are controlled by international breeder companies. Agreement with one of these companies is required before a breeding operation can be established to supply the hatchery with hatching eggs hence an entry barrier.

The largest player in the market, HPF, has shown hostility to the proposed takeover of TCL assets by CBI because they are also bidding to acquire TCL. Their fear is that the entry of CBI would destroy the local market. HPF suggests that it should takeover TCL to consolidate its position in the market and be able to defend the domestic market when the COMESA Zero Tariff takes effect.

**The GRZ Ban on the Import of Poultry and Poultry Products.** The GRZ has since 1994 imposed a Zoo-Sanitary ban on imports of poultry and poultry products from Zimbabwe and South Africa. At the time there was a disease outbreak in the said countries. This is currently the major barrier to import competition. In January 2000, the Department of Veterinary Services destroyed 18,000 DOC imported from USA without a permit and 20,000 dressed chickens from Belgium worth K300 million were also destroyed on 7th May, 2000.

With the coming of FTA, this sanitation ban may prove difficult to justify by the government authorities.

### 4.3.5 Nature and evidence of the Agreement

(i) On the 5th September, 1998 HPF and TCL went into an agreement and article 6.1 read as follows:

> **" if one party shall decide to sell its business during the primary period of 24 months whether by way of a transfer of shares or of the business or otherwise the other party shall have the first option to purchase such shares or business on terms and conditions to be agreed upon by the parties and on the terms following below:**
>
> **6.1.2 The sales price shall be 10% above the current market value or the value fixed by a valuation carried out contemporaneously with the offer.**
>
> **6.1.3 The offer shall be obliged to submit to the offer satisfactory evidence that it has sufficient funds to purchase such shares or business".**

### 4.3.6 Effect of the Agreement

(ii) On the 29th October, 1999 the Executive Chairman of TCL and a representative of the major credit, Holt Whitney of the UK, informed the Commission that TCL was about to be takenover by a direct competitor, HPF. Secondly it was reported that TCL was compelled to sell to HPF on the basis of an agreement signed between them in

1998. Further that TCL's creditors had not been paid for sometime and wanted to put the company under receivership in order to recover their money.

On the 29th November,1999 at a meeting held with management of the LSCS,,the Commission was advised that LSCS wanted to to purchase TCL but were prevented by the clause, **"right of first refusal"** enshrined in the 1998 agreement between TCL and HPF. LSCS became aware about the clause after having made an offer of $1.7million for TCL. On the 1st December, 1999 ZCC nullified the TCL and HPF agreement. On the 8th Decmber,1999 LSCS filed a notification to takeover TCL.

HPF shareholders became restless and tried many actions to stop any other buyer of TCL from succeeding. They started influencing the Ross breed franchise owners so that the Ross franchise is not passed on to the new buyer. The LSCS had the National Chicks of the RSA as the partner as they go into the breeding and hatchery business. National Chicks are a big player in the RSA and have the Ross franchise in that country. According would need the support of Ross Breeders International to get involved in Zambia and takeover the Ross breed. Further, Ross Breeders had their own problems with TCL, TCL was not complying with the original agreement to source agreed volumes of Grand Parent Stock(GPS) in any twelve-month period. This was said to be one cause for a possible franchise termination. The other cause likely is when there is change of ownership of the franchise company as was to happen to TCL and Ross Breeders became aware of events in Zambia. A lot of this information came from HPF shareholders as interested parties in TCL.

As a result of the HPF selfish conduct, Ross Breeders, UK, informed the LSCS that it was not prepared to let LSCS have the rights to produce and sell the Ross birds in Zambia. Secondly, the LSCS RSA partner, National Chicks Limited was forced to withdraw the agreed with LSCS or face adverse consequences in the RSA where both the Abor Acres and Ross breeds are under National Chicks but owned by Avigen (USA).

As a result LSCS pulled out of the bid to acquire TCL as they would not buy assets without the rights to the bird and the technical partner. It was also felt that HPF would be better handled by the brand owners in the USA and indeed HPF has abandoned the Abor Acres, opting for Cobb breed was till now managed in Zambia by Caledonian Hatchery.

On the 14th January, 2000 Ross Breeders Limited terminated the TCL GPS agreement and decided that its own subsidiary, Ross Breeders Zimbabwe, would have the exclusive rights to distribute Ross parents in Zambia. Ross Zimbabwe filed a notification with ZCC on the 14th April, 2000. The transaction was granted an interim authorisation by the ZCC on the 23rd May, 2000 as it did not raise any substantive competition concerns. The final approval was granted on the 9th June, 2000.

The DOC price movements, before and after the sale of TCL were as shown below. It will be clear that

# Merger Case Study: Acquisition of Lyons Zimbabwe (Pvt) Limited by Dairibord Zimbabwe Limited

*Industry and Trade Competition Commission*
*Zimbabwe*

## 1.0 SUMMARY

In April 2001 Dairibord Zimbabwe Limited ("DZL") filed an application in terms of section 35 of the Competition Act 1996 (No. 7 of 1996) for authorisation to acquire as a going concern the business and assets of Lyons Zimbabwe (Private) Limited, including the trade marks and other intellectual property rights used in the acquired enterprise.

The transaction constituted a mixture of conglomerate and horizontal merger. While conglomerate mergers generally do not raise serious competition concerns, horizontal mergers have potential adverse effects in the economy as they usually reduce competition in instances where they create monopolies, reduce the number of players in the market and facilitate coordinated interaction.

## 2.0 FACTUAL AND LEGAL CONTEXT

Section 35 of the Competition Act 1996 provides that *any person who proposes to enter into any agreement or arrangement (including mergers and acquisitions) which he considers may be prohibited, restricted or otherwise affected by the Competition Act may apply to the Competition Commission for its authorization of such agreement or arrangement.*

"Horizontal merger" in terms of section 2 of the Act as *the acquisition of a controlling interest in an undertaking involved in the production or distribution of any commodity or service where the person who acquires the controlling interest already has a controlling interest in any undertaking involved in the production or distribution of the same commodity or service.*

The rationale for the merger as presented by the merging parties was follows:

- The merger has been necessitated by operational difficulties at Lyons Zimbabwe. The company has been experiencing operational difficulties in the past two years and is at the verge of liquidation.

- The interest burden and capital repayments on the long-term debt further strained cash flows and the viability of the company. Lyons Zimbabwe had also been under severe strain from working capital funding and requirements. The current macro-economic environment had resulted in high cash outflows to repay overdraft interest and meeting creditor obligations.

- Most of Lyons Zimbabwe' plant and machinery was old with repairs and maintenance costs increasing each year. Lyons Zimbabwe did not have the cash resources to embark on a much-needed capital investment drive.

Lyons Zimbabwe was a foreign owned company. It was involved in the brand ownership and marketing, manufacturing and distribution of branded and packaged food and beverage products, for both local consumption and export.

Dairibord Zimbabwe is a local company and is the leading processor, manufacturer and marketer of milk and other dairy products with seven factories located in major cities of the country.

Some of the envisaged benefits of the proposed merger include the following;

- the merger would seek to avoid the further distress and possible liquidation of Lyons Zimbabwe. A liquidation of this company would result in loss of employment.
- consumers would lose a wide range of quality products developed by Lyons over time. The merger presented an opportunity to preserve consumer choices and maintain consumer satisfaction.
- Lyons Zimbabwe was 100% owned by foreigners and the merger would result in the localisation of the shareholding and the saving of foreign currency.
- the merger would position the merged enterprise strongly and strategically to compete regionally and internationally.
- the merger would result in increased efficiencies that would result from the merging enterprise sharing costs by combining and consolidating their production and manufacturing bases.

## 3.0 PROCEDURAL ASPECTS

The analysis of the proposed merger was largely based on information supplied by the merging parties. Additional information was obtained from other firms producing and distributing the same products as those of the merging parties.

The examination of the merger was done by the Directorate, which presented a report on its findings to the Board of Commissioners.

## 4.0 COMPETITION ANALYSIS

### 4.1 Market definition

Each of the two companies produces a range of products, with the two ranges being substantially different. The only two areas of overlap are ice cream and soft drinks.

Although ice cream and beverages can both be consumed as refreshments, or as part of a meal, their characteristics appear sufficiently different for them not to be considered as close substitutes. That is, beverages fall into a different product market from ice cream.

The aggregation of market share that would result for soft drinks does not appear to raise any competition concerns because the combined market share would be small. There are several large suppliers of beverages in Zimbabwe.

The two companies are the major suppliers of ice cream, and there are two markets into which ice cream falls. The first category is 'hand-held' ice cream, that is, ice cream that is contained in a cone, is fixed to a stick, or is held in a foil wrapping. These lines often include additions such as chocolate coating or the incorporation of confectionery. A hand-held ice cream is intended for consumption by one person, and may be consumed immediately after purchase.

The second category is bulk ice cream. This is contained in plastic containers, with one litre and two litre containers being popular sizes. These packs are intended for home or restaurant consumption, and the quantity is sufficient for several people. They are kept under refrigeration until they are to be served, and if the container is not fully used on the first occasion, the partially used container may be returned to the refrigerator for use on another occasion.

From the consumer viewpoint the differences in the normal method of consumption are sufficiently large to justify classifying each category as a separate market.

The relevant geographic market because of the nature of the product in question, special handling facilities required (refrigeration) and limited distribution comprise all the urban centres (cities and towns) of Zimbabwe. Ice cream is distributed to these centers throughout the country. Remote parts of the country mainly rural areas are not in the relevant geographic market.

### 4.2 Market structure

DZL and Lyons are the leading producers of ice creams especially bulk ice cream. They produce a range of in-hand and take-home ice cream products. Major inputs include milk powder, essences, sugar, flavourings, chocolate and nuts most of which are sourced locally.

Lyons is the market leader for hand-held market through vendors with a market share of 35% and DZL has 30% share of the market. The other small producers of hand-held ice creams account for the balance and imports mainly from South Africa have an insignificant share (2%) of the market.

It is crucial to point out that the core business of the merging entities is not ice cream making, for instance, Lyons produces a wide range of packaged food, beverages, a diverse of groceries and frozen food items. Ice cream is, however, a significant product for Lyons as it contributes about 26% to total turnover. DZL's core business is processing raw milk and producing a range of dairy products. Ice cream business contributes only 3% to the company's total turnover.

The hand-held ice cream market has more players compared to the bulk ice cream market that has only three players. The hand-held market has basic characteristics of a monopolistic structure i.e several small suppliers selling differentiated products, whilst the bulk ice cream segment could be considered oligopolistic because it is characterized by a few suppliers who dominate the market. It will however change from a three-firm market to a two-firm market after the merger.

The relevant market shares before and after the merger are as shown in the table below.

**Ice cream market shares before and after merger**

**Table 1**

**Hand-held Market**

| | Before | After |
|---|---|---|
| Lyons Maid | 35% | 65% |
| Dairibord | 30% | |
| Other | 35% | 35% |
| **Total** | **100%** | **100%** |

**Bulk Market**

| | Before | After |
|---|---|---|
| Lyons Maid | 20% | 75% |
| Dairibord | 55% | |
| Cortina | 23% | 23% |
| Imports | 2% | 2% |
| **Total** | **100%** | **100%** |

4.4 Barriers to entry into the market

The hand-held ice cream market is relatively contestable. It is not capital intensive and major raw materials are locally available. The bulk ice cream market is a bit difficult to enter. It is capital intensive i.e requires refrigerated storage and distribution facilities. Most of the plant and machinery is imported and requires foreign currency.

4.5 Evaluation

The main reason given by the merging parties for proposing this transaction is the failing firm argument. Lyons Zimbabwe had been facing financial and operational problems over the last few years. Shareholders had not injected additional capital to undertake the necessary capital development. The shareholders instead decided to sell their business as a going concern.

To ascertain whether Lyons Zimbabwe is failing as submitted by the parties the Commission calculated a few key financial ratios (liquidity, debt management, asset management etc) and analysed its cash-flow. It was established that, not withstanding limitations of accounting ratios, Lyons Zimbabwe was in a near-solvency state and only injection of large capital investment could save the company.

The Commission established that the merger would not create a monopoly situation in the relevant markets because there are other producers. The merger would however create a dominant player in the bulk ice cream segment because the merging parties account for over 70%. Market dominance per se does not raise any competition concerns but rather the abuse of this dominance.

It was also established that the merger would not lessen substantially the degree of competition. There is strong competition in the bulk ice cream market from imported South African products and other domestic suppliers.

From the past market conduct of Dairibord Zimbabwe there was no fear of anti-competitive practices arising from coordinated interaction effect.

The Commission was able to identify a number of public interest considerations including the following;

Generation of foreign currency

Dairibord is acquiring a company that is largely foreign owned. The merger will save the country foreign currency outflows by way of dividend and other charges clawed out by foreign owned and controlled businesses. It will also enhance exports from other divisions of the merged business as it will position the merged enterprise strongly and strategically to compete regionally and internationally.

Creation of employment

Lyons, which is at the verge of collapse, employs about 1300 people. The merger will save most of these jobs, and as the merged enterprise grows, it will create further employment opportunities.

Indiginisation of the economy

In line with Government's policy of indiginisation of the economy this merger will go a long way towards meeting this policy objective. Lyons is currently 100% owned by foreigners and this merger will result in the localization of the shareholding to indigenous people. The localization of the acquired enterprise will save the country an outflow of foreign currency by way of dividends, fees and other charges that usually arise with foreign ownership.

## 5.0 THE OUTCOME

The Commission's analysis showed that the acquisition does not raise serious competition concerns and authorised it without any conditions.

# Merger Case Study: Acquisition by Pretoria Portland Cement Company Limited of Portland Holdings Zimbabwe Limited

*Industry and Trade Competition Commission*
*Zimbabwe*

## 1.0 SUMMARY

In August 2001 Pretoria Portland Cement Company Limited ("PPC"), a leading cement manufacturer incorporated in the Republic of South Africa filed an application for authorisation to acquire the entire issued share capital of Portland Holdings Limited ("Porthold"), a leading manufacturer of cement incorporated in Zimbabwe and largely owned by Anglo American Corporation.

The transaction constituted a horizontal merger in terms of section 2 of the Competition Act 1996. Horizontal mergers have potential adverse effects in the economy as they usually reduce competition in instances where they create monopolies, reduce number of players in the market and facilitate coordinated interaction. Because of these potential adverse effects horizontal mergers need to be critically examined by the competition authority.

## 2.0 FACTUAL AND LEGAL CONTEXT

Section 35 of the Competition Act 1996 provides that *any person who proposes to enter into any agreement or arrangement (including mergers and acquisitions) which he considers may be prohibited, restricted or otherwise affected by the Competition Act may apply to the Competition Commission for its authorization of such agreement or arrangement.*

"Horizontal merger" in terms of section 2 of the Act as *the acquisition of a controlling interest in an undertaking involved in the production or distribution of any commodity or service where the person who acquires the controlling interest already has a controlling interest in any undertaking involved in the production or distribution of the same commodity or service.*

The following is the rationale for the acquisition as presented by PPC to the Commission. Anglo American Corporation has, in line with its vision to refocus its operations on identified core activities (principally mining), been disposing of its non-core investments.

Whilst Porthold has been able to capture the largest market share of local cement industry on its own, its lack of association with a large cement producer has now become a serious threat to its competitiveness. Cement production is a capital-intensive industry, which requires significant periodic investment in plant and machinery. By its capital-intensive nature, the amounts required tend to be large and returns on such investments tend to be in the long term. The recent global trend is for cement companies to merge and create synergies and cost efficiencies to remain competitive. Of late, mergers or take-overs have been witnessed with regard to Lafarge S. A. ("Lafarge") (a major French manufacturer of cement) taking over Blue Circle Industries Plc of the United Kingdom. Lafarge have also recently acquired the cement interests of the Commonwealth Development Corporation in Zambia (Chilanga Cement Plc), Malawi (Portland Cement Company Limited) and Tanzania (Tanzania Portland Cement Company Limited). Lafarge, through Blue Circle Industries Plc, owns Circle Cement Limited the second largest manufacturer of cement in Zimbabwe. This makes Lafarge an extremely powerful player in the regional market in the

south eastern area of central Africa and leaves Porthold facing the threat of losing its export markets in Zambia.

Anglo American Corporation Zimbabwe Limited ("Amzim") hold approximately 49% of Porthold shares and control the board of directors of Porthold. In addition, two pension funds associated with Amzim are also shareholders in Porthold and together with Amzim hold more than 50% of the Porthold shares.

- Some of the anticipated benefits to be derived from this transaction, according to the submission by the merging parties include the following:

- significant foreign currency inflows into Zimbabwe.

- in addition, there would be significant capital investment over the next few years commencing with the new slag dryer to be installed during the course of 2001. This would enhance Porthold's efficiency as a low cost cement producer, expand its production capacity and thus place it in a better position to expand its export capabilities in the SADC region.

- additional efficiencies in production that will result from Porthold being linked to a major cement producer operating a low cost plant.

- as a low cost producer, Porthold will be able to take advantage of export opportunities in all the surrounding countries. This should result in up to 25% of Porthold's turnover being export sales.

- PPC plans to introduce a wider product range and promoting the reduction of costs and the development of new techniques.

- The experience that PPC has gained in competing with large international cement companies will be adapted to include Porthold which will ensure an effective strategy in Zimbabwe.

- maintaining and promoting effective competition between cement producers in Zimbabwe.

PPC announced in the local newspapers its intention to acquire Porthold from the existing shareholders. The Commission advised PPC to apply and subsequently a voluntary application was submitted (section 35).

## 3.0 PROCEDURAL ASPECTS

The analysis of the acquisition was largely based on information supplied by the merging parties. The acquiring enterprise made a presentation on the proposed transaction to the Commission staff. This was followed by a formal submission of the application form on the proposal for consideration by the Commission.

Additional information to enable the Commission to make a balanced assessment of the transaction was obtained from other firms producing and distributing the same products, and major users of cement in Zimbabwe. The Commission staff also conducted factory visits to Porthold and other cement companies in Zimbabwe in order to understand and appreciate cement-processing operations at the plant level.

The examination of the merger was done by the Directorate, which presented a report on its findings to the Board of Commissioners.

## 4.0 COMPETITION ANALYSIS

### 4.1 Market definition

All the cement companies in Zimbabwe produce "Portland Cement" (PC) in both PC15 and PC45 varieties. The varieties meet the Standards Association of Zimbabwe specifications. The PC15 variety has a shorter setting period than the PC45 variety and produces stronger concrete. The Commission identified the relevant product market as "Portland Cement". Although the merging parties manufacture other cement related products they constitute an insignificant portion of their core business.

Cement is relatively expensive to transport being a high-bulk/low-value commodity. The local market is split into geographical segments because cement producers and customers try to minimize freight costs

Despite this geographical specialisation it appears that all cement manufacturers could sell throughout Zimbabwe if the other suppliers increase their prices to a moderate extent. Consequently the relevant geographic market appears to be the whole of Zimbabwe.

### 4.2 Market structure

There are four cement-manufacturing companies in Zimbabwe and Porthold is the leading producer. One company is involved in cement production at secondary stage (blending).

Zimbabwe has now a combined national installed cement capacity of 2 000 000 tonnes per annum (tpa). The current actual production is about 1 220 000 tpa. Table 1 below shows the current production and plant capacity.

**Table 1**

**Local Current Cement Production and Installed Plant Capacity**

| Producer | Plant Capacity (tpa) | Estimated Actual Production (tpa) |
|---|---|---|
| Porthold | 1 200 000 | 600 000 |
| Circle Cement | 400 000 | 350 000 |
| ZimCement | 100 000 | 90 000 |
| Sino-Zimbabwe | 300 000 | 180 000 |
| | 2 000 000 | 1 220 000 |

### 4.3 Market concentration

Table 2 shows the market shares of the four cement firms and the respective concentration ratios. The shares were calculated using current production levels.

**Table 2**
**Cement Market Shares and Concentration Indices**

| Producer | Quantity Supplied (tpa) | Market Share (%) | HHI | CR4 |
|---|---|---|---|---|
| Porthold | 600 000 | 50 | 2 500 | |
| Circle Cement | 350 000 | 28 | 784 | |
| ZimCement | 90 000 | 7 | 49 | |
| Sino-Zimbabwe | 180 000 | 15 | 225 | |
| | 1 220 000 | 100 | 3558 | 100 |

Hirschman-Herfindahl Index and the CR4 were used to measure market concentration although they have limitations in small economies such as Zimbabwe.

### 4.4 Barriers to entry into the market

The cement market is a relatively high barrier market. It requires huge capital outlay and access to key raw materials especially limestone. Leading cement producers have mining rights over all the known limestone deposits.

### 4.5 Evaluation

The Commission noted that the acquisition would not create a monopoly situation in the relevant market because there are other three firms that produce cement in the country. However, it was noted that the acquisition would create market dominance and dominance per se does not raise any competition concerns, the potential offence being abuse of this dominance.

Another important finding was that the acquisition would not lessen the degree of competition as PPC is not a participant in the Zimbabwe cement market. There will be no immediate increase in Porthold's market share in Zimbabwe as a consequence of the transaction. The changes will principally be at the shareholding level without technically changing the market structure. PPC is simply stepping into the shoes of Anglo American Corporation, the previous majority shareholder. Also the past market conduct of Porthold did not show anti-competitive practices due to coordinated interaction effect.

The Commission also accepted the efficiency reasons given for the acquisition and found other public interest benefits arising from the transaction and these include foreign currency accruing to the economy (about US$ 19 million) as former shareholders of Porthold receive their proceeds. Planned capital

injection by PPC of US$ 9 million over the next few years, employment creation as production expands and increased export revenue as surplus cement is exported to regional markets.

One concern noted by the Commission arising from this acquisition is the possibility that PPC or any other company that subsequently acquired Porthold may decide to close down the Zimbabwe plants and supply cement from South Africa or elsewhere given the surplus capacity existing in the South African cement market.

## 5.0 THE OUTCOME

The Commission concluded that on the whole, the acquisition does not raise serious competition concerns and authorised it. However, to take care of the concern that Porthold cement plants in Zimbabwe may be closed down the Commission signed an Undertaking with PPC to the effect that;

i) it will honour its commitment to maintain Porthold and continue the production of cement in Zimbabwe.

ii) should it dispose of Porthold, by sale or otherwise, such disposal shall be subject to the condition that Porthold will be maintained and continue the production of cement in Zimbabwe. PPC will consult with and inform the Commission of any planned disposal of Porthold before proceeding with such disposal.

# Report on Investigation into Allegations of Restrictive and Unfair Trade Practices of the Cement Industry of Zimbabwe

*Industry and Trade Competition Commission*
*Zimbabwe*

## 1.0 SUMMARY

The two largest cement companies in Zimbabwe, Portland Holdings (trading as Unicem), of Bulawayo and Circle Cement Limited (Circle Cement) of Harare, both of which manufacture the 'Portland Cement' (PC) variety were alleged to be abusing their dominant position in the Zimbabwe cement industry. It was alleged that they, either individually or collectively engaged in restrictive and unfair trade practices leading to shortages and excessive prices of cement in the domestic market.

## 2.0 THE LEGAL AND FACTUAL CONTEXT

Investigations into the competition concerns were triggered in December 1998 by various allegations of restrictive and unfair trade practices emanating from newspaper reports and from some cement merchants. The following restrictive and unfair trade practices were unearthed by a preliminary assessment of the cement industry by the Commission staff:

i. Vertically restraining cement deliveries to customers through Bak storage (Pvt) Limited of Harare and Zimbabwe General Supplies (Pvt) Limited of Bulawayo (Unicem).
ii. Discriminatory distribution of cement in favour of certain companies (both Unicem and Circle Cement).
iii. Bundling/Tying cement sales to transport services provided by supplier (Circle cement).
iv. Refusing to deal with competitor and raising rivals' costs (both Unicem and Circle Cement).
v. Collusive and cartel-like behaviour between Unicem and Circle Cement.

Restrictive and unfair trade practices are competition concerns emphasized and outlined in the Competition Act, 1996 (hereinafter called the Act). According to the Act, the definition of *restrictive practice* is:

"(a) any agreement, arrangement or understanding, whether enforceable or not, between two or more persons; or
(b) any business practice or method of trading; or
(c) any deliberate act or omission on the part of any person, whether acting independently or in concert with any other person; or
(d) any situation arising out of the activities of any person or class of persons;

which restricts competition directly or indirectly to a material degree, in that it has or is likely to have any of the following effects –

(i) restricting the production or distribution of any commodity or service;

(ii) limiting the facilities available for the production or distribution of any commodity or service;
(iii) enhancing or maintaining the price of any commodity or service;
(iv) preventing the production or distribution of any commodity or service by the most efficient or economical means;
(v) preventing or retarding the development or introduction of technical improvements in regard to any commodity or service;
(vi) preventing or restricting the entry into any market of persons producing or distributing any commodity or service;
(vii) preventing or retarding the expansion of the existing market for any commodity or service or the development of new markets therefor."

The Act simply defines *unfair trade practice* as a restrictive or other conduct specified in the First schedule. Unfair trade practices specified in the First Schedule to the Act include "undue refusal to distribute commodities or services", "bid-rigging" and "collusive arrangements between competitors".

Restrictive practices are contrary to the public interest if they are engaged in by a person with substantial market control over the commodity or service to which the practice relates (Section 32(2) of the Act). They are only permissible in particular instanceS where the public consideration criteria outlined in that section is met.

A restrictive practice that is an unlawful trade practice is deemed to be absolutely contrary to the public interest (Section 32(30 of the Act). Section 42 of the Act prohibits all unfair trade practices specified in the First Schedule to the Act.

## 3.0 PROCEDURAL ASPECTS

A preliminary assessment concerning the alleged restrictive and unfair trade practices was carried out by staff of the Commission in order to establish whether there was a *prima facie* case to warrant an investigation by the Commission in accordance with the provisions of the Competition Act. Evidence collected at that stage showed that the two local cement manufacturers, Unicem and Circle Cement either individually or collectively might be abusing their market dominance of the local cement industry as alleged. The Commission considered a preliminary report compiled in January 1999 and agreed with the recommendation that an investigation into the cement industry in terms of section 28 of the Act be conducted.

In September 1999 the Commission made known in the *Zimbabwe Government Gazette,* and in all the major newspapers, that it was embarking on an investigation in terms of Section 28(1) of the Competition Act into the cement industry since it had reasons to believe that restrictive trade practices existed in the supply and distribution of cement on the local market. Interested persons or parties were requested to submit written representations on the matter within thirty days from the date of the announcement.

The Commission decided to seek additional comments and views from other interested parties in order to get a wider representation on the matter since the response to the public announcement had not been that encouraging. Other interested parties identified included cement manufacturers, cement merchants, building contractors, local authorities and Government departments as well as those companies and organisations that had provided information at the initial stage. In this

regard, the staff of the Commission visited and collected relevant data from all the major centres in the country. They also visited a company that does not manufacture cement but blends PC15cement it procures from Unicem with ground-granulated blast furnace slag to produce a special type of PBFC cement.

The Commission having powers given under the Commissions of the Inquiry Act [*Chapter 80*] held public hearings.

A total of twenty-five organisations gave oral evidence at the public hearings. Some companies and organisations (both in the private and public sectors based in various centres) that had volunteered to appear at the public hearings failed to do so for various reasons. Some of the oral evidence given at the public hearings identified new public interest concerns in the supply and distribution of cement on the local market, the need arose to continue with enquiries after the hearings. Additional information was therefore gathered from other construction companies and cement merchants urban and rural councils and other public organizations who failed to appear at the public hearings. A number of informal cement traders were also approached but were reluctant to give nay information on their operations except the selling prices of their product.

All the above evidence collected from the various sources was analysed by Commission staff and members of the Commission in terms of the provision of the Competition.

## 4.0 COMPETITION ANALYSIS

The evidence was analysed in terms of actual and potential direct competition concerns and other public interest concerns.

There are currently two major companies involved in the manufacture of cement in Zimbabwe, Unicem and Circle cement. Two other companies were involved in cement production at secondary stage. The actual production of cement was 1,436,000 tonnes per annum against a demand of 1, 575,000 tonnes, thus leaving a supply shortfall of 140,000 tonnes per annum. Unicem had a market share of 60%, Circle Cement 31% ZimCement 4% and imports constituted 5%.

Both Unicem and Circle Cement have substantial control over the distribution of cement on the local market either collectively or individually. Collectively, the two companies command 91% of the market share of the highly concentrated local cement market which has only three producers. Individually, while it would seem as though Unicem dominates the market with a higher 60% market share, Circle Cement's 31% market share is also substantial and gives that company considerable market power. The nature of the product itself also lends itself to the creation of spatial monopolies because of the high costs involved in the transportation of cement from one region to the another. As a result, the natural market of Unicem is in the southern part of the country, in which the company has substantial market control over the distribution of the product, while that of Circle Cement is in the northern part, in which the company also has substantial market control.Cement industries are very difficult to enter due economies of scale (both technical and pecuniary), sunk costs, governmental regulations and controls over strategic resources.

Restrictive and unfair trade practices are competition concerns emphasized and outlined in the Competition Act, 1996. Evidence was given that Unicem restricts the distribution of cement

through its preferential cement collection system with Zimbabwe General Supplies of Bulawayo and Bak Storage of Harare. Unicem confirmed that it had a transport and distribution contract with Zimbabwe General Supplies covering the Bulawayo and with Bak Storage covering the Harare area, and admitted that it discriminated against non-transport contract customers in cement deliveries. It put forward an efficiency defense that it wanted to concentrate on its core business, cement production. The conduct constituted a restrictive practice that is prohibited under the *rule of reason* approach but not *per se* prohibited by the Act. Unicem and Circle Cement discriminated against small and medium scale construction companies in favour of large construction companies.

Unicem's practice of importing cement in the finished form at higher prices than those prevailing on the local market for locally produced cement could be viewed as enhancing or maintaining the market price of cement at a higher level. Its active involvement in cement in imports could therefore put the company in a serious conflict of interest in that its imports directly compete with its production. Evidence showed that it was mainly involved in imports during periods of acute shortage on the local market. The percentage changes in Unicem's cement prices were generally higher than those of Circle Cement that was not involved in cement imports. It became apparent that the problem of high cement retail prices on the local market was directly being caused by the exorbitant prices being charged by some unscrupulous cement merchants in the formal sector and by the informal cement dealers.

While no evidence was received during the investigation to the effect that either Unicem or Circle Cement actually prevented the distribution of cement by the most efficient or economical means, there was evidence to show that both companies supported or promoted the inefficient and uneconomical distribution of their cement. Unicem's practice of allowing its customers to queue for cement for up to four days was found to be hardly an efficient or economical way of distributing the product. The same conclusion was also reached regarding Circle Cement's insistence that customers use Circle cement's transport trucks in collecting cement. Both companies admitted that the distribution was flawed in that respect.

A prospective new entry into the cement industry, The Industrial Development Corporation (IDC) had hinted that Unicem had tried to frustrate its construction of a new cement plant by refusing to supply the required cement. No strong evidence was found other than that Unicem discriminated against IDC in favour of its Bulawayo customers.

No evidence was given that either Unicem or Circle Cement unduly refused to give cement to anyone. There was also no evidence of bid-rigging. Allegations that Unicem and Circle Cement are engaged in collusive and cartel-like behaviour could not be substantiated.

A number of public interest considerations were identified in addition to the competition concerns. The issue of irregular supplies and long delays in the delivery of cement by both companies and the insistence on payment of cash up-front despite these long delays are examples of public interest considerations that were examined.

The Competition Commission made orders in terms of Section 31(1) of the Act to the competition concerns arising from the restrictive practices identified from the investigation into the local cement industry that;

(i) that Unicem stop giving preference to its transport contract customers thereby reducing thereby reducing the queuing times of its other customers.

(ii) That Circle Cement give its customers a choice in selecting the most suitable and competitive form of transport to collect their cement.

The enforcement of such order would be closely monitored to safeguard against the re-emergence of such restrictive practices in the cement industry.

It was clear that the structural under-supply on the local market contributed to a a large extent to the employment of those restrictive practices.

The following recommendations arose from the shortcomings closely related to competition concerns.

(a) Unicem and Circle Cement should at provincial and district levels and at Growth Points expand their cement distribution network in co-operation with local developmental quasi- government agencies.
(b) Unicem should when awarding its transport and distribution contracts endeavour to act in a fair and transparent manner to enhance efficiency in cement distribution.
(c) The Minister of Finance should remove sales tax on cement sales below 20 bags in order to increase the competitiveness of small cement merchants.
(d) The Zimbabwe Investment Centre and other related agencies should encourage and support the establishment of economical and less capital-intensive cement production plants in smaller centres to allow new entries to stimulate competition.

# Report on Investigation into Allegation of Restrictive and Unfair Trade Practices in the Coal Industry of Zimbabwe

*Industry and Trade Competition Commission*
*Zimbabwe*

## 1.0 SUMMARY

The Commission investigated allegations of restrictive and unfair trade practices in the distribution of coal on the local Zimbabwean market by the country's sole producer of coal, Wankie Colliery Company Limited (WCC). It was alleged that WCC was abusing its dominance by putting barriers to entry into the coal distributing industry and arbitrarily imposing exorbitant coal price increases.

## 2.0 THE FACTUAL AND LEGAL CONTEXT

In February 1999 R.A.E. (Pvt) Limited of Harare complained to the Competition Commission that WCC was frustrating its efforts to becoming a coal merchant through what it viewed as unreasonably harsh entry requirements. WCC appointed coal merchants to distribute its product, coal, using its laid down criteria. During a preliminary assessment by the Commission to establish a *prima facie* case WCC agreed to give the complainant a chance to operate as a coal merchant and the case was temporarily closed. In June 2000 R.A.E (Pvt) Ltd submitted a fresh complaint to the Commission alleging that WCC was still bent on frustrating its coal distribution project. It was alleged that WCC's conditions relating to the company's trial period as a merchant were specifically designed to discourage the company from entering the coal distribution industry, and that WCC discriminated against the company in the supply of coal. Also in June 2000, The Zimbabwe Iron and Steel Company Limited (Ziscosteel) complained that WCC was abusing its monopoly position in the supply of coal in Zimbabwe by unduly hiking the prices of the commodity.

Section 28(1) of the Competition Act (herein after called the Act) authorises and empowers the Commission to investigate any restrictive practices or monopoly situation which it has reason to believe exists or may come into existence. The market conduct of WCC fell under the definition of a restrictive practice in terms of the Act and could also be regarded as a monopoly as defined by the Act

## 3.0 PROCEDURAL ASPECTS

The Commission undertook a preliminary investigation into the allegations of restrictive and monopolistic that established a *prima facie* case for a full-scale investigation in terms of the Act. The allegations to be investigated were as follows;

(a) that WCC was putting barriers to entry into the coal distributing industry and was not applying its requirements for appointment as a Coal Merchant in a fair and transparent manner;
(b) that WCC was unfairly allocating coal, particularly the popular washed peas, amongst the appointed Coal Merchants;
(c) that WCC was abusing its monopoly position in the supply of coal on the local market by arbitrarily imposing exorbitant coal price increases;
(d) that bottlenecks in the transportation of coal from the Colliery by rail, which is the most



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economical method of coal transportation, were contributing to the shortage of the product on the local market.

A General Notice announcing the commencement of the investigation and calling on interested persons or parties to submit written representations on the matter appeared in the *Zimbabwe Government Gazette* of 6 April 2001. The investigation was also advertised in all the major national newspapers during the same month. The investigation's public hearings were held on 19 June 2001 under the powers vested in the Commission by the Commissions of Inquiry Act [*Chapter 80*].

A total of eleven companies and organisations submitted written representations on the allegations under investigation, while sixteen gave oral evidence at the public hearings. The respondents were a fair representation of the stakeholders in the entire coal industry. These included WCC itself, coal merchants and major users of coal and the National Railways of Zimbabwe among others. The Chairman of the Commission chaired the proceedings in which Commission staff and other Commissioners also attended..

## 4.0 COMPETITION ANALYSIS

WCC supplies Zimbabwe's total coal requirements except for low-sulphur coal and coke, which are imported in small quantities. The major coal consumers of coal in Zimbabwe are Zimbabwe Electricity Supply Authority (ZESA), Ziscosteel, National Railways of Zimbabwe (NRZ), the agricultural industry and various smelting and industrial concerns. WCC distributes coal to its customers either direct or through appointed coal merchants. Direct consumers are those who consume more than 20 000 tonnes of coal per month. Appointed Coal Merchants are automatic members of the Coal Distributors Association (CDA) which is an extension of WCC's marketing department.

The local distribution market covered by appointed merchants is highly concentrated with thirteen merchants located at different major centres of the country. WCC's requirements for one becoming an Appointed Coal Merchant are stringent and include high financial liquidity, wide customer base and control of a rail siding.

The relevant product market investigated was coal, including coke. Coal is supplied in various sizes in the washed or unwashed form. The relevant functional markets are production and bulk supply (WCC), distribution (appointed coal merchants and WCC) and importation (few direct consumers). The relevant geographic market is in two parts. The first is the broad market covering the whole of Zimbabwe and handled at the production and bulk supply level. The second is the smaller market covering regions of the country and handled at the distribution level. WCC has a virtual monopoly in the production of coal and, to a large extent through its appointed coal merchants, through its distribution in Zimbabwe.

The entry barriers to the coal production are very high. Coal production is a capital-intensive operation that requires large investment in exploration, plant, inventories and rehabilitation. The industry is subject to stringent Government safety and health regulations. Entry barriers to the coal distribution are however more moderate. Apart from WCC-imposed requirement of building a railway siding, other barriers are financial resources for carrying sufficient stocks and meeting WCC's strict payment terms.

R.A.E.'s assertion that it was being discriminated against by WCC in coal deliveries was difficult to substantiate. RAE was not and a confirmed Approved Coal merchant and hence should not expect the same treatment accorded Coal Merchant. Even if it were approved, its market share was significantly very low, 1.6 compared to other Approved Merchants such as George Elcombes which had 29.5% and Lakas 40.6%. WCC gave evidence that R.A.E. had not qualified as a an Approved Coal Merchant

because it did not have a large portfolio of customers and in the same breadth admitted that it was unable to meet most of its customers' coal requirements. Other Approved Coal Merchant gave evidence that WCC failed to supply them with their requirements. It became apparent that WCC was not given a chance during the trial period of becoming an Approved Coal Merchant since WCC did not supply it with adequate coal to meet the required minimum business generated of 48 000tonnes per annum. RAE had sought political pressure to force WCC to supply it with coal and WCC had hence abandoned RAE's application consideration exercise before completion.

The availability and allocation of coal was erratic making it impossible for coal merchants to maintain minimum levels of stocks as provided for in their Memorandum of Agreement with WCC. WCC attributed this state of affairs to the frequent breakdowns in the coal processing plant. The shift in demand from the larger size grades of coal to the popular small peas due to technological changes had caught WCC off guard since it still used an old crushing and screening plant commissioned in 1964. This inevitably led to shortages in the market. The significant shortfall and increasingly erratic supply of empty wagons by NRZ was cited as another major cause of the erratic deliveries. WCC gave increased allocations of washed peas to those customers who were prepared to buy the less popular larger sized grade but no customer was ever denied the more popular washed peas. The conditional selling was a loose one. WCC's practice of diverting on the rail coal consigned and destined to one coal merchant or customer to other destinations 'in greater need' without full consultation with the affected original consignee was anticompetitive.

The memorandum of Agreement WCC had with its Approved Coal Merchant forced the coal merchant to operate as a market –sharing cartel which is *per se* prohibited by the Act since it is deemed an unfair trade practice. However evidence showed that this was not rigid and that merchants freely sold to other merchants' zones. WCC's practice of dictating to its approved Coal Merchants the level of mark-up the merchants put on the sale to their customer is referred to as *resale price maintenance.* The Commission did not challenge it since the resale price maintenance specified the *maximum price* at which coal should be sold to customers and not the more competition damaging *minimum price.*

WCC's production costs that are incorporated in its coal pricing determination include; (I) plant and machinery that require foreign-sourced spares (ii) energy costs including electricity and fuel costs accounting for 25% of the operating costs (iii) interest charges (iv) salaries and wages. Transport costs constitute as much as two thirds of delivered cost of coal to customers. All the above costs are beyond WCC's control and are rapidly increasing. The cost-plus pricing method was not challenged since no other alternative coal pricing method could be offered.

WCC allowed the bad blood created between its management and that of RAE (Pvt) Ltd to influence its treatment and determination of RAE (Pvt) Ltd's application for appointment as a Coal Merchant. The zoning of provisions in WCC's Memorandum of Agreement with its appointed Coal Merchants (which have since been removed) created an anticompetitive market-sharing cartel in the coal distribution industry.

WCC only abused its monopoly position in the local industry in so far as it engaged in conditional selling of its popular washed peas grade to move its other less popular grades. The investment by WCC in a new coal crushing plant and screening plant at the Colliery would go a long way in alleviating the acute shortage on the local market of the popular washed peas coal grade.

WCC was already discussing the coal supply and distribution problems with various stakeholders such as ZISCO, the NRZ and other major coal consumers with a view to finding solutions to the problems. Most

of the problems in the local coal industry could be adequately addressed if that industry was included under the Zimbabwe Regulatory Commission.

On the basis of its investigations, the Commission ordered Wankie Colliery limited in terms of section 31(1) of the Act to do the following;

(a) to resume and complete within thirty days its consideration of R.A.E. (Pvt) Ltd 's application for appointment as a coal merchant on the basis of its Requirements for appointment as Coal Merchants already submitted to R.A.E. (Pvt) Ltd.
(b) To disengage itself from the restrictive practice of selling any of its grades of coal on condition that the buyer also purchases any other grades.

In addition the Commission also requested Wankie Colliery Company in terms of section 30(1) of the Act to give a formal Undertaking to the effect that it will not re-introduce market-sharing provisions in its Memorandum with Approved Coal Merchants or other coal merchants. The Commission also requested Wankie Colliery Company to engage in dialogue with other stakeholders in the coal industry to find solutions to other identified problems that came to light during the hearing.

The Commission recommended to the Ministry of Mines and Energy that the coal industry be included under the proposed Zimbabwe Energy Regulatory Commission and that the Competition Commission be consulted on competition issues in the establishment of that regulatory agency. The Commission also recommended to the Ministry of Mines and Energy to urgently implement the recommendations of the 1996 Coal pricing Study that the Government should provide resources through the Mining Industry Loan Fund (and any other indigenous empowerment funds) to facilitate new entrants into the coal mining industry.

## Background Notes: OECD Seminar on Topics in Competition Policy

Market Definition
Market Dominance: Identification and Abuse
Horizontal Agreements
Vertical Restraints
Demonopolization

Market Definition

## 1. Introduction

The delineation of relevant markets is basic to effective enforcement of competition laws, and is usually the necessary first step in the analysis of any conduct. To define a relevant market is to describe the context in which certain economically harmful conduct could take place. Thus, the process of market definition proceeds "backwards." It begins by provisionally assuming certain anti-competitive conduct exists. It then proceeds to define, through a series of questions, the boundaries of the smallest market in which such conduct could be sustained. Then, after the market is defined, the actual conduct in question is examined to determine whether it has or could have an anti-competitive effect.

Identifying relevant markets is equivalent to identifying which products are substitutes for one another, i.e., identifying which products compete with one another. Identification of relevant markets makes possible the identification of firms that compete to supply those products. This makes possible the determination whether, for example, an agreement is an agreement among competitors or whether an enterprise has a large market share.

This note presents a theoretical approach to market definition even though competition officials will often lack the time, resources and information to apply fully the theory. However, the theory of market definition provides a framework for investigations. The theory highlights the significance of some data, the irrelevance of other data and which additional data is needed. In addition, the theory can be used to develop analytical shortcuts.

A relevant market has two fundamental dimensions, product and geographic. (A third possible dimension, type of buyer, is relevant only when price discrimination -- charging different buyers different prices for the same product -- is possible. If there is price discrimination, then there may be two relevant markets with identical product and geographic definitions, one market with buyers who receive the higher price and the other with buyers who receive the lower price.) The product market describes the good or service. The geographic market describes the locations of the producers or sellers of the product.

A relevant market is defined by consumer, or buyer, preferences and actions.[14] Roughly speaking, if buyers consider two goods to be "close substitutes" or "readily interchangeable," then those two goods are considered to be in the same relevant market. For example, butter and margarine might be in the same relevant market. In contrast, even if sellers consider two goods to be very similar -- perhaps they are made on the same machines -- this fact does not affect the definition of relevant market. For example, if 13-inch automobile tyres and 14-inch automobile tyres are made by the same machines, but buyers do not substitute between 13-inch and 14-inch tyres, then the two sizes are in two different relevant markets. (The fact that the two products are made on the same machines would be important when competition officials identify suppliers or potential suppliers to a market.)

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[14] In this note, seller preferences and actions are not considered to be part of market definition, but rather part of a distinct process that follows market definition but which is necessary to the assessment of competition. Some competition authorities consider both buyer preferences and seller preferences to be part of market definition. This "difference" is largely one of approach, not of substance, and is discussed in more detail in part 6.

The second and third sections of this note describe the theoretical framework for determining the relevant product market and the relevant geographic market. The fourth section discusses market definition in the case of price discrimination and when markets can be agglomerated. The fifth section provides examples of some market definitions. The last substantive section discusses the identification of suppliers and entry barriers.

## 2. Product Market Definition

Different definitions of product market are used by various competition authorities. However, the definitions used in many competition offices[15] have in common the characteristic that product markets are defined by the interchangeability or substitutability of goods by buyers. In other words, goods that buyers consider to be substitutes are generally considered to be in the same product market and goods that buyers do not consider to be substitutes are generally considered to be in separate product markets.

One definition of a market is that it is,

> "A product or group of products and a geographic area in which it is sold such that a hypothetical, profit-maximising firm that was the only seller of those products in that area could raise prices by a small but significant and non-transitory amount above prevailing levels."[16]

In this note, a further qualification will be added: that the market be the smallest group of products and geographic area meeting the above criterion. In other words, a relevant product market is the smallest collection of products that buyers consider to be substitutes when the prices of those products, and only those prices, increase by a small percentage for the foreseeable future.

Each of the elements in the above definition is necessary. There are three important elements: 1) the price increase; 2) the reaction of buyers; and 3) the "smallest size" requirement.

### *2.a. Price increase*

The prices discussed here are real prices, i.e. prices adjusted for inflation. Because inflation indices only imperfectly adjust inflated prices and inflation complicates buyers' attempts to minimise costs (through making real prices difficult to measure), high inflation introduces further errors in market definition analysis.

The type of price change to which buyers are responding is a change only in the prices of the products controlled by the "hypothetical monopolist." The idea is to identify goods (or services) that buyers narrowly rejected when deciding which product to buy, but buyers would have bought if the price of the goods that buyers actually bought had been slightly higher. These narrowly rejected goods are the goods that compete closely for the buyers' custom. Other types of price rises will not induce this switching among substitutes. For example, if all prices rose by the same proportion, then relative prices would not change and buyers would not switch to buying substitute goods.

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15 In particular, the definitions of product market developed by the Court of Justice of the European Communities and written into the competition laws of some countries in transition and the Canadian and the American merger guidelines each differ somewhat from the others. Some specific definitions are given in the appendix. In application, there may be little difference among them.

16 *The Glossary of Industrial Organisation Economics, Competition Law and Policy Terms,* Paris: OECD (1993).

The price increase is non-transitory, i.e. the increased price is expected to continue for the foreseeable future. The reaction of buyers to a transitory, or short term, change in price may be different from their reaction to a long term change in price. Consider a hypothetical example. Assume that if cake bakers knew that an increase in the price of butter were temporary, then they would continue to use butter in baking cakes. Assume also that if they knew that such a price increase were permanent, then they would invest in developing a recipe that uses margarine. If competition officials considered only the reaction of bakers to transitory increases in the price of butter, then they would incorrectly conclude that margarine was not in the same relevant product market with butter. However, bakers would switch to margarine if the price of butter remained high for a long period of time, so butter and margarine are in the same product market.

A small increase in price is specified because only a small price change would identify as substitutes only close substitutes. A large price change would identify more distant substitutes. As a result, distant substitutes would be included in the same relevant market. Competition officials would then incorrectly believe that one product exerts a strong competitive pressure on another, when in fact it does not. If this error is made, then competition officials would make errors in decisions about the market share of an enterprise, the competitive effect of agreements among enterprises and other decisions that depend on the definition of the relevant market.

The price change is specified to be significant so that buyers react to the change in price. Because it is costly to learn about alternative inputs, a very small price change may cause no buyer reaction. While there is no precise standard for a "significant" price change, some countries (e.g., the United States and Canada) use 5 per cent in most contexts. One might use a larger percentage if the value-added at the relevant stage of production were small relative to the value of the product, or if high inflation makes real prices difficult to measure.

In practice, these perfect price experiments almost never occur. In periods of high inflation, for example, relative prices might change rapidly and randomly.

### *2.b. Consumer reaction*

Next, consider the reactions of consumers to the price increase. Some buyers switch their purchases from one good (or service) to another. Continue with the butter and margarine example, and consider the reaction of a single buyer who switches from buying butter to buying margarine. One can infer from that switch that he considers butter and margarine to be interchangeable for his use.

Consider now all the buyers who, at the old prices, bought butter. There are two possible extreme responses by those buyers to an increase in the price of butter. If "almost all" of those buyers switched to buying margarine instead, then margarine would be a substitute for "almost all" of the customers of butter, so margarine would be in the same market as butter. The other possible extreme response by buyers of butter is for "almost none" of the buyers to switch to margarine in response to the price increase. In this case, margarine is not a good substitute for butter so butter and margarine would not be in the same product market.

Sometimes, there is not an extreme buyer response to a price increase. It is rarely possible to state a precise percentage of buyers who must switch away from a product (or group of products) in response to a price increase for that product (or group of products) to not be a market. Also, that percentage would vary from product to product. Recall that our purpose is to define the smallest market in which a single "profit-

maximising" seller would raise price a small but significant amount above the prevailing price level. Thus, the question is whether or not a given switch by buyers in response to such a price increase is so large that such a price increase would be unprofitable for the seller. The answer to that question depends on several factors that are difficult to measure, including the amount of likely switching and the prevailing profit margin in the market.

### *2.c. "Smallest market" principle*

The final part of the definition of product market requires that the market be the smallest collection of goods or services for which the consumer reaction holds. This requirement prevents finding such illogical "markets" as butter, margarine and tractors. It also prevents enterprises that wish to lower their apparent market shares from being able, legitimately, to claim that non-substitute products are in the same relevant market.

### *2.d. Practical application of the theory*

In practice, much of the information that is required by the theory is not available. It is rare for there to be sufficient data to estimate the demand elasticity[17] of some group of products in the neighbourhood of prevailing prices. But this is exactly the information that the theory requires! In practice, competition officials must interview a variety of economic agents to gather sufficient information to be able to make reasonable inferences about the correct relevant product market. Economic agents who might be useful to interview include:

- -- buyers of the product;
- -- buyers of similar products;
- -- sellers of the product;
- -- sellers of the same product in another region;
- -- sellers of similar products;
- -- associations of buyers or sellers of the product;
- -- wholesalers and retailers of the product and similar products;
- -- statistical bureaus for the product;
- -- engineering firms or consultants who design the product or uses for the product.

Initially, the investigator will have to learn about the product or service. He will have to learn about its uses, its purposes, how it is made (if a good) or how it is provided (if a service). He will have to learn which characteristics are important to the buyers and the sellers.

Listed below are some possible questions for buyers and competitors. They are designed with an intermediate product -- a product that is not itself used by final consumers -- in mind. These questions would need to be modified before being used in an actual investigation and the questions actually used would be modified as investigators learned better what type of data would be most relevant to their own investigation.

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17 "Demand elasticity" is percentage change in quantity demanded divided by percentage change in the price of the product.

Current buyers can be asked questions such as:

-- Who are your current suppliers?
-- Who have been your suppliers in the past?
-- (if different) Why did you switch suppliers?
-- Who else have you considered as suppliers?
-- Why have you not bought from them?
-- What is important when you decide from which supplier to buy? Why?

The answers to this question might be some physical characteristics (such as energy efficiency or chemical purity), geographic origin (perhaps transportation is costly, difficult or inconvenient), characteristic of the supplier (provides timely delivery, has leading technology or provides on-site technical service) or regulation. The ideal follow-up questions will be specific to the case, but should build on the reason why a characteristic is important. There is likely to be some cost that is avoided in doing things a certain way. If this cost is significant, then what seemed to be substitutes, when one begins an investigation, are revealed to not be substitutes. Conversely, one might learn that apparently dissimilar goods or services are, in fact, alternatives because the costs are about the same and the cost of switching between them is low.

-- Is there a substitute for the product that you could use instead?
-- What would be necessary to substitute that product?
-- How much would that modification cost?
-- Would your cost of production rise? By how much?

Current sellers can be asked such questions as:

-- Who do you think your competitors are?
-- What must you do in order to convince buyers to buy from you (e.g., timely deliveries, advertise or pay for retailers' advertising, superior technical service)?
-- What must you do to convince buyers to switch from buying from one of your competitors to buying from you (e.g., provide independent test results, provide a discount in price for the first delivery)?
-- Is there a type of buyer who tends to buy from you rather than a competitor?
-- If so, how are they different from the other buyers and why do they prefer you? Why do the other buyers tend not to buy from you?

It is difficult to describe completely how to collect the information necessary for defining a relevant product market. Generally one starts with interviewing a few suppliers of what might be the relevant product. From them, one can learn what they consider to be the relevant product market (and why), who they consider to be their competitors, what is necessary for entry and get a list of customers. Then, one can interview customers to identify other suppliers and learn which characteristics are important in their choice of product to buy and which products actually are substitutable by buyers. Interviewing suppliers again, armed with the information about what buyers consider important, provides more precise information about the limits of the market.

### 3. Geographic Market

The principle of geographic market definition is similar to that of product market definition: the geographic market is defined by buyers' views of the substitutability or interchangeability of products made

or sold at various locations. In particular, if buyers of a product sold in one location would, in response to a small but significant and non-transitory increase in its price, switch to buying the product sold at another location, then those two locations are in the same geographic market, with respect to that product. However, if they do not consider the product sold in one location to be a substitute for one sold at the other location, then those two locations are in different geographic markets, with respect to that product.

In practice, the limits of geographic markets are often determined by transportation costs, tariffs and regulations. For example, the markets for sand, gravel, cardboard boxes, refuse hauling and other "heavy but low value" products are often quite small because the cost of transportation quickly becomes a large fraction of the cost of the product. Transportation costs can also indirectly affect the limits of geographic markets. For example, the manufacturer of a sophisticated and expensive machine may not be able to sell beyond its continent because the cost of providing technical service to customers -- transporting technicians or spare parts between the production plant and the machine -- may be too high.

Tariffs and other trade barriers can also limit the extent of geographic markets. If foreign producers of some product must pay a tariff -- and, of course, the domestic producers do not pay the tariff -- then the resulting increase in cost for the foreign product may be so large that domestic consumers would not buy the foreign product. In this case, the geographic market would not extend beyond the country imposing the tariff.

Regulations, such as for health and safety or licensing, can serve as barriers to the sale of some goods or services. For example, a dairy might be licensed to sell milk in one administrative region but not be permitted to sell milk in administrative units that have not certified the dairy. Another example is a nurse, licensed in one administrative region, who might not be permitted to work as a nurse in other regions.

## 4. Price Discrimination and Market Agglomeration

If sellers can price discriminate against some buyers, i.e. if they can charge different prices to different buyers and those differences in price do not reflect differences in cost of supply, then a third dimension to relevant markets is the type of buyer. For example, assume that there are two grades of cement and buyers in group A can use either grade but buyers in group B can use only the higher grade of cement. Assume also that the cost of selling cement to both types of buyers is the same. If a seller of the higher grade cement charges a high price to buyers in group B but a low price to buyers in group A, then the seller is price discriminating.[18] In this case, one relevant market might be "high grade cement sold to members of group B."

Sometimes, relevant markets defined by considering only substitutability by buyers are unwieldy. In an investigation, for example, relevant markets might consist of several different sizes of the same basic product (such as different sizes of automobile tyres or electric transformers for different voltages or powers) or the same product sold over different relevant geographic markets. To make easier the use of the data and to make easier public explanation of the findings of an investigation, it may be useful to agglomerate distinct relevant markets.[19] To limit the loss of information, markets can be agglomerated only in certain well-defined circumstances. Three such circumstances are:

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18 Price discrimination cannot happen if the two types of buyers can arbitrage, i.e. if the buyers who receive the lower price can buy "extra" quantities and then sell to the buyers who would be charged the higher price.

19 The agglomeration of markets is one type of supply substitution, which is discussed in part 6.

-- where the same set of suppliers sell, at essentially the same cost of supply and likelihood of success, to each of the relevant product or geographic markets (then markets meeting this criteria can be agglomerated);
-- where there is significant arbitrage by consumers across relevant geographic markets (then geographic markets can be agglomerated);
-- where two products are complements and used in fixed proportions by the buyers (then product markets can be agglomerated).

## 5. Examples

To this point, the note has been relatively theoretical. This section provides some short examples of delineating relevant product markets.

Consider a country that charges an 11 per cent tariff on imports of fertiliser. Fertiliser producers are located in both that country and adjacent countries. The cost of producing fertiliser is about the same for each producer. Farmers within the tariff-protected country would not switch to buying foreign-made fertiliser because its price (due to the 11 per cent tariff) is much higher than the price of domestic fertiliser. For farmers in the tariff-protected country, the geographic market for fertiliser is no larger than that country. For farmers in adjacent countries, the geographic market may be significantly larger than a country.

Consider automobile tyres. For each particular automobile, only a specific size of tyre can be used without costly modifications. However, sales data by size of tyre is rarely available and automobile tyre manufacturers almost always make the entire range sizes of auto tyres and have similar market shares in those various sizes. Therefore, the various sizes of tyres can be agglomerated. Another difference among automobile tyres is that some are produced especially for automobile manufacturers to be fitted to new automobiles as original equipment and others are produced and sold as replacement tyres. Special production methods are used on the tyres for sale to automakers, so they are of higher quality than replacement tyres. For automakers, tyres made for replacement are not substitutable for tyres made for original equipment. Therefore, there are at least two relevant product markets, automobile tyres for original equipment and automobile tyres for replacement.

Consider the question of whether electric razors are in the same product market as "traditional razors." Men tend to establish shaving habits: they either strongly prefer electric razors or strongly prefer traditional razors and they don't switch back and forth, even in response to large changes in relative prices. An important question is what forms these shaving habits, and how important non-price factors are. If these habits are relatively easy to change, then electric razors and "traditional razors" are in the same product market. Assume, however, that once established, these habits almost never change. This does not imply, however, that the two types of razors are in separate product markets: There are always teenagers, "new shavers," entering the market. Each of these must decide which type of razor to use and, because they have not yet formed any shaving habits, are responsive to changes in relative prices. Therefore, if "new shavers" constitute a large enough part of total demand, then the two types of razors are competitors and in the same market. If "new shavers" are a small part of total demand, then the two types of razors are not substitutes and are in different markets.

It might be useful to point out some of the counter-intuitive properties of a relevant market:

-- products do not have to be perfect substitutes to be in the same market;

-- products do not have to have identical qualities to be in the same market;

-- products do not have to have identical prices to be in the same market;

-- the relevant market will not necessarily correspond to a convenient jurisdictional or administrative area;

-- different parts of a relevant market can be subject to different consumer tastes and different sector shares;

-- the relevant market is not uniquely defined, and it is possible to have one relevant market within another relevant market;

-- if properly carried out the process of market definition must take place simultaneously with the assessment of competition.[20]

20 This list of properties is taken from *Market Definition in UK Competition Policy*, a report by NERA for the Office of Fair Trading, July 1992, p. 13.

## 6. Identification of Competitors and Entry Barriers

Once the relevant market has been defined, the suppliers to this market must be identified. The current suppliers obviously are included. The interesting question is whether there are other firms that ought to be included as potential suppliers even though they are not current suppliers to the market.

There are two broad classes of candidates for inclusion as potential suppliers:

- -- existing firms that currently own equipment or knowledge that can easily and quickly be switched to make the relevant product, but do not now make it, and existing firms that currently make the relevant product, but do not sell it in the relevant geographic market;
- -- other firms.

The first class of firms are those that would quickly enter the relevant market since they face very low entry costs. (Evaluation of entry barriers is discussed in the note on dominant position.) These firms should be included as current suppliers to the relevant market. These firms (sometimes called "uncommitted entrants") should be assigned market shares. While it may be difficult to calculate their market shares -- they have no current sales into the relevant market -- their shares might be assigned on the basis of their total capacity or capacity uncommitted to other markets.

The first class of firms may be larger in economies in transition than in economies with developed markets. For example, there may be enterprises that could have, and would have, made a product, but were prevented by regulation from doing so. After the removal of such regulation, such an enterprise is now free to make any products it wishes. Potential suppliers that currently sell outside the relevant geographic market may similarly arise with the removal of regulations assigning specific customers. For many products, there are many firms of this type when barriers to international trade -- tariffs, quotas, restrictions on the exchange of foreign currency and so on -- are low.

The second class of potential suppliers is probably very small for many products in economies in transition because there are such large difficulties in starting new manufacturing enterprises under such conditions. However, for other markets, such as markets in services, retail sales and distribution, new entrants may be important suppliers in economies in transition.

To evaluate the likely importance of new entrants, one must evaluate the <u>entry barriers</u> to the relevant market. In other words, one must examine the process and the unrecoverable costs that an enterprise, not currently supplying a market, must incur to become a supplier to that market. The specific steps might include: market research (learning what customers want to buy and what price are they willing to pay), renting/leasing/buying land or a manufacturing plant or a retail store location, hiring labour (engineers, accountants or whatever is needed), buying machinery, buying a license to produce a patented product, beginning production, selling a few units at a very low price so that potential customers will sample the product and advertising. Each of these stages requires money and time. There may be other barriers to entry, sometimes called strategic barriers to entry. These are costs that are caused by incumbent firms' actions. One example is an incumbent firm investing in very large but unused capacity as a threat to potential entrants that the incumbent will charge very low prices if any firm tried to enter the market. The sum of all these and similar costs is the size of the barrier to entry to the market in question.

Some markets have very low barriers to entry. For example, a street vendor needs only the capital to purchase his inventory, a table and (possibly) a license to sell. Some markets have very high barriers to entry. If these markets are large and profitable or are expanding, then the high barriers to entry will not keep

out entrants. But the real art in examining entry barriers is in balancing the size of the entry barrier and the future profitability of supplying the market to decide whether the future profitability is sufficiently large to outweigh the entry costs, so that firms would likely enter the market, or whether the entry costs outweigh the future profitability, so that firms would likely not enter the market.

The identification of these potential suppliers and the barriers to entry that they face is necessary for assessing the market power of the current competitors in the relevant markets. This assessment is treated in the note on the identification and abuse of a dominant position.

Some competition offices include the identification of suppliers and potential suppliers as part of market definition.[21] Such an approach would be valuable for competition offices charged with enforcing a competition law that defines "dominance" according to a market share criterion. Under such a law, an enterprise might be found to have a large market share, and hence be labelled as "dominant," even if there were many other enterprises that would immediately shift their production capacity into production of the relevant product if the so-called dominant firm were to behave anti-competitively. Clearly such an enterprise would not be dominant in the economic sense of the word and public resources should not be used for its monitoring or regulation. The use of a demand substitution plus supply substitution model for market definition would avoid this type of error.

The diagram below illustrates two different approaches to market definition.

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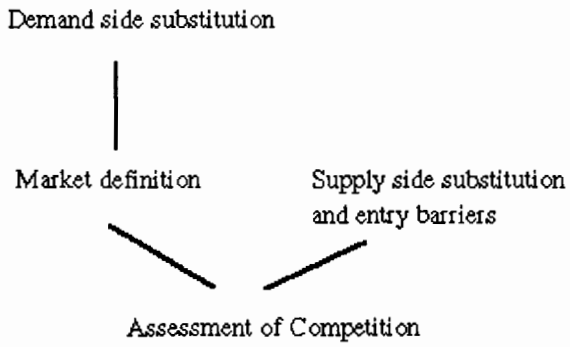
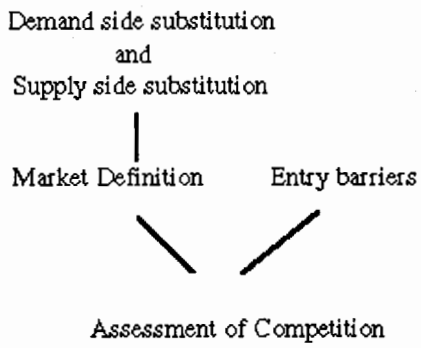
21 This is the case in, for example, the United Kingdom, Ukraine and Lithuania.

**Model 1 (presented here)**




**Model 2**




## 7. Conclusion

The theory of market definition is important in that it focuses investigations on the questions that are critical to the delineation of markets. The theory makes it easier to discern whether a crucial question is left unanswered or whether the critical facts are known and a market can, with sufficient confidence, be delineated.

In practice, defining a relevant market is sometimes only approximate. It is often difficult to predict the reactions of buyers to a price increase. Often, one must depend upon physical similarity or difference to delineate product markets. Sometimes, one must change the definition of a market to conform with available data. However, the experts in finding substitutes, and therefore in providing information for market definition by competition officials, are the current manufacturers and users of the product. They can identify the important characteristics, changes in technology that will change relevant markets and so on. Therefore, information gathered from the market participants is invaluable in the application of these concepts.

*Appendix: Definitions*

This appendix contains the definitions of relevant markets used in merger analysis in Canada, the United States and the European Communities and definitions of markets from laws of some countries in transition.

The 1991 Canadian Merger Enforcement Guidelines state that, "Conceptually, a relevant market for merger analysis ... is defined in terms of the smallest group of products and smallest geographic area in relation to which sellers, if acting as a single firm ("a hypothetical monopolist") that was the only seller of those products in that area, could profitably impose and sustain a significant and non-transitory price increase above levels that would likely exist in the absence of the merger." (section 3.1)

According to the 1992 United States Horizontal Merger Guidelines, "A market is defined as a product or group of products and a geographic area in which it is produced or sold such that a hypothetical profit-maximising firm, not subject to price regulation, that was the only present and future producer or seller of those products in that area likely would impose at least a `small but significant and non-transitory' increase in price, assuming the terms of sale of all other products are held constant." (section 1.0)

The closest comparable definition used in the European Communities is the definition of reference geographical market for use in the analysis of concentrations. A Council Regulation[22] states that, "The geographical reference market shall consist of the area in which the undertakings concerned are involved in the supply of products or services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighbouring areas because, in particular, conditions of competition are appreciably different in those areas. This assessment should take account in particular of the nature and characteristics of the products or services concerned, of the existence of entry barriers or of consumer preferences, of appreciable differences of the undertakings' market shares between neighbouring areas or of substantial price differences."

A recent decision by the Commission of the European Communities[23] states that, "A relevant product market comprises in particular all those products which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use." In determining the geographic market, the Commission considered barriers to importation of the product, costs of transportation and current and foreseeable patterns of sales between geographic areas.

In contrast, in another recent decision,[24] the Commission distinguished between two product markets not because of "a difference in the product itself or [in] the function of the product." Instead, the distinction is based "mainly on the fact that the conditions of competition differ significantly on the two markets, as a consequence of which the producers have to adapt their commercial and entrepreneurial policies to the different requirements of the two sales markets."

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22 *Council Regulation* (EEC) No.4064/89 of 21 December 1989 on the control of concentrations between undertakings, Article 9, paragraph 7.

23 Commission Decision of 2 October 1991 regarding the proposed concentration of Aerospatiale-Alenia/de Havilland.

24 Commission Decision of 31 July 1991 regarding the concentration of Varta/Bosch.

The definition of a market has been written into the competition laws of some of the countries undergoing economic transformations. In other countries, the concept of a market is implicit in the laws but the definition of a "market" will be developed through additional laws, regulations and jurisprudence.

In the Estonian law, a commodity market is defined as, "A sphere of circulation of goods and services in a given territory, which are substitutable by the buyer, considering price, quality, technical conditions, conditions of sale and other qualities."[25]

In the Lithuanian law, a market is defined as, "The total of certain goods involved in purchase-sales processes on the territory of [Lithuania] or part of it, and which regarding their qualities, use and price are compared in such a way that producers and consumers can substitute them for one another in the process of manufacturing or consumption."[26]

In the Ukrainian law, a market is defined as, "The sphere of circulation of goods of the same consumption value, within the boundaries of which a monopolistic position is defined."[27]

The above definitions illustrate that, generally (the Varta/Bosch decision being an exception), competition officials base their definitions of markets on what are substitutable or interchangeable products. Some consider only buyer substitution and supply by uncommitted entrants (taking into account supplier substitution at a later stage) whereas others (e.g. Lithuania and Ukraine) consider both buyer and supplier substitution at the market definition stage.

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25 Article 15, the Act of Competition.

26 Article 2, the Republic of Lithuania, Law on Competition (15 September 1992).

27 Section I, Article 1, Law of Ukraine on the Limitation of Monopolism and the Prohibition of Unscrupulous Competition in Entrepreneurial Activity.

# Market Dominance: Identification and Abuse

## 1. Introduction

Provisions against the abuse of a dominant position are common to many -- but not all -- competition laws. An economic definition of a dominance is that a firm holds a "dominant position" if, in a relevant market, it can behave substantially independently of its competitors.[28] Three distinct parts to the analysis are required for effective enforcement of such provisions. First, define the relevant market. Second, determine whether the firm under investigation has a dominant position. Finally, evaluate the specific activity of the firm to determine whether it is an abuse.

A dominant position does not exist in a vacuum. Simply being a large firm implies nothing about dominance. Instead, a dominant position is held in a particular relevant market. Given a relevant market, whether a firm is dominant is found by considering its exposure to competitive pressures. The market share of the firm is a useful first screen for learning whether it is dominant. However, market share is not the only factor to consider. Two other important factors are the size of barriers to entry into the relevant market and the likely competitive responses by rivals.

The discussion to this point has been essentially static. Dynamic change, however, is important to any evaluation of dominance. In markets undergoing rapid change, a firm with a large market share may not be dominant. Such a firm may not be dominant because the large share may be only temporary -- new rivals may soon enter -- or the market itself may be only temporary -- subsequent innovation may leave the product with no demand as consumers buy the next, improved version. Hence, it is important to consider not only the present environment in evaluating dominance but also to consider the future evolution of a market.[29]

Once a firm has been found to be dominant in a relevant market, it can be difficult to evaluate the effect on competition of a specific activity. Abusive activities can affect competition at any of several levels of production or distribution. Some actions by dominant firms can be pro-competitive or anti-competitive, depending on the circumstances. Some actions can harm some parties, yet be pro-competitive.

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28 The discussion in this note is based on an economic definition of dominance, not the definition of dominance under any country's law.

Under EC law, there is also a concept of "joint dominance," meaning that a group of firms, when considered together, holds a dominant position. This concept is not discussed here.

29 One should also consider the long-term effects of public policy directed toward preventing firms from enjoying a period of market dominance as their reward for innovating or risk-taking. Persistently dominant firms may behave anti-competitively to retain their position, and ought to be prevented from doing so. However, firms that are "dominant" for only a limited period of time may be competing not primarily through prices or quantities, but through innovation. In this sort of competition, at any given moment a firm may seem to be dominant. But, over a period of years, other firms may seem to be dominant as they make successful innovations and take the market from less successful rivals. Computer markets have this type of competition. The apparent profit made on each unit sold is very high. However, these profits are rewards for developing new, better computers. Over time, the dominant manufacturers in each computer market changes and some markets fade away. The firms are rewarded for undertaking the costs and risks of innovation by the high prices and high profits during their periods of dominance. If public policy prevents these profitable periods, then firms would invest less in research and development. Hence, what appears to be, in the short run, a policy in the public interest may, over the long run, not be.

Section 2 discusses the identification of a relevant market. Section 3 addresses the identification of a dominant position. The final substantive section discusses which actions constitute an abuse of a dominant position.

This note does not present a discussion of the offence, "abuse of a dominant position," under any specific jurisdiction. In particular, this discussion differs substantially from EC practice in some important respects. Instead, this paper discusses the topic only from the point of view of economics.

## 2. Relevant Market

For a firm to abuse a dominant position, it must hold a dominant position in a relevant market. Hence, the first step in an evaluation of a firm's actions is to define the relevant market. The definition of relevant markets is discussed in the previous note. Recall that relevant markets are defined by considering the substitutability or interchangeability of products by buyers. Goods that are close substitutes are generally in the same relevant market, and products that are not close substitutes are generally in different relevant markets.

However, defining a relevant market that is dominated by a single firm is more complex than defining a relevant market that is competitive. In fact, if the definition of relevant market presented in the note on market definition were strictly applied, then it is logically impossible to find a monopolist of a relevant market, if the monopolist has already maximised profits. In the note on market definition, a relevant market is defined as the smallest set of products and geographic area meeting the criterion,

> "A product or group of products and a geographic area in which it is sold such that a hypothetical, profit-maximising firm that was the only seller of those products in that area could raise prices by a small but significant and non-transitory amount above the prevailing levels."

Consider the case of an actual monopolist. An actual profit-maximising monopolist will have already raised prices of the products in the relevant market to the profit-maximising prices. Therefore, a hypothetical profit-maximising monopolist would not raise prices above those already prevailing in the market. Hence, the set of products sold by the actual monopolist logically cannot be found to be a relevant market under the above definition.

An escape from the logic trap is to compare the physical properties of products, differences in end uses, differences in consumers and historical patterns of sales. These data can be used to determine whether products are likely or not likely to be physically interchangeable. Interchangeable products would be assumed to be in the same relevant market. It is important, however, to not rely too heavily on physical similarities in defining relevant markets.

Another escape from the logic trap is to ask whether the "possibly dominant" firm would raise prices if one of its possible competitors were removed. If it would raise price, then the two firms are competitors and their products are in the same relevant market. If it would not raise price, then the two firms are not competitors and their products are in different relevant markets.

Another approach is to determine the relevant product markets in another, competitive, location and to assume that relevant product market definitions are universal.

## 3. Identification of a Dominant Position

A firm holds a dominant position if, in a relevant market, it can behave substantially independently of its competitors. That is, it holds a dominant position if it has "substantial market power." Market power is difficult to measure. Statutory monopolies, of course, have substantial market power. For other markets, however, finding whether a firm has a dominant position begins with learning the market shares of suppliers to the relevant market. If the firm has a sufficiently small market share, then it is presumed not to be dominant.

If the firm has a larger share of the market, then other factors -- such as the existence of barriers to entry or expansion by rivals, other firms' market shares, the nature of the product -- are evaluated to determine whether the firm has, in fact, a dominant position.[30] The size of entry barriers is important in that they indicate the level of competition which a firm faces from potential entrants. If entry barriers are low, so that firms would be faced with competition from new entrants if they anti-competitively raised prices, then even firms with large market shares do not have market power and cannot be dominant. On the other hand, if entry barriers are high, then the firm is protected from competition from any firm that is not already a competitor in the relevant market.

Similarly, if current competitors could quickly and substantially increase their sales if the firm under investigation behaved anti-competitively, then that firm cannot be dominant. If other firms have relatively small shares of the market, then there may be something that would hinder those firms from expanding to compete with the firm with large shares. Their products might be designed for special uses or they may have inadequate distribution channels, for example. In such cases, the other competitors may not be able quickly to expand their sales or production in competition with the possibly dominant firm. If they cannot, then the firm is likely to be dominant.

### *3.a. Measuring market shares*

Market shares can be measured in a variety of ways, i.e. by unit sales, value of sales or production capacity. In practice, the measure chosen is often determined by the available data.

The decision about how to measure market shares is especially important in jurisdictions where dominance is defined by law according to specific market share criteria, i.e. where the competition law states that a firm with market share above a certain level is presumed to be dominant. In these jurisdictions, it is particularly important to correctly measure the shares of firms that are not currently active in a market and of firms that are not operating at full capacity. For example, if a firm currently has 50 per cent of all sales in a market, but there are rival firms with large quantities of unused capacity that they could quickly begin to use, then the firm would not be dominant in an economic sense. (That firm could not behave anti-competitively because its rivals could quickly react and take sales from it.) However, in many jurisdictions, if sales were used to measure market shares, then that firm would be found to be dominant under the competition law. If instead, market shares were measured by capacities, then that firm may not be found to be dominant under the law. Hence, the legal environment in which competition officials work influences their choice of market share measures.

If products within a market are sufficiently homogeneous, then unit sales can be used to measure market shares. Market shares of heterogeneous products may be better measured by value of sales, under the

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30 Especially in economies undergoing price liberalisation and other rapid changes, dominance should not be inferred simply from the ability to raise prices. Rather, longer-term indicia of market power, especially the existence of barriers to new entry or to expansion by existing competitors, should be used to evaluate dominance.

theory that higher-priced units provide more "service" to the buyer and therefore should have more weight than lower-priced, presumably lower-quality units.[31]

Shares of capacity can measure market shares, but can be misleading when there are significantly different qualities of capacity. For example, assume that one firm owns two plants. Only 50 per cent of the units produced by one plant can meet the more rigorous technical specifications that can be met by 100 per cent of the units produced by the other plant. In this case, the full capacity of the first plant cannot be considered a possible supplier to customers requiring products meeting rigorous specifications. Hence, in measuring the capacity of the firm to supply such customers, only half of the capacity of the first plant cannot be counted.

One measurement problem is presented if some firms are vertically integrated and others are not. That is, some firms may sell all their output on the market, other firms may sell some of their output but use the remainder internally, and others may always use all their output internally, as an input into another process. For the firms that sell some of their output on the market, then probably all their production (or capacity) that is not committed to internal use should be "counted" as in the market: they would likely not suffer a high opportunity cost (lost profits from downstream manufacturing) from selling some additional production to the market.

For the firms that do not sell to the market, it is more likely that their production or capacity should not be "counted" as in the market. Attention should be given to whether there are substantial investments needed for marketing or distributing the product (such as a requirement for highly trained technical servicepersons or for a chain of distribution outlets) and to whether sale of the product provides significantly lower (marginal) profits than internal use. If there are barriers to selling on the relevant market, or if the firm would suffer a decrease in profits if it were to divert units from internal use to sale on the market, then the capacity or production or value of internal transfers of the vertically integrated firms should not be counted in making market share calculations. Otherwise, uncommitted capacity of vertically-integrated firms may be "counted" as in the market.

A different problem is presented by markets in which sales are not stable over time. This problem can arise when there are very few sales, such as for very unusual pieces of machinery, e.g. large steam turbines for electricity production. In this case, the variation in shares is a consequence of the indivisibility and infrequent sales of the product and statistical methods can be applied.

Another problem, perhaps especially important for economies in transition, is unstable sales due to noncyclical changes in the market. For example, if a new technology were recently introduced, and the firm with that technology has rapidly growing sales, should its current market share be counted or historical share or projected share? Alternatively, if buyers are operating at much reduced levels and only vertically-related suppliers make sales, then should current or historical market shares be measured? In these cases, current market shares may be uninformative and it may be useful to use "best estimates" of future sales shares because it is future competition, or dominance, that is of interest.

Having found a measure of market shares, the share of the possibly-dominant firm is evaluated to determine whether it is sufficiently large to indicate possible dominance.

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31 In fact, if market shares measured in units are substantially different from market shares measured in value, this could indicate that markets have been mis-defined. For example, firms' products may appear to be similar, but some firms may sell substantially more expensive and specialised versions to buyers who find the lower quality version to be unacceptable. In such a case, there are at least two product markets, the high-quality, specialised product and the low-quality product either alone or in the same market with the high-quality product.

### *3.b. Dominance-indicating market shares*

Economic theory, in itself, cannot suggest "rules of thumb" relating share of a market to degree of dominance. Where each firm has a small share, then it seems unlikely that any firm has market dominance, even if there are high entry barriers into a market. On the other hand, if only one firm supplies a market and it is protected by high entry barriers, then it is clearly dominant. The problem is that there is no percentage of a market above which economic theory implies that a firm is always dominant.

In various jurisdictions, "rules of thumb" have been established that relate market shares to dominance. For example, the Commission of the European Communities has said that it takes the view that a dominant position can generally be taken to exist when a firm has a market share of 40-45 per cent, and cannot be ruled out in the range 20-40 per cent.[32] In the United States, the legal provisions closest to those prohibiting abuse of a dominant position are those prohibiting "monopolisation" and "attempt to monopolise."[33] One summary of the case law states,

> "Courts consistently find market shares of 80-90 per cent and higher to be sufficient to conclude that the defendant is a monopolist. They also consistently find market shares of less than 50 per cent to be insufficient. A majority of courts are reluctant to find sufficient monopoly power when the market share is less than 70 per cent."[34]

Simply knowing a firm's market share is just the beginning of an analysis of dominance. The possible reactions of competitors and possible entrants is not measured by such a share. However, market shares might usefully serve as a screen, so that firms with smaller shares are presumed not to be dominant but firms with larger shares are subject to further scrutiny.

### *3.c. Barriers to entry*

The size of entry barriers to the market, i.e. the size of entry costs, is the second important factor in finding whether a firm is dominant. If there are no (or low) barriers to entry into a market, then even a firm with large market share has no market power. If other firms could enter a market quickly with little sunk cost,[35] and at sufficiently large scale, then firms in the market cannot act anti-competitively. That is, they

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32 Richard Whish, *Competition Law, 2nd ed.*, Butterworths: London, (1989), p. 294.

33 These two related offences are similar to "abuse of a dominant position" in the sense that activities that may be condemned if a firm is a "monopolist" or "attempting to monopolise" in the United States are the same activities as those that may be condemned if a firm is "dominant" in the European Communities, e.g. predatory pricing, price discrimination, vertical integration, and tying. Nevertheless, one jurisdiction's "dominant position" is not exactly another's "monopoly."

34 Herbert Hovenkamp, *Antitrust,* Black Letter Series, West Publishing Co., St. Paul, MN (1986), p. 106.

35 A "sunk cost" is a cost of entry that cannot be recovered upon exit. For example, assume that a new ice cream shop must spend $50.000 for advertising and $300.000 for specialised freezers. Assume that the freezers could be sold, in the used freezer market, for $200.000. If the ice cream shop decides to close, the advertising expenditure cannot be recovered. However, the freezers could be sold. Therefore, the sunk cost of entry for the ice cream store, in this example, is $150.000, of which $50.000 is the advertising expenditure and $100.000 is the loss on the freezers.

Where capital markets do not work perfectly, the distinction between sunk and non-sunk entry costs becomes less important. As a practical matter, where capital markets work poorly then the relevant costs are likely to be

cannot be dominant. The reason for this is as follows. Assume that there are very low entry barriers into a market, and that an incumbent firm has a large share. Assume the firm raises its price. Firms that were not originally suppliers to that market would recognise the high profits that could be earned in the market. They would recognise that entry costs are low. Therefore, they would enter the market. They could offer lower prices and take away the customers of the incumbent firm. With this threat of competition from new entrants, the firm with large market share cannot persistently act anti-competitively. It cannot be dominant.

There is a policy debate over what types of costs should be considered in assessing entry costs. One side argues that costs that must be borne by entrants but that were not borne by incumbents are the only type of entry costs which should be considered. For example, if the incumbent's mine was opened when receiving government permission cost $50.000, but now the cost of receiving government permission is $75.000, then, according to this view, only the increase in cost ($25.000) would "count" as a cost of entry. Another side argues that any cost that must be borne by entrants but is not currently borne by incumbents are entry costs which must be considered. In this example, $75.000 would constitute an entry barrier. Clearly, it is entry barriers of the second type that affect the probability that new entry will occur in response to anti-competitive action by the incumbents.

In practice, it can be difficult for competition officials to identify the barriers to entry of a market. Not being businessmen, they often do not appreciate all the elements of successful entry into a market. Examples of entry costs include:

- -- government regulations, which can either explicitly limit entry or be very costly to comply with;
- -- exclusive long-term agreements with suppliers of necessary inputs, so that new entrants cannot buy inputs;
- -- cost disadvantage if there are economies of scale (lower unit costs as a higher quantity of units are produced) and new entrants cannot quickly achieve sales at the low cost quantity;
- -- capital cost disadvantage if the incumbent has a cheaper source of capital than potential entrants;
- -- expenditure to overcome "strategic barriers to entry;"[36]
- -- expenditure to overcome "switching costs" of buyers, that is, costs which make it difficult for potential customers to switch from buying from the incumbent firm to buying from an entrant;
- -- expenditures to overcome the fact that "reputation" for high quality products is important. (This would be true for products where customers cannot easily inspect or test the product for quality and customers bear very high costs if the product is of unexpectedly low quality.)

In the last two cases listed, consumers would be unlikely to buy from a new supplier.

It can be difficult to determine whether a particular cost of entry is "low" or "high." This judgement is made in comparison with expected profits if a firm enters the market. Unfortunately, such profits are not easily predictable by competition officials.

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any cost of entry, not just sunk costs. In the example above, if the shop owner could not borrow to buy the freezers, but must already have the capital to buy them, then that fact in itself increases the barriers to entry.

36 A "strategic barrier to entry" is an entry barrier that results from actions of a rival firm. For example, if a rival has invested in large excess capacity in order to convince future potential entrants that they should not enter, then this investment would be called a "strategic barrier to entry."

In order to assess entry barriers, one might wish to ask the following questions:[37]

1. Are there potential suppliers or firms that could substitute production that could switch easily and quickly to the supply of the relevant market? (This is equivalent to the search for uncommitted entrants in the market definition note.)

   -- Are there other industries or markets that use a similar production technology?
   -- Are there producers that use similar distribution channels and distribution networks who could start production or acquire the relevant product?
   -- Are there firms that produce the relevant product in other geographic markets, not separated by large transport costs?
   -- Is there idle capacity in the industry?
   -- Are there vertically-integrated firms who could easily increase production to serve the market?

2. What is the recent history of entry? (Lack of successful entry is not sufficient evidence of entry barriers: perhaps the market is very competitive so there are no excess profits to attract entry.)

   -- Has entry occurred by investments in new capacity, acquisition of an existing supplier or by firms already producing similar products moving into a new (product or geographic) market? (If entry has been only by acquisition, then that says little about the existence of entry barriers. If entry has been by large scale investment in new capacity, then this suggests that barriers to entry are not high.)
   -- How long does entry take?
   -- Have conditions in the market changed substantially in recent years, i.e. deregulation, changes in tariff, laws, technology, demand conditions, prices of substitutes, new substitutes, etc.? (If so, then historical entry evidence may not be relevant.)

3. Assessment of absolute or cost advantages

   -- Do incumbents have any particular cost advantages vis a vis new entrants, i.e. control over scarce resources, patents, copyrights, trade secrets, expertise/experience, contracts with input suppliers?
   -- Are there any other cost advantages to incumbency?
   -- Are there any legal or regulatory barriers to entry which apply to entrants but not to incumbents? Licensing, certification, etc.?

4. Assessment of strategic (first mover) advantages

   -- How large are sunk costs, i.e. can equipment be leased, resold or transferred to other uses? Does equipment have a short useful life? Are there contract manufacturers? Are there contract distributors?
   -- Are there large fixed costs, i.e. are there significant expenditures on research and development, product development, advertising, distribution, etc.? Does the manufacturing itself have large economies of scale, i.e. do costs per unit fall significantly when only a small quantity is produced?

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37 The step-by-step process and many, but not all, of these questions are from *Barriers to entry and exit in UK competition policy,* Office of Fair Trading Research Paper 2, London Economics (1994), pp. 26-35.

-- How large are "switching costs" for buyers, i.e. how costly is it for a buyer to change from buying from one supplier to another, taking into account possible necessary changes in equipment or other inputs?
-- Is a reputation for quality necessary for significant sales? (If buyers can cheaply, before purchase, determine the true quality of the product or if the buyer does not suffer a large loss if the quality is bad is, then a reputation for quality is probably not necessary for significant sales.)
-- Is entry more difficult because of vertical foreclosure, i.e. do contracts or agreements between vertically-related firms increase the difficulty of entry? (For example, an exclusive dealing agreement could make entry more difficult for some firms under some circumstances. These are discussed in the note on vertical agreements.)

### *3.d. Other dominance-indicating factors*

In addition to market share and entry barriers, the likely response of current competitors should be considered in evaluating the dominance of a firm. If current competitors can respond quickly, substantially and inexpensively to anti-competitive behaviour by a large firm, then it cannot hold a dominant position. Current competitors are likely capable of such a response if they have large excess capacity, if capacity can quickly be expanded or if capacity to supply one market can quickly be re-directed to supply another market.

Another factor that might affect possible expansion by rivals is the nature of the product. Two of the entry barriers listed above, switching costs and reputation being important, can serve to limit expansion by current competitors as well as barriers to the entry of new competitors. For example, 1 cm pipe and 1.5 cm pipe may be substitutes for some use when the pipe is initially installed. However, once installed, replacement of one section of pipe can only be by pipe of the same size as the remainder of the system. Switching from one size to the other would incur large costs, as the entire installation would have to be replaced. If one company can make only pipe of size 1 cm, then it cannot rapidly expand its sales to take advantage of anti-competitive behaviour by a rival making pipe of size 1.5 cm. Similarly, if reputation for quality is important, then consumers are less likely to switch suppliers in response to anti-competitive behaviour. Therefore, rivals could not expand sales in response to such behaviour.

Other factors have been cited as indicating market dominance. These include: strong vertical integration or a well-developed distribution system, superior technology, strong brand name, extensive range of products, mature market, technological and financial resources and conduct.[38] Except for "conduct," each of these factors is a factor that might increase barriers to entry, which has been discussed above. For example, if a well-developed distribution system is necessary for success in a market, then the time and cost of developing one must be considered in evaluating whether new entry might occur in response to anti-competitive behaviour in the market. But "a well-developed distribution system" cannot otherwise enter into an evaluation of a dominant position. The same argument applies to the other factors. "Conduct" is rarely an indicator of dominance. However, if certain conduct is rational only if a firm is dominant, then such conduct is an indicator of dominance.

Market dominance of a firm is established by considering its exposure to competitive pressures. Such pressure can come from current competitors and from potential competitors. If, upon investigation, it is found that neither current nor potential competitors can substantially react to abusive behaviour by the firm, then such a firm has a dominant position in that market. The next section discusses the ways in which such market power could be abused.

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38 Whish, pp. 294-300; Ivo Van Bael and Jean-François Bellis, *Law of the EEC*, 2nd ed., CCH Editions Limited (1987), pp. 71-74.

## 4. Abuse of a Dominant Position

Holding a dominant position is not, in itself, anti-competitive. However, interfering with the competitive *process*, such as preventing or discouraging entry into a market by new entrants, is an abuse of dominance. For example, it would be an abuse if a dominant firm refused to supply an input to a potential competitor with the intention of preventing its entry into a market. In contrast, charging prices above the competitive level is not an abuse of a dominant position under this definition. (Under EC law, charging excessively high prices is an abuse of a dominant position.) In other words, an abuse of a dominant position is using a firm's current market power to interfere with the *process* of competition, such as interfering with new entry or expansion of capacity or output by rival firms.[39]

Firms' actions can have different effects in different environments. An action might be pro-competitive under some circumstances but be anti-competitive under others. An action might have no effect on competition if performed by a non-dominant firm but be anti-competitive if performed by a dominant firm. There are no simple "rules of thumb," applicable under all circumstances, that state that a particular action is always anti-competitive or never anti-competitive. Nevertheless, some common approaches are explained below.[40]

### *4.a. Excessive pricing or restriction of output*

#### *4.a.i. Excessive pricing as an abuse of a dominant position*

Charging excessive prices, or prices significantly above competitive levels, can be the result of exploiting market power. Under EC law, charging excessively high prices can be an abuse of a dominant position. In the definition adopted here, however, charging excessive prices is not an abuse of a dominant position: it does not, in itself, interfere in the competitive process.

The reason "excessive pricing" is not, by the definition presented here, an abuse of a dominant position is that it would be difficult to enforce and would, generally, be counterproductive. Enforcement of a prohibition against "excessive pricing" by dominant firms in economies in transition would restrict the growth of a market economy -- by interfering with the process by which prices signal firms about what and how much to produce, by discouraging risk-taking, by discouraging new firms from entering a market due to fear of legal troubles -- and require excessive resources from the competition authorities. There are several parts to this argument.

First, high prices and high profits provide signals to firms and incentives for increasing production. Current competitors have incentives to expand production and other firms have incentives to enter, if possible, the market and begin production. Controlling prices would interfere with the information flow and incentives of a free market economy.

Second, it is difficult to determine whether a price is, in fact, "excessive." It is difficult to identify and measure the costs that can be allocated to the particular product. It is difficult to determine a "fair" profit

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39 In both the European Communities and the United States, holding a dominant position is not itself illegal. In the European Communities, an impairment of competition constitutes abuse. This can include charging excessive prices, where the burden to prove "excessiveness" is on the plaintiff. [Whish, p. 512.] In the United States, the unilateral exercise of market power is not an offence, but wilful acquisition or maintenance of market power can be an offence.

40 Abuse through vertical restraints, the subject of another note, are not here discussed in detail.

when firms must be rewarded for risk-bearing, innovation and so on. It is difficult to determine appropriate changes in "fair" prices as demand and supply conditions change. It is difficult to determine whether the price prevailing in a freely competitive market elsewhere would be the "fair" price to impose in another market. Applying the limited resources of a competition agency to such investigations may change the agency into a price control agency which neglects its role in fostering competition.

Third, it would be difficult to devise appropriate legal tests or remedies for "excessive" pricing. Dominant firms would need low-cost means of determining, before they choose a price, whether it is "excessive." Courts would also need a low-cost means of determining whether a price is "excessive." Once a court has determined that a price is excessive, it would need a low-cost, appropriate remedy. In particular, a court cannot become a price regulator.

*4.a.ii. Responses to excessive pricing*

Excessive pricing can be a persistent problem in some markets in economies in transition. The best response by governments to excessive pricing depends upon the facts of the specific case. Some markets are natural monopolies, that is, markets in which a single firm can supply the market at lower cost than any combination of two or more firms. For these markets, the best response is likely direct regulation by a specialised regulatory agency.

In other markets, excessive pricing should be ended by the entry of new competitors and the expansion of rivals. In these markets, the negative effects of a delay in the adjustment to a market economy probably outweigh any political or social benefit to temporary price regulation. In these markets, the long-term solution is not a pricing decision by a court but instead the growth of competitors. A possible response to the problem of slow and inadequate entry would be fostering better conditions for entry, such as effective banking, financial and business information systems. The competition office might also focus on prevention of exclusionary practices by firms and by other parts of the administration.

There remains a difficult problem for economies in transition resulting from the pattern of past capital investments, when decisions about plant size and ownership were not market-based. Some of these deliberately created monopolies might not, especially given all the obvious problems of economies in transition, be soon eroded by the market forces described in the preceding paragraph. Here, one could imagine the firm still having substantial market power five or ten years hence. For these "unnatural monopolies," if the price is clearly persistently excessive, then temporary price regulation by a price regulating agency might be appropriate.

The time period over which excessive pricing is expected to persist is estimated by considering entry barriers into the relevant market. If entry barriers can be overcome in the reasonably foreseeable future, then the excessive pricing is unlikely to persist.

### *4.b. Predatory pricing or expansion of output*

Predatory pricing is "the use of short-run price-cutting in an effort to exclude rivals on a basis other than efficiency in order to gain or protect market power."[41] In predatory pricing, the predating firm suffers immediate losses in order to gain, subsequently, sufficient market power to make profits that outweigh the early losses. Hence, for predatory pricing to be profitable, the firm must be dominant in the sense developed here. I.e., the firm must currently have a large market share -- since if it did not, it is unlikely to grow large enough quickly enough to be soon capable of exercising market power to raise price[42] -- the firm must be protected by entry (and re-entry) barriers, and the rival firms must be likely soon to exit the market.

Even when these conditions exist, a firm may charge very low prices for competitive, not anti-competitive, reasons. Competitive reasons why products may be sold at low prices include: obsolescence, the risk of spoilage, shifts in consumer tastes and the need to offer low, introductory pricing of a new product. Because there can be both pro- and anti-competitive reasons for "excessively" low prices, predatory pricing is evaluated on a case-by-case basis in the context of the particular market.[43] There is little agreement about workable rules to differentiate predation from intense competition in the case of a firm with large share in a market with entry and re-entry barriers.

### *4.c. Raising rivals' costs*

A dominant firm may seek to maintain its dominant position by raising the costs of its rivals. If the firm raises the costs of entry, then it reduces the number of competitors. If the firm raises the costs faced by its current competitors, then it reduces the severity of competition to which it must react. One way in which a firm can increase entry barriers is through the use of government regulation. (Another way is through signing long-term contracts with customers.) Such regulation might explicitly limit entry of new firms or it might simply raise the costs of entry so that no firm chooses to enter. Alternatively, a firm may use government regulation to increase the cost of its rivals' business. For example, regulations to ensure health and safety might be deliberately written so that one firm can more cheaply comply than the other firms. While such use of regulation to raise rivals' costs is unusual in established economies and legal systems, they may be more common during periods of transition.

### *4.d. Vertical restraints*

Vertical restraints are agreements between enterprises at two levels of production or sales. For example, an agreement between a brewery and pubs that the pubs will not sell beer made by any other brewery is an example of a vertical agreement. When one party to a vertical agreement has a dominant position, then it can use that agreement to abuse its position.

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41 *Predatory Pricing,* OECD: Paris (1989), p. 81.

42 A firm operating in several different markets might, under certain conditions, predate in one market despite having, in that particular market, a less-than-dominant market share.

43 One necessary – but not sufficient -- condition for predation that has been used in the United States is the "Areeda and Turner rule," according to which a price is deemed to be possibly predatory if it is below "marginal cost." Marginal cost is the additional cost incurred in the production of an additional unit. Marginal cost is commonly considered to be relevant for findings of predation because of its role in very simple economic models of competition. In these models, the only reason a firm prices below marginal cost is to predate. More realistic economic models of competition indicate that the simple approach of the Areeda and Turner rule is misleading because there are many competitive reasons for firms to price below marginal cost.

There are two primary ways in which vertical restraints can be used to abuse a dominant position, market foreclosure and reduction in competition in a market. Market foreclosure means that entry into a market is made more difficult or more costly.

Market foreclosure can occur because of exclusive dealing agreements, exclusive territories agreements or tying agreements.[44] For example, exclusive dealing agreements imply that the supplier's competitors are denied access to certain downstream enterprises. If such tying-up of downstream firms is practised on a wide scale and with contracts of long duration, then it may be difficult for new suppliers to get their products on the market. If the upstream party to the exclusive dealing agreement is dominant, then there may be too few downstream enterprises that have not signed an agreement with him. Entrants into the upstream market might have to set up their own downstream firms, obliging them to enter two markets at once. Because of the additional cost, potential entrants may be unable to enter and upstream rivals may be unable to expand.

Exclusive territories agreements can foreclose markets if all upstream enterprises have signed long-term agreements covering all territories. In this case, no entrant could enter the downstream market without also entering the upstream market because none of the incumbent upstream firms would sell to it. If there is a dominant firm in the upstream market, none of its rivals are large, and there are economies of scale in the downstream process, then a firm that is dominant in the upstream market may foreclose the downstream market through exclusive territories agreements.

If the market for one product is competitive, the market for another product has a dominant firm, and the dominant firm ties the products, then this can foreclose the competitive market. For example, if there is a dominant firm in the shoe market and the firm ties the sale of shoe care products to the sale of shoes, then enterprises that make only shoe care products may not be able to survive because their potential customers will have bought shoe care products from the shoe manufacturer. A firm that wishes to sell shoe care products may have to sell shoes as well.

Vertical agreements may reduce competition in a market, but only if at least one side of the agreement is a dominant firm and there are barriers to entry into the other market. For example, assume that a dominant firm signs exclusive territories agreements. Then, within those territories, the only competitors faced by the downstream signatories are firms that buy from competitors of the upstream signatory. If the upstream competitors are very small and have limited ability to expand, then downstream competition is diminished.

Note, however, that each of the vertical restraints discussed here can also act to help new entrants enter a market and can reduce costs of enterprises. Thus, these types of agreements are not, in themselves, anti-competitive. Very often, indeed usually in OECD Member countries, these agreements have pro-competitive effects. This subsection, however, explained how their use by a dominant enterprise can have anti-competitive effects.

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44 Under an exclusive *territories agreement,* an upstream enterprise agrees not to sell to any other downstream enterprises within the same territory. "Territory" may have geographic meaning, or may refer to type of downstream consumer. For example, McDonalds Corporation may promise that no other McDonalds restaurant will open within the same city or within some specified distance of existing McDonalds restaurants. An *exclusive dealing agreement* is exclusive in the opposite direction, so that the downstream firm promises not to deal with any other upstream firms. An example of such an agreement is an auto retailer promising to sell the automobiles of only a single manufacturer. Often, exclusive dealing agreements are paired with exclusive territory agreements. *Tying* is requiring a buyer to buy one product in order to have the right to buy another. *Refusal to deal* is the practice of refusing to supply a product to a buyer. Such a practice may be used to enforce the other vertical restraints.

### *4.e. Price discrimination*

Price discrimination is charging customers different prices for the same goods, for reasons unrelated to costs. Dominant firms may engage in price discrimination if they face competition in local markets. They may charge lower prices in the more competitive markets and higher prices in the less competitive markets. Hence, price discrimination can be an indication of vigorous competition. On the other hand, price discrimination can have anti-competitive effects. For example, it can increase the production costs of new entrants, if the supplier of an input discriminates in favour of the incumbent firms.

## 5. Conclusion

Market dominance is determined by considering the whole competitive environment of a firm. If it does not face substantial competitive pressures, so that it can behave substantially independently of its competitors, then it is dominant. One screen for dominance is market share: if the firm has a small market share, then it cannot be dominant. A second screen for dominance is barriers to entry: if the barriers to entry are small, then the firm cannot be dominant. If a firm has a large market share and is protected by significant barriers to entry, then one would wish to evaluate the possible expansion by competitors in response to anti-competitive behaviour, the ease with which customers can change suppliers, and other factors. Simply being dominant is not anti-competitive. Rather, the effects of the alleged abuse must be evaluated.

**Appendix: Brief Statement of EEC Law Regarding Dominant Position**

Under EEC law the existence or attainment of a dominant position is not in itself objectionable. However, Article 86 of the EEC treaty prohibits abuses committed by an already existing dominant undertaking.

Dominant position is defined by EEC authorities 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.

A dominant position does not require the existence of a monopoly or of a quasi monopoly. Once the market has been properly defined from geographical and product viewpoints, the main criterion used by the EEC Commission to appreciate the existence of such a dominant position is market share. Except in exceptional circumstances, a market share of 50 per cent demonstrates the existence of a dominant position. On the other hand, a firm with a market share below 25 per cent is unlikely to be found in such a position. For cases which fall between these limits, other criteria will also be taken into account. Among these, are the relative size of the market shares of the leading firm's nearest rivals, stability of the leader's market share over a period of time, and barriers to entry.

Numerous conducts have been found to be abusive under EEC law.

One major feature must be underlined in this respect: an abuse may consist in the exploitation of the dominance, meaning that the firm uses its position to reap trading benefits which it would have not reaped in a competitive market. This is the case of excessive pricing or price discrimination which may be condemned under the EEC Treaty, even if there is no specific damage caused to competitors.

Another type of behaviour are exclusionary practices which are aimed to eliminate competitors of the dominant firm. Among those practices there are, for instance, predatory pricing, granting of fidelity rebates, tying, refusal to deal, and long term exclusive supply agreements. Tests have been developed by the EEC Commission to determine when such conducts are to be forbidden. Recent developments of the EEC law have even showed that in some circumstances, it is an abuse for a dominant firm to refuse some kind of co-operation with its competitors to enable them to compete efficiently on the market.

# Horizontal Agreements

## 1. Introduction

Agreements between competitors can reduce, eliminate or increase competition. For example, competitors' agreements on prices or the allocation of customers directly reduce competition. Hence, in many jurisdictions, such "hard core" cartel agreements are vigorously prosecuted. In some jurisdictions, such agreements are a serious crime. Other agreements between competitors can, however, increase efficiency. For example, competitors could agree to engage jointly in research that they would not have funded individually and that results in lower production costs.

Aside from inherited monopolies, horizontal agreements may be the largest source of anti-competitive behaviour in economies in transition. Such agreements can negate the positive effects of a market economy because markets require competition among independent enterprises to efficiently allocate resources and to force efficient production and further innovation.

One important determinant of the effect of an agreement is the relationship between the parties to the agreement. The parties may be actual competitors, potential competitors, or not competitors at all. If the parties are actual competitors, then the agreement might immediately eliminate competition. If the parties are potential competitors, then there may be an immediate, though subtle, reduction in competition and a reduction in future competition. However, if the parties are not competitors (and neither is the customer of the other) then an agreement is unlikely to reduce competition and may increase current or future efficiency.

The legal relationships among the parties to an agreement can also influence the agreement's effect on competition. If, for example, the parties are two divisions of the same private company, then the agreement would generally not affect competition because the company already has the right to co-ordinate their actions. At the other extreme, if the parties are completely distinct private companies, then an agreement may reduce competition through restricting the companies' independent decision-making. State ownership may affect the applicability of the competition law.

A practical and legal problem is determining exactly what constitutes an agreement. Rarely do parties make a contract containing provisions contrary to the competition law. Instead, an "agreement" is more likely to be of a form that is difficult to define precisely. For example, if no competitor has ever communicated with the others, but each is confident that if he changed his prices all the other competitors would change theirs by the same amount, then is there an "agreement"? Each jurisdiction defines an "agreement" differently.

This note discusses the above aspects of evaluating horizontal agreements, that is, agreements between actual or potential competitors. Section 2 discusses the relationships among parties to an agreement. Section 3 discusses various types of horizontal agreements. Section 4 discusses joint ventures and Section 5 provides some "rules of thumb" regarding cartels. The appendix provides an introduction to what constitutes "agreement" in a few jurisdictions.

## 2. Relationships Among Parties

In this note, "horizontal agreement" refers to agreements between actual or potential competitors. For enterprises to be competitors, they must be independent suppliers to the same relevant market or, alternatively, independent buyers from the same relevant market.[45] (One enterprise is a potential competitor

[45] See the note on market definition.

of another if it is a potential entrant into the relevant market supplied by the other.) Therefore, the analysis of a horizontal agreement begins with identifying relevant markets. If two enterprises supply different relevant markets, and neither is a potential entrant into the other's market, then the enterprises are not actual or potential competitors and any agreement between them is not horizontal.

### *2.a. Actual competitors*

If parties to an agreement supply (or buy from) the same relevant market, then they are competitors and an agreement among them is a horizontal agreement. For example, if one enterprise produces fresh milk in Canada and another enterprise produces fresh milk in Ukraine, then, because fresh milk is not traded between Canada and Ukraine, the enterprises are not suppliers -- or potential suppliers -- to the same relevant market and any agreement between them will not affect competition. In contrast, if one enterprise produces fertilisers in Canada and another enterprise produces similar fertilisers in Ukraine, and if fertilisers are traded internationally, then the two enterprises may be suppliers to the same relevant market and an agreement between them may be a horizontal agreement.

### *2.b. Potential competitors*

If one finds that the parties to an agreement are not active in the same relevant market, then the next step is to determine whether any party is a "potential competitor" of the other, i.e., whether any party would be "reasonably likely" to enter the relevant market of the other if the agreement were not in force. It is difficult to define "potential competitor" or "reasonably likely to enter" in a meaningful way. One wants to capture the idea that a "potential competitor" has, or likely would have, an effect on competition in a relevant market. A possible definition is that a potential competitor is an independent enterprise that does not currently sell into the relevant market but would quickly begin to do so in response to a small, long-term increase in prices in that relevant market.[46]

For example, if two enterprises manufacture and sell telecommunications equipment in several countries, but neither currently sells such equipment in country X, are they potential competitors in selling telecommunications equipment in country X? I.e., would an agreement that one enterprise would not enter that market have an effect on competition? To answer this question, one would begin by determining the demands of the telecommunications equipment buyers located in country X. Would the equipment made by each enterprise be technically suitable, including compatible with the installed parts of the telecommunications system? Would their prices be competitive with the prices offered by current suppliers to country X? These questions are similar to those asked when determining the identity of suppliers to a relevant market.

The negative effects of an agreement with a potential competitor are of two types. The immediate negative effects occur because the threat that a potential entrant might enter a market affects the behaviour of current suppliers. If that threat is removed by the horizontal agreement, then current suppliers have additional scope for anti-competitive behaviour. In practice, of course, for there to be a significant effect on current competition the potential entrant must be very close to becoming an actual competitor. The other negative effect of an agreement with a potential competitor occurs if the agreement prevents the entrant from entering the market when he otherwise would have. Then there is a direct diminution of future competition.

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46 "Potential competitor" here is equivalent to "uncommitted entrant" in the note on market definition.

### 2.c. *Private and state-owned parties*

The relationship between the parties to an agreement is another important dimension. Examples of possible relationships between private parties are:

- -- parts of the same legal entity, such as a parent and a subsidiary or two subsidiaries;
- -- legally independent but controlled, through common majority ownership, by the same person;
- -- independent both legally and with respect to control.

Economists would argue that only parties of the last type -- independent both legally and with respect to control -- could make a horizontal agreement of interest to competition officials. This is because parties with the other relationships could, rather than make an agreement, simply follow equivalent directives of persons in control of both parties. Such directives would be internal to the enterprise and so would not usually be subject to control by competition laws.

In economies with large numbers of state-owned enterprises, a strong argument can be made that they should be subject to the competition law and that common ownership should not be a basis on which their agreements can be exempted from coverage of the competition law.

## 3. Subjects of Agreements

### 3.a. *Always anti-competitive agreements*

Some horizontal agreements have a direct negative effect on competition and at the same time are very unlikely to bring consumers any real benefits. To reduce enforcement costs, these agreements are, in many jurisdictions, treated as *per se* illegal, i.e., if the agreement is proved then a violation is established; no effect must be proved. This type of horizontal agreement includes agreements on:

- -- prices, tariffs, discounts or any other charges;[47]
- -- prices at auctions (except for joint bids disclosed to the party soliciting the bid);
- -- quantity of output;
- -- division of the market, whether by territory, type of good, type of customer or other divisions;
- -- elimination from the market, or limitation of access to the market, of other enterprises;
- -- refusal to conclude contracts with particular sellers or buyers.

While the above list is written as though the parties to the agreement were sellers in a market, the anti-competitive effects are similar whether the parties to an agreement are buyers or sellers in a market. Examples of market power -- and sometimes anti-competitive agreements -- on the buyer side of markets are sometimes found in agricultural products, such as grain and milk, where individual farmers face very few possible buyers of their products.[48]

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47 Variations on these types of usually *per se* agreements include agreements to use a price book and to adhere to a particular form of pricing.

48 "Pooling agreements" are sometimes used to support anti-competitive agreements. One type reduces profits going to "aggressive" competitors by specifying profit-sharing among parties to the agreement. Another type is an agreement for a jointly-funded pool of money to compensate "losers" in bidding contests. Provisions might not only specify transfers of money but also transfers of customer lists, patents or other intellectual property. If these assets are transferred without adequate compensation for their developer, then the agreement decreases enterprises' incentives to develop them in the future, reducing also future competition.

### *3.b. Agreements with pro- and anti-competitive effects*

Outside of the area of the above types of agreements, there are many agreements that have both significant pro-competitive and anti-competitive effects. They are best analysed on a case-by-case basis which considers and weighs both sets of effects. Such a "rule of reason" approach is applied to horizontal agreements on:

- -- establishment of product, labelling, etc. standards;
- -- joint or restricted advertising or promotion;
- -- joint training of workers;
- -- exchange of some information
- -- research and development.

The types of anti-competitive behaviour that can result from horizontal agreements of this type are the exclusion of competitors from the market (e.g., through standards establishment and advertising restrictions), facilitating tacit collusion as competitors become more familiar with each others' costs and interests, and facilitating outright collusion through providing a means to exchange sensitive information. Only information exchange and research and development agreements are discussed here.

#### *3.b.i. Information exchange*

An agreement that successfully raises prices relies on an ability to detect and punish cheating in order to persist. Some kinds of information help in the detection of cheating and other kinds of information help parties to reach an agreement. On the other hand, some exchanges of information among competitors have pro-competitive effects.

Information exchange about prices and sales might have anti-competitive effects, since it may enable parties to detect cheating on a price or market-allocation agreement. To see this, consider an agreement to raise prices above the competitive level. If one enterprise tries to sell some of its output at a slightly reduced price but its co-conspirators learn about it, then in a well-designed cartel the enterprise would be punished and the agreement would remain effective. If, in contrast, an enterprise could sell some of its output at a slightly reduced price and keep the fact secret from its co-conspirators, then each enterprise might cheat and the agreement might fall apart. Hence, if parties to an agreement can monitor adherence to the agreement, then the agreement is more likely to remain effective. The time at which co-conspirators learn about cheating is important because that determines when cheaters would be punished: the earlier the punishment, the more the threat of punishment deters cheating.

Sharing total annual sales data may or may not be anti-competitive. If individual firms' sales cannot be identified from the data, sharing such information might serve the (positive) purpose of helping enterprises better plan changes in capacities, etc. On the other hand, sharing such information might serve the (negative) purpose of helping to monitor anti-competitive agreements on market share or quantity of sales.

Information may also be used to signal competitors regarding future intentions. For example, if one enterprise announces the price it intends to charge in the future, and other enterprises respond with announcements about their intended future prices, then the announcements can be a means to negotiate an agreement about future prices. Only the other hand, if buyers must make advance commitments to buy the good, then advance knowledge of future prices can enable them to plan better.

The exchange of information about production costs and capacities might facilitate parties' reaching a mutually acceptable anti-competitive agreement.

Information about general marketing opportunities, new developments in technology and the credit-worthiness of third parties may increase competition because this type of information makes it easier for enterprises to begin selling into different markets or to reduce their costs.

An important aspect of information exchanges is whether the "other side of the market" (the buyers or the sellers) knows about the agreement. If the "other side" can take actions to increase the degree of competition, then knowledge of the agreement can act to reduce any anti-competitive effect of the agreement. Of course, if "the other side" knows about the agreement and can take no action to increase competition, then the knowledge does not reduce the anti-competitive effect of the agreement.

For example, groups of enterprises might make joint bids -- i.e., submit one bid from the group rather than to submit individual bids -- to purchase petroleum exploration licenses. If the seller of the licenses knows that the enterprises make joint bids and if there are enough bids from independent groups of enterprises, then competition is not harmed by the joint bidding. Indeed, it may be increased because some of the bidders might have been unable independently to exploit the license. However, if the seller knows that the enterprises make joint bids but there are *not* enough independent bids, then the seller may be able to force the enterprises to bid independently -- rather than jointly -- or may be able to delay the sale of the licenses until after he has found additional bidders. Since the seller knew about the joint bids, he could take actions to increase competition among bidders.

### *3.b.ii. Research and development*

Agreements about research and development ("R&D") can have both pro- and anti-competitive effects. The pro-competitive effects can come from allowing enterprises to bring together complementary skills, apply know-how gained in one market to another market and share the costs and risks of projects beyond the reach of a single enterprise. On the other hand, anti-competitive effects can arise if the enterprises would have engaged in independent, competitive research. A reduction in research may slow the pace of discoveries and negatively affect competition in future markets. The precise provisions in a R&D agreement can have varying effects on enterprises' incentives to engage in independent research and to compete in the market for the subsequently developed product.[49] In many cases, the evaluation of an R&D agreement relies largely on the trade-off between a possible reduction in competition today and a possible increase in new or better products or production techniques in the future. In other words, a decision must often be made between current static efficiency and dynamic efficiency.

## *3.c. Agreements subject to varied treatment*

Some agreements are treated very differently in different jurisdictions. This variation in treatment reflects different views -- different underlying economic models -- about markets. Some of these types of agreements are discussed here.

### *3.c.i. "Small" agreements*

The competitive effect of an agreement depends, among other things, on the market structure and the position in the market of the parties to the agreement. As the market is more concentrated -- having

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[49] When there are no ancillary restraints on subsequent sale of the product, R&D agreements are almost always permitted in many countries.

fewer, larger sellers -- and as the parties to the agreement are larger, the potential for an anti-competitive effect of an agreement is larger. For example, two small suppliers reaching a price agreement has a smaller effect than two large suppliers reaching a price agreement. This is because the competitors who are not party to the agreement can more easily undermine the agreement: they can more easily expand their sales by a small amount than by a large amount. The above logic is behind the exemption in some competition laws of otherwise anti-competitive agreements among enterprises with very small market shares. Note, though, that if the competitors who are not party to the agreement cannot easily expand their sales -- perhaps because of capacity constraints -- then even an agreement among very small suppliers can have an anti-competitive effect on the market.

A practical, enforcement problem raised by an exemption for enterprises with small market shares is that enterprises will claim a very broad "market" so that they can claim small shares of the "market." If the competition authorities determine that, in fact, the relevant market is narrower and the enterprises have "large" shares, then the enterprises could (perhaps successfully) plead for leniency in their punishment because they "didn't know" that they were breaking the law. Reduced punishment for collusion would weaken the competition law.

### *3.c.ii. Declining markets*

Some enterprises might argue that horizontal agreements in a declining market do not have anti-competitive effects. Indeed, under certain circumstances, some jurisdictions permit enterprises in declining markets to agree to a fixed schedule of capacity-reductions, though never permit them to agree on prices or customer allocations.

Another view of this problem is that capacity-reduction agreements are unnecessary because the least efficient enterprises will leave the market absent an agreement. According to this view, the agreement serves only anti-competitive purposes. The logic of this argument is that decisions about capacities imply decisions about future outputs and prices. Therefore, agreements about capacities are agreements about the nature of competition in the future.

### *3.c.iii. Import and export cartels*

Import cartels harm domestic consumers and can be treated like any other sort of horizontal agreement on prices or quantities.

Export cartels are more difficult to characterise. They have an anti-competitive effect on the world (or foreign) market only if the export cartel provides a significant part of world supply of the product. If an export cartel affects the world market, then the price rise acts as a tax on the rest of the world, transferring wealth from the rest of the world to the cartel. This, of course, is good for the owners of the cartel members. However, there may be negative effects on the domestic economy. The members of the cartel may extend their agreements regarding export sales to cover also domestic sales. The information they share regarding export sales might help them to develop a domestic agreement. Potential new entrants into the domestic market, if not admitted to the export cartel, might not be able to reach minimum efficient scale on the basis of domestic sales alone, and therefore might not enter the market at all.

## 4. Joint Ventures

### *4.a. Analysis*

Joint ventures stand half-way between horizontal agreements and outright mergers. In joint ventures, the operations of two or more firms are partially, but not fully, integrated. In most cases, the common functions will be performed by a new legal entity owned by the joint venturers. Joint ventures can have both anti- and pro-competitive effects. They can be particularly advantageous and pro-competitive in areas such as large-scale natural resource exploration/exploitation, large scale engineering and construction projects, buying groups organised by small- and medium-sized firms, and research and development. Their anti-competitive effects may come from making easier information exchange and reaching anti-competitive agreements. Because pure research can often have large spillover effects (firms that don't pay receiving the benefits of the research), there are stronger arguments for letting firms engage in joint research. In contrast, there are fewer spillover effects from marketing, so joint marketing agreements are more likely to be prohibited because the potential anti-competitive effects outweigh the potential efficiency effects. Hence, competition officials are generally more concerned about joint ventures the less they involve pure research and the more they involve joint marketing and selling.

Some important sources of anti-competitive effects of joint ventures are:

- The elimination or reduction of competition between the parents in areas covered by the joint venture;
- The reduction of competition from a parent of the joint venture, i.e., where the parent, but for the joint venture, would have entered independently;
- Anti-competitive market foreclosure arising when vertical relationships between the joint venture and the parents deny potential competitors equal access to an essential input.

Some questions to consider in evaluating a joint venture include:

- Do the parties to the agreement have large current market shares? (If they do, then there is a greater risk of anti-competitive effect. If they do not, the risk is minimal.)
- What is the importance of the joint venture function in long-term competition in this market? (The more important they are, the greater the danger of an anti-competitive effect.)
- Will participating firms have reduced incentives to engage in their own, independent parallel functions? (If so, then the agreement reduces competition in those functions. This could have important long-term effects especially in the case of R&D joint ventures.)
- When the joint venture partners have market power over an input that is both essential and costly to independently produce, how are such inputs priced to members and non-members of the joint venture?

### *4.b. Special issues in economies in transition*

In economies in transition, there are sometimes proposed international joint ventures in which the domestic partner is a long-lasting monopolist. The usual advantage to the domestic partner is a technology transfer. The usual advantage to the foreign partner is an advantage over its foreign rivals in the domestic market. However, if the domestic partner is a long-lasting monopolist, then such a joint venture could reduce later competition in the domestic market.

One problem arises if there is a limited number of possible foreign producers, the domestic partner makes several different products and is a monopolist in each market, and some markets are not natural monopolies. (A natural monopoly is a market that a single enterprise supplies at lower cost than any combination of two or more enterprises.) In this case, the domestic partner can reduce competition in each market through the creation of interlocking joint ventures. Assume, for example, that there are six multi-

product, multi-national telecommunications enterprises and six distinct product markets supplied by the domestic enterprise. Assume that the domestic enterprise forms six joint ventures, each supplying a different product and each formed with a different foreign partner. Now consider the incentives of a foreign partner. It earns profits from the JV from sales to one market. The foreign enterprise might consider entering a second market, in competition with its domestic partner. However, its profits from the JV might depend on the total profits of the domestic partner. If this is so, then the foreign enterprise's incentives to enter a second market are reduced. As a result, competition in each market is reduced by the interlocking JVs. (The same sort of reduction in competition arises if the interlocking JVs cover different territories rather than different product markets.)

A second problem arises if the joint venture agreement forecloses a market to future entrants. A JV agreement might grant to a foreign partner the exclusive right to a necessary input for the supply of another product. If this happens, then future entrants into the downstream market are "foreclosed," they cannot enter or can enter only at very large cost. Competition in that market is reduced.

A third problem arises because of the incomplete transition from one legal/economic system to another. Assume that there is a domestic monopoly in a market that is not a natural monopoly. Then one would expect that, eventually, competition would develop in that market. However, if the domestic partner has the right to commit to long-term, exclusive rights to supply that domestic market, then such a sale would condemn buyers to an unnecessary, long-term monopoly. On the other hand, some type of exclusive rights might be necessary in order to induce the foreign partner to invest in the domestic market.

In economies with many monopolistic or near-monopolistic markets, international joint ventures can be a mechanism for the quick introduction of competition. They provide a means for intellectual property, products and services to cross international borders. On the other hand, some provisions of such joint venture agreements could unnecessarily monopolise the domestic market.

## 5. Rules of Thumb

It can be helpful to know the conventional wisdom, the "rules of thumb," regarding which conditions are likely to facilitate anti-competitive agreements. These "rules" may be generally true but there are also many counter-examples. Nonetheless, the conventional wisdom can be of practical value.

### *5.a. Number of competitors*

Anti-competitive agreements are more likely to occur in markets containing relatively few enterprises. One author suggests that they are likely in markets with 2 to perhaps 7 or 8 enterprises, but that such agreements are extremely difficult to maintain in markets exceeding 15 or 20 enterprises.[50] Nevertheless, some famous cartels have included far more than 20 members.

### *5.b. Barriers to entry*

It is supposed to be difficult to fix prices in markets in which barriers to entry by new competitors are low. This is because, if the price-fixing is profitable, potential entrants will enter the market. The potential entrants will see the profits to be gained by entering the market and either slightly undercutting the cartel or joining the cartel. If they enter the market and undercut, then members of the cartel lose profits if

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50 Herbert Hovenkamp, *Antitrust,* Black Letter Series, West Publishing Co., St. Paul, 1986.

they do not match the entrant's prices. If they enter the market and join the cartel, then cartel members' profits decline as they must split the profits among ever more members. In practice, however, cartels are discovered in markets in which entry barriers seem to be almost non-existent.

### *5.c. Homogeneity or "standardisation" of the product*

The conventional wisdom is that it is easier to fix prices on homogeneous products, i.e., on products that are identical from one producer to another and do not have very many variations. But again, famous cartels successfully set prices on highly differentiated products, such as electric generators and transformers.

### *5.d. Number of buyers*

The conventional wisdom is that cartelisation is easier if sales are made in frequent, small amounts rather than infrequently, in large amounts. The idea is that detection and punishment of cheating will be quicker and therefore the cartel stronger. On the other hand, of course, it would seem that detection of cheating on a large order would be easier than detection of cheating on a small order.

### *5.e. Facilitating practices*

Certain practices can strengthen cartels. In a "most favoured nation" clause, the seller promises that the buyer is receiving the lowest price of any buyer. If the buyer can find any other customer of that seller who is paying a lower price, then the seller agrees to charge the lower price instead. In a "meeting competition" clause, the seller promises that if any seller offers a lower price, then he, too, with sell at that lower price. Both of these provisions help to enforce a price agreement. In each case, individual buyers act in their self interest to report low prices to the sellers. Therefore, it is difficult for sellers to make secret price cuts. Essentially, the buyers monitor an agreement against themselves.

Another facilitating practice is "base point pricing." Sellers set their prices according to a particular type of formula. Sellers agree upon a "base point" -- a location -- and are quite open with customers about the existence of a "base point" agreement. The price each seller charges is the sum of the price at the "base point" and transportation cost from the "base point" to the customer. If the sellers choose to fix prices, then they must agree only upon the price at the "base point" and the cost of transportation per kilometre. Given this system, every seller offers a given customer the same price. The "base point pricing" system simplifies collusion for sellers that are geographically dispersed.

### *5.f. Patterns*

If there is a cartel in a market for a particular product in one region, it may be worthwhile to look for cartels in markets for that product in other regions. Similarly, if one group of enterprises is found to have formed a cartel in one product, it may be worthwhile to investigate whether they have created cartels for other products, as well.

## 6. Gathering Information about Collusion

Some suggestions about sources and types of information that might be helpful in proving a case of collusion are provided in the table below. These are just general guides, because the types of acceptable proof, the standard of proof, and the methods for gathering proof will be a function of each country's laws.[51]

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51 Much of this table is from information provided at the Investigative Techniques Seminar, led by the United States Federal Trade Commission and Department of Justice, 7-9 March 1994.

| Source | Information |
|---|---|
| correspondence and meeting files of current employees (e.g. president and marketing director) of each major competitor | reference to meetings with competitors, documents referring to agreements with competitors |
| interviews with former management and marketing employees | familiarity with any agreements, formal or informal |
| customer complaints (both former and current employees) | evidence of pricing and discount patterns or parallel conduct or non-compete agreements |
| interviews with customers | the forms of competition, other than price -- is competition mainly on the basis of price or on service or something else? |
| bid records of government customers | bid patterns |
| interviews with small suppliers about pricing behaviour of major competitors | confirmation of customer and documentary evidence |
| interviews with importers and new entrants | information about pricing practices of major competitors |
| correspondence and trade association records used to generate industry information for trade association members on prices and quantities | how similar the reported data is to the actual transaction data |
| correspondence of the trade association director | reference to agreements and efforts to enforce agreements |

## 7. Conclusion

While, as a broad class, horizontal agreements can have positive or negative effects, there are certain sub-classes of horizontal agreements that are almost universally considered to be anti-competitive. These include agreements among competitors on price, on the allocation of markets, the elimination of other firms from the market and refusal to conclude contracts with particular firms. Other horizontal agreements are examined on a case-by-case basis, always keeping in mind the effects the provisions of the agreement will have on firms' incentives and ability to compete or to behave anti-competitively. Sometimes, a trade-off must be made between static and dynamic efficiency, such as for agreements regarding joint research and development.

## Appendix: What Constitutes an Agreement?

There are two distinct problems to resolve: What constitutes an "agreement"? What constitutes proof of an agreement? The essential problem is obvious: only especially foolish parties to an illegal agreement would make the agreement very clear and easy to find. But competitive behaviour is sometimes difficult to distinguish from collusive behaviour.

In no jurisdiction does parallel pricing (or other parallel behaviour), by itself, constitute proof of an agreement. This is due to the fact that parallel pricing can occur for entirely innocent reasons. For example, firms' prices might rise and fall at the same time because the cost of a common input rises and falls. (Gasoline retailers in a town might buy their gasoline from the same pipeline. When the pipeline changes the wholesale price of gasoline, this changes an important cost for the retailers. Therefore, each retailer's retail price changes follow the changes of the wholesale price. As a result, the retailers' prices are highly correlated, even though there is no collusion.)

Firms' prices might be identical because they face the same market conditions. In a farmers' market, the prices of new potatoes offered by each farmer might be very similar. This could be due to collusion. But it also could be due to the fact that the farmers have about the same costs of production and they face the same set of buyers in the market on that day.

Firms' prices might be identical -- even if they have different costs -- because they recognise their interdependence. A firm might consider charging a lower price than its competitors, but it might believe that the others would match the price decrease and take back their customers, so that lowering price would not be profitable. If each firm independently follows that same reasoning, no one will lower price. There is no agreement in this story -- each firm operates without communication and acts in its own best interest -- and yet the prices are identical.

In sum, there may be identical or almost identical prices and price changes in a market even if there is no agreement. The problem for enforcers of competition laws is to distinguish between agreement and innocent parallel behaviour.

While in theory market data might be used to distinguish agreement from independent action, in practice this is rarely sufficient. (Of course, the practical value of market data in "proofs" of an agreement may vary from jurisdiction to jurisdiction as the burden of proof varies. As the burden of proof is lessened, the practical value of market data increases.) In practice, documents or witnesses are almost always necessary to prove the existence of an agreement. Documents might be diaries showing dates and participants of meetings, or records of telephone calls to other members of the cartel, indicating conversations just prior to price changes, or travel records, indicating members of a cartel being present in the same city on the same date. Witnesses might be witnesses to cartel meetings, perhaps former employees of cartel members, or employees of former cartel members.

An investigation might be initiated on the basis of an article in a newspaper or trade journal that indicates suspicious pricing or selling patterns. It might be initiated on the basis of a complaint, although such complaints should be carefully screened. A useful complaint will have details and be consistent with other known information. The complaint will usually be useless if it is anonymous or if the writer is unwilling to cooperate to provide more information.

Provided below is some specific information about the treatment of horizontal agreements by competition laws in the United Kingdom, the European Communities, and the United States.

**United Kingdom**

Under UK law, an "agreement" is not exhaustively defined, but the law does say that it, "includes any agreement or arrangement, whether or not it is intended to be enforceable ... by legal proceedings...."[52] One can summarise the UK case law as:

> "An arrangement involves the intentional coordination of conduct and must consist of mutual rights and obligations; it can come into existence when representations are made between firms as to their intended conduct, and these representations may be verbal or observed [i.e., actions]; the exchange of information may give rise to an arrangement; but the Court will require proof of the necessary consensus and will not infer an arrangement *simply* from parallel action."[53]

**European Communities**

According to Article 85 of the Treaty of Rome (setting up the EEC), agreements between undertakings, decisions by associations of undertakings and concerted practices are prohibited if they "may affect trade between Member States and they have as their object or effect the prevention, restriction or distortion of competition within the common market," unless they are exempted under 85 (3).

Because both "agreements" and "concerted practices" are prohibited, it is most useful to examine the definition of "concerted practice." The legal test of what constitutes a "concerted practice" is provided by two cases:

> "There must be a mental consensus whereby practical cooperation is *knowingly* substituted for competition, but the consensus need not be achieved verbally and can come about by any direct or indirect contact between the parties."[54]

**United States**

In the United States, the definition of an agreement is approximately the same as under UK law. "The existence of price fixing agreements is virtually never established exclusively on the basis of price or cost information."[55] If persons accused of an illegal agreement deny the existence of an agreement and can

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52 The Restrictive Trade Practices Act of 1976, 43 (1), quoted in Whish, p. 139. An "arrangement" is less formal than an "agreement," in common English usage.

53 Whish, p. 144.

54 Whish, p. 223.

55 Hovenkamp, p. 79.

offer a sound reason why their actions are likely to be independently taken, then they are not found guilty. Usually, proof of the existence of an agreement involves a witness to some of the communication and a witness to activities carrying out the agreement. An agreement cannot be inferred from parallel action.

# Vertical Restraints

## 1. Introduction

Enterprises generally engage in several activities, each of which could be performed by a separate enterprise. For example, a brewery might not only make beer, but may also own pubs where it sells beer directly to customers. If the brewery owns pubs, then it is said to be *vertically integrated*. That is, the brewery provides its own input (beer) into another process (retail sale of beer). If the brewery sold its beer only to pubs, then it may impose *vertical restraints* on pubs. For example, the brewery might determine the retail price of its beer (i.e., the price the pubs must charge), or it might require that any pub selling its beer cannot also sell competing brands of beer. Restraints between enterprises at different levels of production or distribution are the subject of the present note.

Firms use vertical restraints for a variety of reasons. They can be used to increase co-ordination between different levels of production or distribution. They can also be used to allocate risk between the upstream and downstream firm[56] and to protect intellectual property. On the other hand, vertical restraints can be used anti-competitively to reduce competition directly, or indirectly by raising barriers to the entry of new competitors.

Vertical restraints may increase efficiency because they may reduce the externalities[57] generated by decisions by upstream and downstream firms. These externalities can reduce profits and increase costs. The firms each make choices that affect consumers' prices, the level of customer services, product quality and the mix of inputs. When making these choices, the firms ignore their effects on the profits of the other firms in the vertical chain. Such externalities may reduce the profits and efficiency of the vertical structure as a whole.

The effects on competition of vertical restraints are complex and subtle. Because of this, there are no simple rules for evaluating their competitive effect. Each instance must be examined in its context. However, some very broad guidelines can be provided.

The remainder of this paper is organised as follows. Section 2 discusses vertical integration, i.e., when one firm owns both the upstream and downstream process. Note that vertical integration -- common ownership -- is, in fact, a kind of vertical restraint, and a possible strategy of firms whose choice of vertical restraints is restricted by competition laws. Section 3 provides a series of theoretical models that introduce the reasons why firms might want to use vertical restraints. Section 4 discusses each of the most common vertical restraints, with short descriptions of their possible pro- and anti-competitive effects. Section 5

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56 A firm is *upstream* of another if it provides an input into the other. A firm is downstream of another if it uses an output of the other. In this paper, the shorthand of calling the upstream firm the "manufacturer" and the downstream firm the "retailer" will often be used. Many other types of firms have vertical relationships. For example, a transmission manufacturer and an automobile manufacturer are vertically related.

57 Externalities are costs or benefits that are not captured by the firm creating them. For example, if two adjacent retail stores sell the same products and one store advertises the attractive qualities of the products, then the other store would receive the benefits of the advertising without paying. Therefore, the benefits to the non-advertising store are external to it, or "externalities."

provides very broad policy suggestions for vertical restraints. The appendix contains definitions of various vertical restraints.

## 2. Vertical Integration

A firm is called *vertically integrated* if it owns both an upstream and a downstream process. For example, a shoe manufacturer that owns a shoe factory and retail shoe stores is "vertically integrated." Another example of a vertically integrated firm is a dairy that owns its dairy farms. The farms produce raw milk and the dairy uses that as an input into the production of processed milk, butter, cheese and yoghurt.

In a market economy, distinct processes can be vertically related by

-- market transactions between separate firms
-- contracts between separate firms
-- vertical integration into a single firm.

Firms vertically integrate to avoid inefficiencies that can arise from contracts or market transactions. If contracts cannot adequately specify firms' obligations, then the firms may substitute ownership for contracts. For example, if a firm wished to write a contract containing vertical restraints which were illegal under the competition law then, since the contract would not be enforceable, the firm may instead vertically integrate. Below, general problems with contracts are discussed.

### *2.a. Limitations of contracts*

Firms use contracts to specify the obligations between firms. However, contracts can be inadequate because

-- the product/service cannot be well-specified,
-- obligations cannot be specified in all possible circumstances,
-- the legal system may not enforce the contracts.

Sometimes it is too expensive or impossible to describe the product so that an independent arbiter, such as a court, could determine whether the terms of the contract were met. If the firms were vertically integrated, the managers of the firm would have an incentive to provide the correct product, even though it could not be sufficiently well-described in a contract.

Contracts are difficult to write to cover all possible conditions. If an unanticipated event occurs, and if the contract does not state each party's obligations in such an event, then the contract is costly or impossible to enforce.

If a contract contains vertical restraints that are illegal under the competition law, then such a contract is unenforceable. Further, in periods of radical change in a country's legal structure, when laws may be unclear, contracts might be particularly costly, difficult or impossible to enforce.

### *2.b. "Hold-up"*

Two specific problems that can be avoided by vertically integrated firms are "hold up"[58] and "poor co-ordination." Hold up occurs when one firm must make specific and unrecoverable investments[59] to use the output from another firm and no adequate contract can be written beforehand. For example, a coal mine might build a rail spur to a specific railroad. After the mine builds the spur, switching to another railroad would be costly. The mine effectively faces a monopolist. The price offered by the monopolist railroad will not be the competitive price. Therefore, the mine buys "too little" transportation services. In contrast, if the mine and the railroad were owned and managed together to maximise their total profits, then the railroad would not hold up the mine. The internal price of rail transportation would be the cost of transportation, and the optimal quantity of transportation would be used. Vertical integration is a better solution, in this case, than keeping the firms separate.

### *2.c. Poor co-ordination*

Co-ordination of assets may be easier if they are held in the same firm, under common ownership and management, than if they are held in different firms. Consider the relationship between a blast furnace and a primary reduction mill in steel production. The material must be delivered from the blast furnace to the mill at the correct temperature, at the correct time, and meeting certain chemical specifications. The demands of the downstream process change rapidly and unpredictably. Poor co-ordination between the furnace and mill is costly. If the furnace and mill were owned by separate firms, then the contract between them would be impossible to write since each party's obligations under all possible circumstances would be difficult to specify beforehand.

### *2.d. Anti-competitive vertical integration*

Vertical integration -- common ownership and management -- can overcome some many of the problems specified above. However, vertical integration can reduce competition if it results in vertical foreclosure[60] or higher entry barriers. Consider the case where there is an essential input into some other process. For example, consider the case of mines containing a particular type of ore and smelters who use that ore. If the firms are arranged so that all but one smelter is owned by a mine, then the non-integrated smelter may be subject to anti-competitive behaviour by the integrated firms: perhaps, in periods of shortage, the non-integrated smelter cannot buy ore. Also, if the non-integrated downstream firms are subject to anti-competitive behaviour, then vertical integration may raise barriers to entry. Potential entrants will determine that if they enter one market then they must enter both markets. As a result, fewer firms enter the markets and competition is reduced.

Rather than vertically integrate, firms might impose various vertical restraints on separate, independent firms. Vertical restraints are the topic of the remainder of the paper.

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58 "Hold up" means taking advantage of the other party's weak bargaining position.

59 Investments which are specific and unrecoverable, such as building a rail spur to a single railroad, are called "idiosyncratic" investments. If firms must make these types of investments, then competition to supply those firms is very limited.

60 Vertical foreclosure results if some firms in one market vertically integrate into an upstream (input) market so that other, non-integrated, firms in the initial market do not have independent sources of supply of the input.

## 3. The Uses of Vertical Restraints

This section provides a series of theoretical models that illustrate the reasons firms may wish to use various vertical restraints. The next section, Section 4, provides a more practical discussion of the same material.

In this section, it will become apparent that one of the reasons firms might use vertical restraints is to limit *free riding*, i.e., one firm receiving benefits from the actions of another without paying or sharing the cost. An earlier example was given in which there were two retail stores. One store advertised products that were available in both stores, and both stores benefited from the advertising. In this example, the second store is free riding on the store that bought the advertising. Not every service is subject to free riding, and when free riding on the provision of a service is put forward as a reason for a particular use of vertical restraints, the nature of the service must be critically examined. If the service can be charged for separately, as alterations of clothing can be, then there can be no free riding. The problem with free riding on an activity is that, if the free riding is significant, it can result in the service not being provided at all. It may be the case that the firm that pays for the activity does not itself receive enough benefits, so that it ceases to engage in that activity. In the above example, if the advertising store were the only one in the area that sold the advertised products, then it would receive all the benefits of the advertisement and might find advertising profitable. But if the other store received "too many" of the benefits of the advertising -- it took too many customers from the advertising store -- then the advertising store might find advertising unprofitable and discontinue it.

### *3.a. Upstream monopoly, downstream monopoly*

Consider a case in which there is a monopoly manufacturer and a monopoly retailer. The manufacturer sells its product to the retailer at the wholesale price. The retailer sells the product to consumers at the retail price.

Because the retailer is a monopolist, it chooses a retail price that is higher than its cost.[61] The manufacturer is also a monopolist. Therefore, it chooses a wholesale price that is higher than its production cost. Each firm maximises its own profits: neither firm considers the effects of its own choice on the profits of the other. In particular, the retailer does not take into account the manufacturer's marginal profit (wholesale price minus production cost) from each unit sold when it chooses the retail price. As a result of the manufacturer's and retailer's choices, the retail price is "too high" relative to the production cost. A vertically integrated monopolist would charge a lower retail price. The price would be even lower if both the manufacturing and retail markets were competitive. So, in the successive monopoly case, the manufacturer would make higher profits if it could convince the retailer to charge a lower retail price.

The manufacturer could impose some vertical restraints on the retailer in order to convince it to charge the profit-maximising retail price.

- The manufacturer could change the retailer a *franchise fee* (a fee that does not vary with the quantity sold) and set the wholesale price equal to production cost. In this solution, only one firm -- the retailer -- marks up its price over its cost. The retailer feels the full effect of its

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61 The cost includes not just the wholesale price of the good, but also the salaries of the workers, the rent and other overhead costs.

pricing decision on total -- retail plus manufacturing -- profits. As a result, total profits increase and retail price decreases.

-- The manufacturer could tell the retailer the maximum retail price he can charge, i.e., it could impose a form of *resale price maintenance* ("RPM").

### *3.b. Upstream monopoly, downstream monopoly, and provision of retail services important*

Consider now a case in which there is a monopoly manufacturer and a monopoly retailer, and services provided by the retailer to consumers are "important." Such services might include alterations (e.g., for clothing), delivery, or pre-sale information (e.g., for cameras). These services can be "important" in that they substantially increase consumer demand for the product. For example, a consumer is more likely to buy a camera if the salesman can teach him how to use it.

The retailer may not want to provide as many services as the manufacturer wishes him to provide. This is because, as in the example above, the retailer does not take into account the profits the manufacturer makes on each unit of sales. Instead, the retailer provides only as many services as maximises his own profits. Assume that it is very costly for the manufacturer to monitor the retailer to learn whether it provides these extra services. The manufacturer cannot, therefore, write a contract specifying the retailer's services. The manufacturer must, instead, devise a system of incentives to induce the retailer to provide the services.

-- The manufacturer could, as in the above case, set the wholesale price equal to its production cost and charge a franchise fee.

-- In contrast to the above example, resale price maintenance -- where the manufacturer specifies the price at which the retailer sells the product -- does not alone solve the problem of the retailer not providing enough services. The retailer provides only the amount of services that maximises its own profit; he does not get enough additional profits per customer to induce it to offer enough services. Only if the manufacturer also charges a franchise fee and sets wholesale price at its production cost, can RPM give the retailer the incentive to provide enough services.

In evaluating the competitive effect of resale price maintenance in this case, one must learn whether there is a tangible, substantial service that retailers supply to consumers, that substantially increases consumer demand for the product, and that the manufacturer cannot monitor. One must also determine the relationship between the wholesale price and the marginal production cost.

### *3.c. Upstream monopoly, downstream competition*

In this sub-section, assume that the manufacturer is a monopolist but the retailers are competitive. The externalities that retailers create for each other are examined here. The effects of *resale price maintenance, exclusive territories* and *tying* are shown.

#### *3.c.i. RPM and exclusive territories*

Assume that retailers provide some non-appropriable service[62] to customers, such as informative advertising, pre-sale information, or a large assortment of products. When consumers can go to a high-price, high-service retailer to get the service, then buy the product from a low-price, low-service retailer, the low-service retailer is said to be "free riding" on the high-service retailer. Because, by assumption, retailers are competitive, high-service, high-price retailers cannot survive. Therefore, no retailer offers the service and, eventually, it is not available to consumers.

The manufacturer does not want this outcome, because its sales are increased when the service is available. The manufacturer therefore acts to reduce free-riding among the retailers.

- The manufacturer could impose a minimum retail price (a form of *resale price maintenance*). Consumers will buy the product where they get their service because they know that they cannot find a lower price at another retailer.
- The manufacturer can grant *exclusive territories,* i.e., choose a retailer in each region or market segment to be the only retailer with the right to sell the product. In this case, the retailer has an incentive to provide more non-appropriable service since consumers cannot take the retailer's service and buy the product from a competitor. Instead, the retailer's sales are directly dependent on the service he provides. (Note that "territories" need not have a geographic meaning. Manufacturers could assign retailers to distinct types of customers, such as government, business and individual consumers.)

Either of these actions can increase profits of the manufacturer.

Either of these vertical restraints could have negative effects on competition. If the manufacturer imposes RPM, then retailers cannot compete by offering lower prices. Perhaps they will compete in providing better service. But if consumers do not value the extra service, then the competition does not benefit them. Alternatively, if retailers cannot compete on price (because the manufacturer has imposed RPM) then perhaps the retailers will not compete at all. If the manufacturer assigns exclusive territories, then each retailer will be a monopolist retailer of that manufacturer's brand in its territory. The resulting loss in retail competition may be worse than the loss of the non-appropriable service.

Therefore, to evaluate the competitive effects of the vertical restraints in this case, it is important to learn whether there is a service provided by retailers, but for which they cannot charge separately. The service must have a substantial effect on consumer demand. If there is no such service, then there are unlikely to be efficiency reasons for this vertical restraint and this vertical restraint may be used to reduce competition.

### *3.c.ii. Refusal to supply*

A manufacturer may refuse to supply a retailer because it has signed agreements with other retailers granting them exclusive territories. If a "nearby" retailer asks to sell the manufacturer's products, the manufacturer must either refuse to supply or violate its previous agreements. A manufacturer might refuse to supply a retailer because the manufacturer practices resale price maintenance and the retailer has cheated on the RPM agreement in the past. Hence, refusal to supply can be a tool to enforce another vertical

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62 "A non-appropriable service" is a service that the retailer cannot charge for separately. This means that customers can receive this service at one retailer and buy the product at another retailer.

restraint. (A manufacturer may refuse to supply on other grounds as well: the retailer may not be credit-worthy or may be likely to harm the reputation of the manufacturer, perhaps by not properly handling or servicing the product. These are valid business reasons.)

A refusal to supply has anti-competitive effect if it denies an input to a new entrant. For example, assume that a mine owns a rail spur and a new mine wishes to connect to it. If the first mine refuses to sell the service, "use of the rail spur," to the new mine, then this refusal to supply may prevent the new mine from operating and reduce competition in the ore market.

### *3.c.iii. Tying*

Consider now a variation of the case in sub-section 3.c.i. Rather than assume that the provision of a non-appropriable service is important, assume that it is important that the good sold by the monopolist be used with a particular good which is sold in a competitive market. For example, assume that vinegar is monopolised, food oils are not monopolised, and the quality of salad dressing made from the vinegar is dependent on the quality of the oil. The price of vinegar is the monopoly price, but the price of food oils is the competitive price. The downstream makers of salad dressing may substitute low quality oil for high quality oil and substitute too much oil for vinegar. Their salad dressing will not taste as good as if they had used high quality oil and the correct proportion of vinegar to oil. This could ruin the reputation of the vinegar maker, because consumers may blame the bad taste on the vinegar. Therefore, the seller of vinegar may tie vinegar to food oils, so that any buyer of vinegar must buy oil from him. In this case, the tying may have a positive competitive effect: the vinegar maker has an incentive to provide good vinegar and better salad dressing is available to consumers.

In other cases, the monopolist might be using its monopoly in one market -- vinegar -- to extend that power into another market -- food oil. In such cases, tying harms competition.

In evaluating the competitive effect of tying, one should determine whether there are technical reasons for the tie. Perhaps the performance of one good is substantially reduced if the other good is of low quality, and consumers cannot identify the reason for the low performance. Perhaps there are substantial cost savings from supplying the two goods together. If, on the other hand, one finds no such technical reasons for tying the products, the tying may be used to extend monopoly power from one market into another or to avoid price control in one market.

## *3.d. Upstream competition, downstream competition*

Consider the case where there is competition both in the upstream and the downstream markets. Assume that the manufacturer performs some non-appropriable service,[63] such as advertising or training retailers. For example, Volkswagen trains retailers' salesmen how to sell cars and retailers' technicians how to repair cars. Volkswagen faces the risk that a retailer will use that training to sell and repair Fiats as well as Volkswagens. It faces the risk that, when customers come to the stores, the retailers may try to convince consumers to buy a competing brand, Fiat, instead. (This may happen if the retailers get higher profits from the sale of Fiats than from the sale of Volkswagens.) The manufacturer of Fiat is said to be "free riding" on the training provided by Volkswagen.

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63 In this instance, a "non-appropriable service" is a service for which the manufacturer cannot easily charge the retailers.

In response, the manufacturers may impose *exclusive dealing* agreements on the retailers. I.e., each manufacturer may require that any retailer carrying its product cannot also sell a competing product. The exclusive dealing agreement enhances efficiency in this case because it stops the free riding of the manufacturer who does not provide the service on the manufacturer who does provide the service. If this free riding could not be prevented, then the manufacturer would provide less, or none, of the service.

Exclusive dealing agreements have an efficiency-enhancing effect only if there is a non-appropriable service performed by the manufacturer. If there is such a service, then exclusive dealing agreements encourage manufacturers to make the investment in the non-appropriable service and compete in the market.

Exclusive dealing agreements can harm competition in a number of ways. Exclusive dealing agreements reduce competition among different brands within a single retail outlet. However, this effect is unimportant if there are enough competing retail outlets. Long term exclusive dealing contracts can increase the barriers to entry into manufacturing if they force new entrants to set up their own distribution network.

To determine whether exclusive dealing agreements are justified, one should determine whether the manufacturer provides a service to the retailers for which the manufacturer cannot charge but which could help the retailer sell a competing brand. This service might be informative advertising, training of retailers, providing information to retailers, research and development, or so on. If such a service is provided, then the exclusive dealing arrangement may have a net positive effect on competition. If such a service is not provided, then the exclusive dealing agreements may be acting to reduce competition.

For the same reasons that a monopoly manufacturer might impose exclusive territories agreements, competitive manufacturers might do so. A manufacturer may wish to increase the quantity of non-appropriable services provided by retailers of his products in order to increase demand for his products. Consider an example in which there are both exclusive territories and exclusive dealing agreements. Assume that Volkswagen grants to its retailers exclusive territories. That is, they may promise to their retailers that no nearby retailer will be allowed to sell Volkswagen automobiles. If a potential buyer comes to a retailer to learn about Volkswagen cars, then the retailer is willing to spend hours answering questions and permitting a test drive because the retailer knows that the consumer can buy a Volkswagen only from him and not from any other retailer. The consumer can gather the same type of information about Fiats from the Fiat retailer. Therefore, the consumer learns all the relevant information about these cars and can make an informed choice between them. The consumer sees competition between Fiat and Volkswagen.

Consider what would happen if, instead, Volkswagen and Fiat did not grant exclusive territories to their retailers. Then, consumers could go to one Volkswagen retailer, use a salesman's time asking questions, then go to another low-price, low-service Volkswagen retailer to buy the car.[64] In this case, the high-price, high-service retailer cannot afford to provide the free information to potential buyers. He quits providing the service. Volkswagen is harmed because its reputation for high quality rests, in part, on the high quality of the service provided by its retailers. Also, consumers are less willing to buy a Volkswagen because they are less certain about its characteristics. Competition between Volkswagen and Fiat is diminished. Hence, granting exclusive territories can increase competition among brands.

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64 On the other hand, if the customer is using the pre-sale service to evaluate the quality of post-sale service (which is generally appropriable), then the pre-sale service is not subject to free riding.

### *3.d.i. RPM as a cover for cartel behaviour*

Consider another variation of the above case. Consider the case where the upstream market is competitive, the downstream market is competitive, but the retailers create a dealer cartel. In other words, the retailers create an association which then "imposes" RPM or exclusive territories on them. The result is that the retailers effectively reduce competition among themselves. However, there is no justification for their competition reduction: the restraints do not overcome any vertical inefficiencies. The phoney upstream institution is just a cover for a competition-reducing cartel.

## 4. Restraint by Restraint Review

### *4.a. Exclusive dealing*

An exclusive dealing agreement restricts the downstream firm, who agrees not to engage in any other business that competes with the upstream enterprise's activities.

An exclusive dealing agreement can reduce free-riding in the upstream market. If, for example, a manufacturer provides non-appropriable know-how or services to retailers and retailers carry competing products, then the retailers could apply the know-how or services to sell the competing product. An exclusive dealing agreement would reduce this behaviour, thus providing more incentive for the upstream enterprise to invest in and provide such know-how and services. For example, Volkswagen and Fiat may require that retailers sell only their own brand of auto. In return, Fiat and Volkswagen may provide to the retailers technical training on how to repair autos, how to run a small business and so on. If a Fiat retailer sold also Volkswagen autos, he might apply his Fiat training to sell the Volkswagens. If this occurs, Fiat's investment not only did not benefit it, it actually harmed Fiat.

Long-term exclusive dealing contracts by an upstream enterprise with large market share can raise entry costs of a potential upstream competitor if the downstream process has significant economies of scale or scope or if there are significant entry barriers.[65] Suppose, for example, that a coal mine has long-term exclusive dealing agreements with all the coal-fired electricity-producing plants ("generators") in its region. If another enterprise wished to open a coal mine in that region and sell to generators, it would have no customers in that region. It either must sell to generators outside that region, incurring higher transport costs, or to other coal customers. If the alternative buyers are too small, then the long-term exclusive dealing agreements may be a barrier to entry.

On the other hand, exclusive dealing agreements can facilitate entry by an upstream firm. For example, if the downstream firms are retailers, then such an agreement gives them strong incentives to engage in strong selling efforts.

### *4.b. Exclusive territories*

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65 Economies of scale means that, over some range of number of units, unit average cost is lower as more units are produced. E.g., the production of concrete has economies of scale. Economies of scope means that it is cheaper to produce two (or more) products together than to produce them each separately. E.g., the production of electricity and steam heat have economies of scale.

An exclusive territories agreement limits the territory or group of customers that a particular downstream enterprise may serve. Provisions do not necessarily refer to geographic territories; they may also refer to some other segmentation of the market, such as between business customers and non-business customers.

Exclusive territories agreements can reduce free-riding among downstream enterprises. If, for example, consumers can easily receive retail services from one retailer and buy from another, then some retailers may provide no such service but instead sell to consumers who received the services from other retailers. Simply because retailers provide some service, however, does not imply that free-riding is possible. Retailers can free-ride on the provision of retail services only if the retailer providing the service cannot realise all the additional revenue generated by the services. For example, if the retail service can be charged for separately, or is provided by a third party such as a consumer magazine, or is not costly relative to consumers' costs of implementing the free-riding, then there can be no free-riding on the provision of retail services. Similarly, if the upstream enterprise can enforce contracts specifying the retail services to be provided, there can be no free-riding.

Exclusive territories agreements can reduce or eliminate downstream competition. If the downstream parties to the agreement constitute a large part of the suppliers to the downstream market, then the set of exclusive territories agreements acts as a market-allocation agreement. E.g., if an upstream dominant firm signs exclusive territories agreements with almost all the downstream firms, then the downstream market is effectively allocated among them. On the other hand, if the upstream market is competitive, then the exclusive territories agreements do not have significant negative competitive effects.

Exclusive territories agreements might be used to support a cartel among downstream firms to limit output and divide markets. I.e., such agreements may be "covers" for downstream cartels, whereby downstream firms demand that an upstream enterprise "impose" an exclusive territories agreement and use the upstream enterprise to monitor and punish cheating on their cartel.

Exclusive territories agreements might be used by new entrants into the upstream market in order to convince downstream firms to buy from them. In this case, such agreements aid entry and the development of competition.

### *4.c. Tying*

A tying provision requires the downstream enterprise, if it buys one product, to buy another product from the same upstream enterprise.

Tying agreements might allow the upstream enterprise to monitor the level of downstream sales and to ensure some aspect of downstream "quality."[66] An example of the monitoring function is requiring the use by downstream enterprises of packaging material supplied by the upstream enterprise. An example of the quality assurance function is the upstream enterprise selling a complex machine only if it also sells a service contract for the machine. A rationale for this may be that the machine will have fewer breakdowns only if well-trained technicians service it, that the upstream enterprise can best monitor this quality and that buyers wish to pay a higher price for the better quality.

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66 See also F.M. Scherer, *Industrial Market Structure and Economic Performance* (1980), pp. 582-583.

Tie-in agreements can be used to price discriminate if the seller can charge higher than competitive prices for the tied good. For example, if the same buyers who highly value the machine also intensely use a particular input, but buyers who do not highly value the machine use the input less intensely, then the seller can tie the input to the machine and charge a low price for the machine and a supra-competitive price for the input. In effect, more intensive users pay a higher price for the use of the machine.

### *4.d. Resale price maintenance*

A resale price maintenance ("RPM") provision specifies the final price that downstream enterprises can charge customers. Variants specify price floors (minimum prices) or price ceilings (maximum prices).

RPM (setting a minimum retail price) may reduce downstream free-riding, such as free-riding on the provision of retail services, but only if retailers could free-ride (see the conditions above) and would not otherwise compete.

RPM may induce quality-certifying retailers to carry a product. If it is costly for a retailer to create an image of high-quality, then the high-quality retailer would be willing to carry a product only if the retailer would receive sufficient profits from its sale, i.e., only if it would not also be sold by a discount store.

RPM may reduce efficiency by limiting consumers' choice of price/service bundles for a given brand of product. It may also inhibit the development of more efficient forms of retailers, such as discount stores. It might also serve as a "cover" for a price cartel, in which downstream firms use the upstream firm to monitor and punish cheating on the downstream cartel.

## 5. Evaluating the Competitive Effects of Vertical Restraints

This section provides a brief guideline for evaluating the competitive effects of vertical restraints. Recall from the introduction that there are not simple rules which can tell competition officials when a particular vertical restraint should be prohibited and when it should be permitted.

- Consider the *market share* of the parties to the vertical restraint. Vertical restraints are unlikely to harm competition if the parties have small market share. On the other hand, if the parties have large market shares, the restraint may significantly reduce competition in a market, or even -- with sufficiently large market shares -- foreclose a market.

- Is one of the parties to the agreement a *new entrant*? An entrant may use the vertical restraint to facilitate his entry, i.e., for efficiency reasons. Generally, entrants are free to use vertical restraints.

- Consider *market structure*. Vertical restraints are unlikely to harm competition if the markets are not concentrated.

- Consider how *widespread* the use of vertical restraint is. The more widespread, the more interactions among the restraints may reduce competition.

- Consider the *dynamics of the market*. If entry is relatively easy, if there is innovation and are new entrants, then vertical restraints may be used to support the dynamic change rather than to suppress competition.

- Consider the *nature of the product*. Look for the service that may be the efficiency-increasing reason for the vertical restraint. For example, if a manufacturer has granted exclusive territories to retailers, look for the retail service upon which other retailers could free ride. If a manufacturer has imposed exclusive distribution, look for the manufacturer's service upon which other manufacturers could free ride. If there is no such service, then the vertical restraint is more likely to be anti-competitive. Note, though, that a vertical restraint could be both efficiency-enhancing and anti-competitive. Then the competition office must decide which effect is more important.

- Consider the *length of the contract*. As the term of the contract is longer, it has more potential to foreclose a market.

- Consider the *likely response* of the firms if the competition office prohibits the vertical restraint. For example, they may vertically integrate, substitute another vertical restraint, or exit the market. Determine whether this outcome would be worse than the current situation.

- Consider the *likely long run effects* of a prohibition. Would some firms be discouraged from entry or investing in research and development? Would such an effect be more or less important than an immediate reduction in competition?

## Appendix: Definitions of Some Vertical Restraints[67]

20. ***Bundling***

This term is also referred to as *package tie-in* and tends to occur when one product is sold in proportion to another as a requirement for the sale. It is related to the concept of **tied selling**. For example, a computer manufacturer may require customers to purchase along with the computer all or a specified amount of ancillary products such as floppy disks and printing paper. Alternatively, the sale may be made as a complete package such as an automobile equipped with all options including automatic transmission, cassette-radio and air conditioning. Bundling of products may be a source of economies or efficiencies for the manufacturer, part of which may be reflected in a lower composite price for the buyer than if all the different products were supplied or bought separately. However, bundling may also make it difficult for firms to enter different product segments of the market. The competition implications of bundling, including that of tied selling generally, are complex and need to be evaluated on a case by case basis adopting a **rule of reason** approach. See also **Tied Selling**.

90. ***Franchising***

A special type of vertical relationship between two firms usually referred to as the "franchiser" and "franchisee". The two firms generally establish a contractual relationship where the franchiser sells a proven product, trademark or business method and ancillary services to the individual franchisee in return for a stream of royalties and other payments. The contractual relationship may cover such matters as product prices, advertising, location, type of distribution outlets, geographic area, etc. Franchise agreements generally fall under the purview of competition laws, particularly those provisions dealing with **vertical restraints**. Franchise agreements may facilitate entry of new firms and/or products and have efficiency enhancing benefits. However, franchising agreements in certain situations can restrict competition as well.

168. ***Recommended or Suggested Price***

In several industries, suppliers may recommend or suggest the price at which a product may be resold. In certain cases the supplier may indicate the "maximum" price for the product in order to discourage retailers from raising prices to increase their own margins and thus reduce total sales. Such practices may be adopted in order to avoid violating laws against **resale price maintenance**. The specification and attempted enforcement of "minimum" prices for products is illegal in many countries.

169. ***Refusal to Deal/Sell***

The practice of refusing or denying supply of a product to a purchaser, usually a retailer or wholesaler. The practice may be adopted in order to force a retailer to engage in **resale price maintenance (RPM)**, i.e., not to discount the product in question, or to support an *exclusive dealing* arrangement with other purchasers or to sell the product only to a specific class of customers or geographic region. Refusal to

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67 The definitions are excerpted form *The Glossary of Industrial Organisation Economics, Competition Law and Policy Terms* (OECD, 1993).

deal/sell may also arise if the purchaser is a bad credit risk, does not carry sufficient inventory or provide adequate sales service, product advertising and display, etc. The competitive effects of refusal to deal/sell generally have to be weighed on a case-by-case basis.

173. ***Resale Price Maintenance (RPM)***

A supplier specifying the minimum (or maximum) price at which the product must be re-sold to customers. From a competition policy viewpoint, specifying the minimum price is of concern. It has been argued that through price maintenance, a supplier can exercise some control over the product market. This form of vertical price fixing may prevent the margin from retail and wholesale prices from being reduced by competition. However, an alternative argument is that the supplier may wish to protect the reputation or image of the product and prevent it from being used by retailers as a **loss leader** to attract customers. Also, by maintaining profit margins through RPM, the retailer may be provided with incentives to spend greater outlays on service, invest in inventories, advertise and engage in other efforts to expand product demand to the mutual benefit of both the supplier and the retailer. RPM may also be used to prevent **free riding** by retailers on the efforts of other competing retailers who instead of offering lower prices expend time, money and effort promoting and explaining the technical complexities or attributes of the product. For example, one retailer may not reduce price but explain and demonstrate to customers the use of a complex product such as a computer. The customer may after acquiring this information choose to buy the computer from a retailer that sells it at a lower price and does not explain or demonstrate its uses. In many countries, RPM is *per se illegal* with few exceptions or exempt products. Many economists now advocate adopting a less stringent approach in competition law towards RPM and other **vertical restraints**.

196. ***Tied Selling***

Refers to situations where the sale of one good is conditioned on the purchase of another good. One variant is *full-line forcing* in which a seller presses (or forces) a complete line of products on a buyer who is predominantly interested in only a specific product. Tied selling is sometimes a means of price discrimination. Competition concerns have been expressed that tying may foreclose opportunities for other firms to sell related products or may increase **barriers to entry** for those that do not offer a full line of products. An opposite view is that these practices are efficiency driven i.e., used to reduce costs of producing and distributing the line of products and ensuring that like quality products are used to complement the product being sold. For example, a computer manufacturer may require purchase of disks in order to prevent damage to or poor performance of his equipment by the use of substitute lower quality disks. There is increasing recognition that depending on different market situations, tied selling arrangements may have a valid business rationale. In the administration of competition policy, an increasing number of economists suggest adopting a **rule of reason** approach to tied selling.

203. ***Vertical Restraints (or Restrictions)***

Refers to certain types of practices by manufacturers or suppliers relating to the resale of their products. The usual practices adopted in this regard are **resale price maintenance (RPM)**, *exclusive dealing* and exclusive territory or geographic market restrictions. Under exclusive dealing and/or exclusive territory, a single distributor is the only one who obtains the rights from a manufacturer to market the product. A significant debate exists in the economic literature as to whether this confers **monopoly power** on the distributor. Usually, the distributor's market power is limited by inter-brand competition. The

manufacturer's purpose is normally to provide incentives to the distributor to promote the product and provide better service to customers. See also discussion under **Free Riding** and **RPM**.

# Demonopolisation

## 1. Introduction

Demonopolisation is a step that must be considered for an emerging market economy on its transition away from central planning and widespread state ownership of property. As the term is used here, demonopolisation means the breaking apart of one enterprise into two or more separately owned and managed enterprises, for the purpose of creating or furthering competition. The unrestrained economic freedom and private ownership of productive facilities that characterise capitalism are fully effective in serving the public interest only if conditions of competition are pervasive. The conversion of enterprises that are state-owned and managed into private enterprises will not fulfil its promise for prosperity and opportunity if the process creates pervasive private monopolies with the power and incentives to over-price their outputs and to ignore the needs and demands of their customers. Only competitive private enterprises are fully driven to fulfil current and anticipated consumer needs with products and services that are efficiently produced and offered with attractive quality and prices.

Demonopolisation should be planned to precede or accompany privatisation. Delay means that the economy will suffer from the needless exercise of market power during the period between privatisation and demonopolisation, and unnecessary long-lasting distortions may be induced by adaptation to these circumstances undertaken during this period. Demonopolisation is likely to be more difficult to accomplish after privatisation, because powerful resistance will be mounted by the new stakeholders created by privatisation. Equally important, the process of privatisation is likely to be impeded by the prospect of subsequent demonopolisation. This prospect will create unnecessary uncertainties for the valuation of property to be divested by the state, and may tilt the disposition of the property towards those with the most expected power to resist demonopolisation.

Of course, there is a natural temptation to delay or forego demonopolisation in the hopes of thereby increasing the state's proceeds from privatisation. Economics teaches that this temptation should be overcome. Whole foregoing demonopolisation can be expected to increase the state's proceeds from privatisation, it is a fundamental finding of economics that this increase in revenues is generally outweighed, to a significant extent, by the gains in social real income that are created by moving from monopoly to competition. If demonopolisation will certainly follow privatisation, then the bidders for the property will reflect this eventuality in their bids, and bid even less due to the uncertainties surrounding the scope and details of the eventual demonopolisation. And if demonopolisation is left completely indefinite during privatisation, the result will be even greater uncertainties and unfortunate opportunities for the new owner to derail the promotion of competition.

Thus, while it would be unduly limiting for national authorities entirely to relinquish their power to effect demonopolisation after privatisation, there is much to be said in favour of policies that raise substantial barriers to such interventions, and make it routine for demonopolisation to be considered prior to privatisation.

The perspective addressed by this paper is that of government officials in an emerging market economy with the responsibility of considering demonopolisation of a state enterprise prior to privatisation. The mandate of the officials is to decide whether to allow the enterprise to be privatised with its current structure and, if not, how to separate its assets into efficiently configured groups so that the resulting daughter enterprises will be viable and will promote competition. As will shortly become clear, there is no

formula to guide the officials in their work, and each enterprises to be privatised requires its own case-by-case fact-intensive analysis. Further, the demonopolisation decision for one enterprise may well depend on the decisions to be made about the structure of other ones.

Plainly, then, demonopolisation decisions will be made imperfectly, and the officials will be forced to made complex trade-offs among conflicting concerns on the basis of judgements that will inevitably be aided by far less information than would be ideal. Nevertheless, in emerging market economies, where the forces of evolution that have operated over time in mature market economies have been absent, it seems far better to make the inevitably imperfect attempt to promote competition with demonopolisation that to cede the economy to the structures that are inherited from a statist past. Further, a careful merger policy after markets have begun operating may diminish some errors of demonopolisation.

The aim of this paper is to suggest, with humility in the face of a difficult but vital responsibility, an analytic framework and process to assist government officials in emerging market economies in their task of considering demonopolisation. The first step of the process is the identification of the "relevant markets" (a term borrowed from competition or antimonopoly analysis), i.e., the groupings of products, with their associated locations of production or sale, within which to assess how the structure of the enterprise will affect the prospects for competition. The second step is to assess whether demonopolisation is necessary to promote competition in the relevant markets. If so, the process continues with the interactive analyses of the third and fourth steps that entail assessments of where and how many horizontal and vertical cuts should respectively be made in the enterprise's structure to create separate independent entities.

## 2. The Role and Identification of Relevant Markets

Whether or not the terminology is employed, any consideration of demonopolisation must make use of the idea of relevant markets. For example, no one would think that the existence of many sellers of vegetables would make it unnecessary to consider breaking up the only enterprise that makes and sells bicycles; that many food stores 200 kilometres away would make it unnecessary to consider breaking up the only enterprise that retails food in a town; or that the only enterprise retailing food on the south side of town should be broken up if there are many food stores on the north side of town, 1000 metres away. Translated into the language of "relevant markets," these examples say that the relevant market for bicycles does not include vegetables; that the relevant market or food stores in the town is too local to include stores 200 kilometres away; and that the relevant market for food store on the south side of town does include food stores on the nearby north side of town.

The first step of the analytic process suggested in this paper is to identify the relevant markets in which to assess the impacts on competition of the structure of the enterprise. A relevant market has two important dimensions, product and geography. The natural starting place is the set of products (and services) currently sold by the enterprise, and the locations of their production. The relevant product market for each such product is built up by adding any other products that are close substitutes to the first, from the perspective of their purchasers. For each product market, the associated relevant geographical market is built up from the location of the enterprise's production by adding any other locations from which production would offer good alternatives to those who buy from the enterprise.

Any independent firms that sell products in the relevant product market from a place that is in the relevant geographical market offer customers of the enterprise good alternatives, or close substitutes, and so are a source of competition for the enterprise. Conversely, firms whose products or locations are outside the

relevant market for an offering of the enterprise do not give the enterprise's customers good alternatives, and so are not a active source of competition for the enterprise.

Now that we have developed what we said is the natural starting point for the identification of relevant markets -- the set of products, with the associated geography, currently sold by the enterprise -- it is time to move on to less obvious, but perhaps equally important, relevant markets. One category of these starts with intermediate products of the enterprise that are not currently sold to customers, but that might find demand if they were offered for sale instead of being exclusively utilised inside the enterprise. For example, an enterprise might own and control a fleet of trucks that are employed exclusively to transport materials from one facility of the enterprise to another. Then a relevant market to analyse starts with trucking services in the region where the enterprise's facilities are located, and might be expanded to include other substitute forms of transport (like rail or boat) and other regions whose transport services would be a close substitute for the trucking services that the enterprise could offer. Such intermediate product relevant markets may be important to identify and analyse, because if no other firm offers products within them, appropriate demonopolisation of the enterprise may be vital to create a market that others can access in order to go into different lines of business, or to offer competition to the enterprise's sales of its end products.

Before moving on to the next step of the analytic process, it is important to alert the reader to a practical and conceptual problem with identifying relevant markets for demonopolisation analysis. What products are close substitutes to those sold by the enterprise will generally depend on the relative prices of the products, as well as on other prices in the economy. For example, medium power computers may be close substitutes for low power computers if the latter are priced well above costs, while they might not be good alternatives if the low power computers are priced closer to their costs. Consequently, the degree of competition for the sales of low power computers, which would affect their pricing, would influence the scope of the identified relevant market. In such a case, it would be a serious error to infer that a single seller of low power computers at high prices need not be demonopolised because of ample competition from sellers of medium power computers.

One solution to this conceptual problem of endogenous relevant markets for demonopolisation analysis is to avoid assessing customers' willingness to substitute at current prices, in favour of a test based on product functionality and production cost. Another product would thus be found to belong in the same relevant market as one sold by the enterprise if and only if they would become close substitutes when the enterprise's product were hypothetically priced close to its production cost. Alternatively, a judgement might be made about the degree of similarity of the products' functionality for buyers when prices were hypothetically close to costs.

Other prices in the economy might also affect the scope of relevant markets for demonopolisation analysis. For example, two gravel pits 100 kilometres apart might well offer buyers good substitutes if the rail or truck transport prices were sufficiently low, but become irrelevant as alternatives for each other at higher transport prices. It is clear that the identification of relevant markets should take such prices at their future anticipated levels, but it is also clear that in emerging market economies it may be impossible accurately to make such predictions. Since the analyst must adopt a view, it may be best to err on the side of conservatively narrow relevant markets in order to avoid subsequent danger to competition.

## 3. Whether to Demonopolise

The second major step in the demonopolisation analytic process is deciding whether to do it at all for the enterprise in question. Once the relevant markets have been identified, the question should be addressed of each one whether demonopolisation is necessary for the promotion of competition. The level of competition might not be significantly increased by breaking apart the enterprise because it already faces effective competition from foreign suppliers or from new entrants. At the other end of the spectrum, it may be the case that the enterprise is a natural monopoly for its relevant markets, so that demonopolisation would result in substantially higher market-wide production costs than the original enterprise would experience. In these cases, where entry barriers would protect the monopolist, regulatory alternatives to demonopolisation should be considered.

### *3.a. Markets with international trade*

International trade may limit the effect that demonopolisation of domestic industry would have on the degree of competition in a relevant market. If there are low transport costs and low import barriers, so that foreign producers are effective competitors of domestic producers, then demonopolisation will not significantly improve the competitive performance of that relevant product market.

Barriers to international trade can take various forms. Import barriers include not only tariffs and quotas; certain laws can aid or hinder international trade. For example, foreign sellers usually insist upon a convertible currency and the right to repatriate profits as prerequisites for trade. Foreign producers of a good that requires a distribution system, perhaps to provide technical service, need a contract law and the supporting legal system to ensure that they can make enforceable contracts with local distributors. Foreign investment laws can prohibit foreign ownership of certain production plants or protect property from confiscation. Foreign licensers are less likely to license domestic producers if there is insufficient protection of licensers' intellectual property. If these laws are inadequate, then competition from foreign producers may not be sufficient to provide effective competition to domestic monopolies.

"Temporary protectionism," which countries undergoing radical economic change may find attractive, affects the decision to demonopolise. Temporary monopoly prices may distort decisions regarding investments that will last beyond the period of protection. For example, a temporarily protected monopoly may invest in high-cost capacity, with which it will be encumbered long after the removal of tariff barriers. When long-term distortions would be large, it might be advisable to demonopolise an enterprise supplying relevant markets for internationally tradeable products even if import barriers were expected to be temporary. Demonopolisation might be inadvisable if the long term negative effects of monopoly were small and the import barriers were truly short-lived. However, privatisation without demonopolisation would create a powerful new interest group with strong incentives to resist the opening of trade.

When import barriers and transportation costs are low, foreign suppliers can compete against domestic enterprises. If foreign suppliers provide sufficient competition for domestic producers of a good, then demonopolising the domestic assets that supply that market would generally not increase the level of competition in that market. When import barriers are low, the following products, for example, might be tradeable: various sorts of steel, trucks and automobiles, large electrical generation and distribution equipment, some chemicals, and many other manufactured or agricultural products. However, if a product is not tradeable or if there exist other barriers to free importation, then demonopolisation may be advisable because enterprises that sell these products are less likely to face effective competition from foreign

producers. For example, retail distribution and many professional services are not usually traded internationally, so their suppliers should not be excluded from demonopolisation on the basis that foreign competition will be effective.

### *3.b. Markets with easy entry*

For markets into which entry is relatively free, demonopolisation may not significantly increase the level of competition. In such markets, the competition provided by actual or potential entry can constrain anti-competitive behaviour by incumbent producers in two ways: enterprises may enter the market and reduce the dominance of even a former monopolist; and enterprises may credibly threaten to enter in the event of anti-competitive behaviour. Regardless of which mechanism is the more important, demonopolisation would not further directly change the competitiveness of markets characterised by easy entry.

For entry to ensure long term competitive behaviour in a market with concentrated structure, three conditions must hold: entry into the market must be timely, of sufficiently large magnitude and likely in the event of anti-competitive behaviour in the market. "Entry" may mean the creation of a new enterprise to operate in the relevant market, or the extension of the activities of an existing enterprise outside the relevant market to new production within the relevant market.

Markets are less likely to satisfy the conditions for easy entry in economies undergoing radical transformations than in mature market economies. Even if the particular good has characteristics that make entry into its production or sale sufficiently easy (low sunk costs necessary for entry or a relatively small scale of production that is required for commercially viable cost efficiency), an "economic infrastructure" must be in place: there must be unhindered markets for intermediate and basic inputs, including capital, and an effective code of property and contract law. If these conditions do not hold, as they do not in many transforming economies, then entry cannot be counted on to limit anti-competitive behaviour sufficient to render demonopolisation unnecessary.

One factor that may offset the difficulties inherent in market entry in a transitional economy is technological change. Relative production costs enter importantly into an enterprise's decision to enter a market. If everything else is equal, entry is more likely when the entrant would use production methods with lower costs than the incumbents' method, as compared to the case where the two types of enterprises would have the same production costs. Thus, if existing monopolies have obsolete, high-cost production technologies and new competitors in transforming economies can readily import lower-cost production technologies from abroad, then entry may be easy and demonopolisation may be unnecessary.

In markets for which entry is sufficiently difficult that the decision is made to demonopolise the current supplier, entry conditions might nevertheless influence the partition decision. The demonopolisation partition would be less critical if subsequent large changes in market structure were expected. Such changes might result from substantial entry by new or foreign enterprises, or from technological change that quickly renders the present physical assets obsolete.

### *3.c. Alternatives to demonopolisation*

Some industries have such large economies of scale and scope over the range of outputs demanded in the relevant market that there is the condition of natural monopoly, where only one enterprise

can efficiently supply the market. Smaller producers would face such a large cost penalty that they would be uneconomic. Such industries may include the local distribution of electricity, natural gas, and some areas of telecommunications. If multiple producers cannot efficiently produce because of these cost conditions, then some means of limiting inefficient or anti-competitive behaviour other than demonopolisation must be sought. One solution is to privatise and regulate the monopoly. A discussion of the pertinent policy principles for this possible solution is outside the scope of this paper.

## 4. Partitioning Monopoly Enterprises

Having decided to demonopolise a particular enterprise, the next steps in the analytic process entail assessing how to partition the assets of the enterprise with horizontal and vertical cuts. The approach presented here focuses on the fundamental relationships among the current assets of the enterprise. Some assets should be held within a single enterprise in order to exploit economies of scale or scope or to exploit efficiencies of vertical integration. Other currently intra-enterprise relationships can be replaced, without significant efficiency loss, by arms' length transactions in a market.

Once these relationships are understood, the decisions about which assets belong together in one enterprise and which should be assigned to separate enterprises can be made. Sometimes, the benefits of additional competitors must be balanced against the benefits of economies of scale and vertical integration. The trade-off between efficiencies from vertical integration and the efficiencies resulting from creating formerly missing markets may also be weighed.

In any enterprise, a variety of assets work together to transform the enterprise's inputs into intermediate and final outputs. The two major categories of relationships among assets are horizontal and vertical. Two assets are related vertically if the output of one (the "upstream" asset) is the input of the other (the "downstream" asset). Two assets are related horizontally if they supply the same relevant market. For example, a production plant and its distribution network are vertically related, but two production plants that make the same product in the same town are horizontally related.

In practice, demonopolisation choices are constrained by sunk investments. For example, if machines are grouped together in a single factory, then assigning them to separate enterprises would require either that some of the machines be moved or that there be continuing negotiation by the separate enterprises over necessarily common inputs such as management, real estate and utilities (water, sewer, electricity). If these additional costs are large, then the machines must be assigned to the same enterprise by the demonopolising authority.

### *4.a. Horizontal cuts*

Demonopolisation decisions regarding the ownership of horizontally-related assets that supply the same relevant market are critical because the structure of the ownership of such assets affects the competitive conduct of private enterprises in that market. The primary way in which demonopolisation can ensure competition is in separating those assets into different enterprises, creating competition among multiple independent suppliers.

There is no definitive wisdom on the number of independent suppliers in a relevant market that is necessary for competition to be effective. It is generally accepted that more is better, to a decreasing extent, so long as the accompanying splintering of production does not raise total market-wide production costs.

The greatest incremental gain in social benefits from competition comes from replacing unregulated monopoly with two rivals, so long as they do not implicitly or explicitly collude. However, among oligopoly market structures, duopoly is the most prone to stable collusion. Thus, three firms might be seen as the smallest number from which the benefits of competition can be relatively confidently expected. It should be emphasised in any discussion of the impact of the number of market participants on competition that a host of other more detailed market characteristics may be equally or more important determinants of the degree of competition that can be expected in any particular relevant market.

There is thus a strong case for attempting to demonopolise to at least three equally capable suppliers for each relevant market by separating the horizontally related assets of an enterprise into groupings to be assigned to different independent enterprises.

There is also reason to go further, if doing so does not cause undue adjustment costs and does not cause ongoing loss of important economies of scale. Physically distinct plants that could participate in the same relevant market are natural candidates for separation. Physically distinct production lines in the same overall facility are the next most natural candidates, although a balance must be struck between the impact on competition and the costs of effectuating enough physical separation to make feasible their separate and competing management and ownership.

The fixed costs of individual production lines and facilities are one important source of scale economies that should obviously be taken into account in the balancing between number of competitors to be created and cost impacts. Another frequently important source of scale economies is a vertically related stage of production that feeds into or is fed from several physically distinct production lines or facilities. For example, one warehouse might be used to store the outputs from several plants, or one machine shop may fashion the tools and dies for several lines of metal-working machines. This source of scale economies may not need to be traded off against the number of independent suppliers, if it is reasonably efficient to separate this stage from the adjacent stage of production by means of a vertical cut.

In dividing horizontally related assets, attention must be paid to the division of a state enterprise's intellectual property among the daughter enterprises. If patents, licenses, blueprints and information accumulated through experience is improperly divided, then enterprises could be left without legal access to the technology they use and without the means of servicing old equipment or installed products. This problem could be avoided if intellectual property were distributed so that each daughter enterprise had the intellectual property (including patents, licenses and blueprints) that it applies to its physical assets. In order to facilitate competition in the servicing of installed products, the intellectual property associated with those sales (e.g., equipment installation and repair records) might be made available on a non-discriminatory basis to all daughter enterprises.

### *4.b. Vertical cuts*

There are two prominent and interrelated reasons for demonopolisation analysis to consider making vertical cuts among the assets of the enterprise. First, as just discussed, vertical cuts may diminish the costs of horizontal cuts by separating from the enterprise the source of significant scale economies. Second, vertical cuts can create new markets for intermediate products and services than can be accessed by the daughter enterprises created from the original one, by new entrants into the relevant downstream market and by enterprises entering different markets whose production can make use of the same intermediate products and services. These rationales would not apply where the relevant markets for these intermediate products and services already are supplied competitively. And these rationales should be balanced against

the efficiencies of vertical integration that would be lost from vertical cuts. To assess this balance, it is useful to have in mind the economic framework for analysis of vertical relations that has recently been developed.

Market transactions, contracts and integration are alternative ways in which assets can be related to one another. When failures of contracts or market transactions among assets would result in sufficiently large inefficiencies, then those assets should be assigned by the demonopolising authority to the same enterprise. This discussion identifies some cases in which the efficiency losses from non-integration are likely to be large.

Enterprises may use contracts to specify the characteristics of the products they buy and sell. However, sometimes it is too expensive, or impossible, to describe all the relevant characteristics in such a way that an independent arbiter, such as a court, could determine whether the terms of the contract were met. At other times, the terms of a contract cannot be specified under changing conditions, such as periods of unanticipated demand or after unanticipated technological change. If a country's contract law is not well-developed, then contracts may be more expensive to enforce, or enforcement may be more uncertain, than in countries where contract law is better developed. Therefore, in such countries, it may be more efficient to have more assets held within single enterprises than would otherwise be the case.

Two benefits of integration that should be considered in making demonopolisation decisions are the avoidance of "hold up" problems and the facilitation of the coordination of assets when the costs of faulty coordination are high.

"Hold up" occurs when one enterprise must make idiosyncratic investments -- that is, investments that are specific to the product of the supplier -- to use the output from another enterprise and no adequate contract can be written. For example, a coal mine may build a rail spur to a specific railroad. After the mine builds the spur, changing to a different supplier of rail transportation would be costly. The mine faces a monopolist; its next best alternative may be building another expensive rail spur to another railroad. The price offered by the monopolistic railroad will not be the competitive price, so the mine buys a smaller than optimum quantity of rail transportation. If the two enterprises were owned and managed together to maximise profits, then one enterprise would not "hold up" the other, and the optimal quantity of the good (rail transportation, in this example) would be traded between them. Therefore, when demonopolising, assets that could substantially "hold up" other assets should be placed together into the same enterprise.

Coordination of assets maybe easier if they are held in the same enterprise, under common ownership and management, than if they are held in separate enterprises. The efficiencies arising from vertical integration are apparent in a comparison of the following examples. One example is of relationship that is commonly contractual, without integration, while the other relationship is usually one of common ownership. A compressor is a pre-assembled component in a room air conditioner. Compressors must have specific physical characteristics and must be delivered to the air conditioner manufacturer according to a schedule. Coordination between the compressor factory and the air conditioner factory is achievable through a contract, enforceable through the courts, because the design of the air conditioners does not change very often or unpredictably: it is possible to specify each of the physical characteristics required of the compressor and the delivery schedule in a way that the parties to the contract are satisfied and a court can determine whether the terms of a supply contract were met. Integration is not required. Hence, an integrated compressor plus air conditioner manufacturing enterprise could be separated by a vertical cut, without loss of efficiencies, by the demonopolising authority.

The second example of a vertical relationship highlights the advantages of common ownership. This example involves a blast furnace and a primary reduction mill in steel production. In steel production, the metal must be delivered from the blast furnace in a molten state, at the correct time, at the correct temperature and with a chemical composition within certain specifications. It may be impossible to write an enforceable, comprehensive contract for this vertical relationship because the demands of the downstream processes change frequently and unpredictably, so that they would be difficult to specify beforehand. Effective, enforceable standards describing the quality of output provided by the blast furnace may also be difficult to specify in a way that can be verified later by an independent arbiter. Such stages of production should not be separated during demonopolisation.

Where there are no large cost savings from integration, vertically integrated enterprises compete in markets with non-integrated enterprises. For example, some room air conditioner manufacturers produce their own compressors while others buy compressors from other enterprises. Another example is provided by corrugators and carton-making machines. A corrugator is a machine that produces corrugated board from paper and glue. Carton-making machines are an array of machines that cut, print and fold the corrugated board to transform it into corrugated board cartons. Often, the corrugator and the downstream carton-making machines are owned by the same enterprise and located in the same building. Sometimes, however, the corrugator and carton-making machines are owned by separate enterprises and located several kilometres apart. In this industry, operations that are related by market transactions and by integrated ownership exist simultaneously, although each type of enterprise tends to specialise in the production of distinct types of cartons. When enterprises with different degrees of integration suffer little or no cost penalties, the daughter enterprises that result from demonopolisation need not have the same degree of vertical integration, and vertical cuts can be designed in the demonopolisation process to promote competition.

## 5. Demonopolising Example

This section provides an example of the demonopolisation of a vertically integrated monopoly food retailer. Although simplified, this example illustrates the examination of horizontal and vertical relationships between assets and the effect of economies of scale at one level on the ownership structure of another level. The example is a hypothetical one; in practice, entry barriers into food retailing are likely to be sufficiently low that careful demonopolisation would be unnecessary.

Assume that a single enterprise, named "StateFoods," owns all the retail food stores and a small fraction of the warehouses in a city. For simplicity, assume that a retail food store sells only shelf stable food (e.g., canned foods, flour, sugar, rice and spaghetti), which does not require special handling. The warehouses are used to store food before they are distributed to the retail stores. Statefoods obtains the food through supply contracts with food processors and food importers.

The analysis begins with identifying the relevant markets that the assets held by StateFoods will supply after the economic transformation. The relevant product markets may be found to be warehousing and food retailing. It is likely that food store customers will not travel far to buy food since the trip must be made frequently. Therefore, the geographic markets over which retail food stores compete are relatively small, perhaps a few kilometres in radius or less. Because the cost of transporting a truck over a few kilometres is small relative to the value of a truckload of food, a geographic market for warehouses is likely to be a city or large portion thereof.

The second step is to determine whether to demonopolise. If the input market (for example, the wholesale food markets and real estate market) worked well, effective competition from new entrants is likely: under such circumstances, a single retail store would not suffer significant cost disadvantages relative to the incumbent and the sunk capital costs would be relatively small. If sufficient and timely entry is likely, then demonopolisation would be unnecessary. For the sake of the example, though, the decision to demonopolise is assumed.

Next, horizontal and vertical cuts are considered, by analysing the relationships among the assets owned by State Foods. Retail stores use warehouses to hold their inventory since there is insufficient storage space in the stores. Therefore, the stores require timely delivery from the warehouses.

The necessary coordination between stores and warehouses might be achieved in a number ways. The same enterprises could own both the stores and the warehouses. Alternatively, separate enterprises could own the warehouses, lease them to the stores, and the stores manage the warehouses. A third alternative is for separate enterprises to both own and manage the warehouses, so that the stores simply buy food from the warehouse owner, who is now a wholesale food broker. The choice among these three (and more) alternatives is based upon at least the following considerations: the state of contract law and economies of scale in the provision of food warehousing.

If contract law is not well-developed, so that a store cannot be confident that terms of contracts will be met, then the store may need to own and operate its own warehouse. Because (by assumption) StateFoods owns only a small fraction of the warehouses in the city, such a solution likely would not significantly affect the level of competition in the warehouse market. Alternatively, if contract law is poorly developed but there are many food brokers in the city, the store might simply buy from the food brokers. In the event that one broker does not fulfil a contract, the store could buy from another broker. The credible threat of lost customers may limit the extent to which brokers do not fulfil their contracts.

If there are significant economies of scale in the provision of food warehousing, so that the per-store cost of food warehousing is substantially lower when a warehouse serves several retail stores than when it serves one, then there are two likely efficient configurations: retail stores remain independent and buy from food brokers, or retail stores are grouped into chains. In the first configuration, food brokers may be sufficiently large that they can fully exploit the economies of scale of warehousing and there may be enough competition among brokers that those cost savings are passed onto the retail stores. In the second configuration, each enterprise owns one or more warehouses and enough retail stores to exhaust the economies of scale at the warehousing level. If the state of contract law is such that stores and warehouses must be owned by the same enterprise, and food brokers do not provide an adequate alternative, then the second configuration would be superior.

Finally, the level of competition in the relevant markets, under the provisional demonopolisation plan, is evaluated. In this example, this evaluation is relatively simple. By assumption, the warehousing market is very unconcentrated, so it is likely to be competitive. The retail food store markets are likely to be competitive if each few square kilometres area had a number of retail stores. If the stores were grouped into chains, then losses of competition among retail stores can be minimised by having each small area served by several different chains.

## 6. Conclusion

Consideration of demonopolisation is a necessary component in the transformation of emerging market economies that should precede or accompany privatisation. Each part of the microeconomic transformation is linked with the others so that demonopolisation decisions may be affected, for example, by the robustness of capital and real estate markets, the level of import tariffs, and the convertibility of the currency. Further, the conflicting concerns that demonopolisation analysis must reflect and resolve take their shapes and levels of significance from a complex fabric of case-by-case facts and circumstances. Therefore, there can be no single policy prescription or formula for demonopolisation. It is inevitable that demonopolisation will be undertaken with inadequate information and insufficient time to evaluate the available information.

For such an environment, this paper has suggested an analytic framework and process for the officials undertaking the vital responsibilities of demonopolisation. The framework will best come to life and become more refined and useful as it is applied to the individual cases engaging the efforts of officials from emerging market economies.

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## Seminar on

# Competition Policy and Regulation: Telecommunications

## Pretoria, 13-14 June 2002

## Competition Commission of South Africa and OECD Centre for Co-operation with Non-Members


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**The opinions expressed herein are those of the authors and do not necessarily reflect the views of the U.S. Agency for International Development.**



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## AGENDA

## SEMINAR ON COMPETITION POLICY AND REGULATION: TELECOMMUNICATIONS
## PRETORIA, 13-14 JUNE 2002

### Thursday, 13th June

| | |
|---|---|
| 8:30 | Arrival, last-minute documents, coffee/tea |
| 9 | Welcome by Adv. Menzi Simelane, Commissioner |
| 9:15 | Introduction to the seminar |
| 9:20 | Overview of access regime reforms—Richard York |
| | coffee/tea |
| 10:30-12 | Competition and regulation in telecommunications—Christopher Libertelli |
| | lunch |
| 13-14 | Telecommunications access regulation in Australia—Richard York |
| 14-15 | Introduction to the South African reforms with emphasis on access issues |
| | coffee/tea |
| 15:15-17 | Presentations introducing reforms in SADC countries with emphasis on access issues |
| | --Botswana |
| | --Zimbabwe |
| | --Mauritius |
| | --Zambia |

### Friday, 14th June

| | |
|---|---|
| 8:30-10:45 | Presentations introducing reforms in SADC countries with emphasis on access issues (continuation) |
| | --Kenya |
| | --Malawi |
| | --Mozambique |
| | --Namibia |
| | --Seychelles |
| | coffee/tea |
| 11-11:30 | Number portability and carrier pre-selection—Richard York |
| 11:30 - 12 | Universal service—Christopher Libertelli |
| | Lunch |
| 13-15 | Policy implications for Southern Africa: Discussion |



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**Botswana**
**Department of Trade and Consumer Affairs**

## DESCRIPTION OF THE COMPETITION AND REGULATION OF BOTSWANA'S TELECOMMUNICATIONS SECTOR

### Basic structure of the Sector and any recent reform

The telecommunication sector in Botswana is guided by the Telecommunications Act, 1996(No.15 of 1996). The Act was established after the adoption of the 1995 Telecommunications Policy to licence all operators following the liberalisation of the Telecommunications Sector in the country. It led to the creation of the Botswana Telecommincations Authority (BTA) to regulate competition in the telecommunications sector.

### Institutions

The Ministry of Works, Transport and Communications (MWTC) was in the early 1990's charged with the responsibility of introducing sector reform and competition in telecommunications. Following a comprehensive public consultation MWTC prepared the 1995 Telecommunications Policy for Botswana. This document was subsequently considered by cabinet and adopted by parliament. The said Policy provided for the establishment of an independent regulator inorder to attract investment. In 1996 the Telecommunications Act, 1996 ("the Act") was enacted and the said Act established the Botswana Telecommunications Authority (BTA).

### General duties of the BTA

The BTA is a fully autonous body headed by the Executive Chairman. It is empowered to supervise and and promote the provision of efficient telecommunications services in Botswana. BTA's mandate covers three main areas;[1]

- Promoting the provision of services to satisfy all reasonable demand for services including emergency services, call boxes service and directory services;
- Promoting the interest of consumers in respect of prices charged, quality and variety of services, equipment and terminal equipment; and
- Promoting and maintaining competition and efficiency among service providers.

The Act further grants the BTA power to publish principles to be applied in the setting of tarrifs as well as to approve tariffs. It also has the exclusive right to award licences, to establish a national radio frequency plan, to monitor radio frequency use, resolve disputes amongst service providers and charge and retain licence fees.

Decisions made by the BTA in its dispute resolution are only appellable at the High Court, save for tariff disputes, which may be appealed to the Minister of Works, Transport and Communications.

[1] Effective Regulation Case Study: Botswana 2001 ITU/BDT



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**Accountability and reporting requirements**:

The BTA is accountable to a number of stakeholders to wit, Parliament through the Minister of Works Transport and Communications, operators and BTA Board members. The BTA is required to submit to the minister of Works, Transport and Communications an annual report on its yearly operations together with an audited report of its financial accounts. The Minister is further required to submit this report to parliament to ensure accountability.

**Economic regulation**

This sector has got no specific laws that govern it. Everything evolves around the Telecommunications Act, 1996. Ownership is not necessarily restricted to citizens there is however emphasis on citizen empowerment whereby locals are encouraged to team up with foreign investors. During the tendering process the issue of citizen ownership is an essential ingredient.

**Licences for various activities**

The BTA is empowered under the Act to issue various licences for the provision of various telecommunications services. The number of licences is not necessarily restricted to the provision of a particular telecommunications service.

The encumbent BTC also provides other services besides the fixed telephony. It also has an Internet Service provider Licence through its subsidiary company called BOTSNET.

The provision of services where no separate network is established, the operation of public call boxes, sale of terminal equipment other than radio equipment, however, do not require a licence.

**Access pricing**

The operators are allowed to make proposals on access prices to the BTA. If BTA finds that they are not consumer friendly it then makes counter proposals to the operators until a consumer friendly price is reached. The BTA in all these negotiation ensures that the best interests of the consumers are served.

**Final pricing**

The BTA, as stated earlier, is responsible for publishing principles to be applied in the setting of tariffs and also has to approve the said tariffs. So far it is in the process of setting up guidelines for the pricing of telecommunications services, which once finalised by the consultant and finally approved by the BTA will be published and used by the operators. The issue of interconnection is however left to the operators to negotiate and come up with certain charges. If they however cannot reach a consensus they forward the dispute to the BTA for resolution.

So far the BTA has successfully made one interconnection ruling. The BTA has also resolved a matter in which one of the ISPs had sought its intervention where the incumbent operator was reluctant to provide leased lines to it. The BTA ruled in favour of the said ISP and the incumbent has appealed the matter to the High Court. The said matter is still pending before the High Court.

**Universal Service**

Currently the MWTC plays a major role in the implementation of the nation's universal Service initiative, which is based on annual subsidies paid to BTC. In the early 1990's BTC was required to ensure that every village of 250-500 people would have the essential services. These were to include one public payphone, one line to the village chief and his administration, one to the school, in addition to lines to the clinic and the secondary school if they existed.[2]

The BTA is working on developing a Universal Service/access policy strategy to provide services to consumers that cannot otherwise afford them BTA has therefore commissioned Price WaterHouse Coopers to provide advice on how to design an efficient Universal Service programme. This would be paid up from the BTA's budget surplus. In the meantime mobile operators are helping to provide services in a number of communities. Both GSM operators have exceeded the coverage requirements included in their licence obligations.

**Number portability and carrier pre-selection**

This allows a customer to keep his directory number when changing his telecommunications network connection in order to spare the customer the inconvenience/cost of a number change while enabling them to benefit from competition and service upgrades. This was initially entrenched in the licence conditions for mobile operators but so far it has not been implemented and therefore there's no regulation on it.

Pre- carrier selection may only be feasible where there are more than one fixed line operators. At the moment we only have one fixed line operator.

**Commercial activities**

**Structure of the Sector**

The telecommunications market in Botswana comprises of one fixed line operator the BTC which is 100% owned by government. This was established in 1980 through the enactment of the Botswana Telecommunications Corporations Act and it became the sole provider for telecommunication services in the country. By the mid 1990s there was some disgruntlement by consumers and the coming into effect of mobile technology urged government to commission the MWTC to come up with a policy on sector reform hence the Telecommunications Policy of 1995 which introduced competition in the sector.

Following its establishment, the BTA licenced two mobile operators i.e. Mascom Wireless and Vista Cellular. The incumbent was not successful in the endeavour to bid for the GSM. The current GSM operators were granted a duopoly until 2003.

The two mobile operators have so far done well in the market such that one of them Mascom Wireless has overtaken the incumbent operator in terms of subscribers. In March 2002 the latest telecommunications statistics were as follows:
**BTC (fixed): 148155 subscribers**
**Total for both mobile: 332314**
The above data gives a fixed line teledensity of 8.8% and 19.7% for mobile telephony.

[2] Ibid

**Competition concerns**

There have been instances where the incumbent operator has abused its dominant power in the market. It has for instance, refused to provide leased lines to Internet service providers. The concerned ISP declared a dispute and the matter came to the BTA for resolution. After considering evidence before it the BTA issued an order directing the incumbent to provide the said leased lines to the aggrieved party. The incumbent was not satisfied with the decision by the BTA and appealed to the High Court. The matter is still pending.

Section 48 of the Act makes it an offence for any telecommunications operator to do any act that would amount to anti-competitive behaviour. If the BTA is satisfied that the operator has behaved in a manner that would be deemed as anti competitive, the matter would be referred to the Attorney General for prosecution. The said section 48 is therefore directly concerned with anti-competitive practices that would otherwise impede competition.

There is however a proposal by the Ministry of Trade, Industry, Wildlife and Tourism to set up a competition Authority to deal with competition issues during NDP9 2003-2009.

**Kenya**
**Monopolies and Price Commission**

## DESCRIPTION AND REGULATION OF KENYA'S TELECOMMUNICATIONS SECTOR

### I. Summary

The telecommunications infrastructure in Kenya is more or less consolidated under Telkom Kenya, which is a monopoly.

A ew years ago, Telkom Kenya was running the only Mobile Telephony network. The present structure in the telecommunications sub-sector is now a duopoly following the recent establishment of Kencell as a mobile services provider.

There has also been an attempt to establish three regional fixed lines providers. This attempt has not succeeded.

### II. Institutions

Overall regulation of the telecommunications sector is vested upon the communications commission of Kenya (CCK) which is established under section 3 of the Kenya Communications Act.

As a creature of parliament, a priori, there is no doubt that Parliament has a role in what it does. In any case, Parliament can amend or even repeal the law establishing CCK. At the Government level, the Ministry of Transport and Communications has a supervisory role and is answerable to parliament for CCK activities.

Under the Kenya Communications Regulations, 2001, CCK has power to demand information and to demand compliance by companies or enterprises which are actors in the Communication Sector.

Appeals against decisions of CCK are made to the Communications Appeals Tribunal established under section 102 of the Kenya Communications Act.

### III. Economic Regulation

**A.** The main law is the Communications Act of Kenya (No. 2 of 1998).

**B.** Restrictions

- The Law allows CCK to prescribe the terms and conditions of all licences. This does not preclude imposing terms and conditions germane to ownership.
- The Law allows CCK to prescribe terms and conditions relating to virtually all operational activities.

**C.** Although there is a duopoly in the Mobile telephony sub-sector, the two existing firms rely on Telkom Kenya for important services. The pricing of their services is therefore affected. Incidentally, one of the firms, Safaricom, is a subsidiary of Telkom Kenya which owns more than 50 percent of its shares. Also, even though there are about 60 registered internet service providers, they are all dependent on a single internet backbone supplier, Jambonet, which is owned by Telkom Kenya.

**D.** Disputes are resolved through Communication Commission of Kenya.

**E.** Universal Service. As pointed out, Telkom Kenya is a virtual monopoly.

## IV. Commercial Activities

(a) The fixed lines sub-sector is a virtual Monopoly. The mobile telephony sub-sector is a duopoly.

(b) The Communications Act of Kenya promotes Competition in this sector.

(c) In the mobile telephony sub-sector, consumers have benefited from Competition as shown herebelow.

**Table 1: Costs of Mobile Telephony under Different Market Structures**

| S/No. | Tariff Category | Rate in Kenya Shillings | |
|---|---|---|---|
| | | Monopoly | **Duopoly** |
| | Connection Fees | 68,000 | Zero to 2,500 |
| | Deposit | 40,000 | Zero to 4,000 |
| | Monthly fees | 3,500 to 20,000 | Zero to 750 |
| | Terminals (Least) | 10,000 | 5,000 |
| | Type approval | 10,000 | Zero |
| | Usage per minute | 21 to 28 | 10 to 15 |
| | SMS | No Service | Zero to 5 |
| | Service outlets | Nil | Legion |
| | Coverage | Nairobi | All major towns<br>Extending to Rural Areas |

***Source:*** *Summit Strategies and author. Any mistake(s) recorded herein should be attributed to the author and Summit Strategies remain absolved. Note that roughly 8 Kenya Shillings equal one Rand.*

(d) As said earlier on, there is only one fixed line national telecommunications provider. There are no providers of local fixed telecommunications although there are plans to establish 3 regional providers.

(e) There are two mobile telephony providers. They have spawned robust Competition and prices have gone down tremendously.

## V. Reform

There are plans to increase telecommunications providers. These plans will affect the germane gamut of entry, pricing freedom, exit freedom, universal service etc.

## VI. Competition Concerns

Section 5 of the Restrictive Trade Practices, Monopolies and Price Control Act, allows CCK to handle Competition matters specific to the Communications Sector.

The Monopolies and Prices Commission (MPC) is, however, not precluded from handling restrictive trade practices in the sector. The MPC must also approve all mergers/takeovers and can handle abuse of dominance issues.

Regulation 7 of the Kenya Communications Regulations, 2001, which deals with complaints regarding unfair Competition, provides that an aggrieved party can take any other action provided for under other applicable law. This gives the MPC some level of parallel jurisdiction. This is definitely short of concurrent or better still substantive jurisdiction.

**Malawi**
**Communications Regulatory Authority (MACRA)**

## THE COMMUNICATIONS SECTOR IN MALAWI

### BASIC STRUCTURE

The Government of the Republic of Malawi passed the Communications Sector Policy Statement in August, 1998. Following up on the Policy, the Communications Act, 1998 was enacted. The Act created the Malawi Communications Regulatory Authority whose remit is to regulate Telecommunications, Broadcasting, Postal Matters and Frequency Allocation and Management.

### OPERATIONAL RELATIONSHIPS

The Malawi Communications Regulatory Authority (MACRA) has a non-executive Board of nine with one of them designated as Chairman. They are appointed by the President on a four year renewable term. The Board reports to the Minister of Information. The Management of MACRA is headed by a Director General and a Deputy Director General and such other officers as the Board deems fit to appoint. All regulatory matters are handled by MACRA but the Board is required to seek the direction of the Minister on all Policy issues.

MACRA in its regulatory function has the power to enter and inspect the premises of operators and/or Broadcasters, ask for any information which would assist in the efficient performance of its functions and has the power to summon an operator for an explanation for certain conduct. It ensures a level playing field through deliberate licence conditions. The Communications Act gives MACRA the power to hear and make determinations where operators have a dispute with each other or with their customers. The decisions of MACRA can be appealed from to the High Court.

### ECONOMIC REGULATION

The question of ownership is governed by Government Policy. In this regard, Government Policy is aimed at empowering indigenous Malawians by giving them the opportunity to participate in the investments of telecommunications and/or Broadcasting Companies. A 100% foreign ownership without local participation is therefore clearly discouraged. The Authority (MACRA) has the mandate to decide, after assessment for the demand of the service, to issue or not to issue additional licences for any category of services.

The Policy statement clearly states the Government objective of making telecommunications services accessible to all the people of Malawi at affordable prices. To this end, MACRA, with the financing from DANIDA Commissioned a study to give an in-put to a Rural Telecommunications Policy whose draft now awaits Government approval.

Under the Policy, there is a Rural Telecommunications Development Fund to be managed by an agency comprising MACRA, Government and stakeholders. It is envisioned that operators who roll out to designated non-profitable areas will be subsidized from this fund.



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## COMPETITION ISSUES

In December, 1998, the Government of Malawi enacted the Competition and Fair Trading Act. MACRA in the exercise of its functions pays regard to this ACT, particularly now because the Government has not yet established the Competition Commission. Of particular interest to MACRA when scrutinizing Agreements, Decisions and practices of operators is section 32 which reads:-

> "Any category of agreements, decisions and concerted practices which are likely to result in the prevention, restriction or distortion of competition to an appreciable extent in Malawi or in any substantial part of it are declared anti-competitive trade practices and are hereby prohibited."

It will be an exciting day when the efforts of the Regulator (MACRA) are married with those of the competition Commission once established. In Malawi competition is yet to take off because there are only two cellular telephone operators and one fixed line operator. The relationship has been stormy forcing MACRA to issue a decision in May, 2000 suspending the interconnection Agreement for 24 months until the parties agreed on another more workable Agreement on Commercial terms.

## CURRENT DEVELOPMENTS

MACRA has concluded the process leading to the issuance of a Third Mobile Licence to Malawi Mobile Limited, a consortium of Ubambo of South Africa and Malawi businessmen in the ratio of 40% - 60% shareholding. It is believed that with the incumbent on the verge of being privatized by the invitation of a Strategic Partner and the three Cellular Operators, real competition will be engendered.

Studies to change the Numbering Plan were carried out sometime in 2001 and a new Numbering Plan, moving from the old six digit Scheme to an eight digit scheme will come into operation on 1st July, 2002.

Broadcasting is another fast expanding area. Having started with the National Broadcaster in 1998 when the communication Act was passed, MACRA has licenced another eleven Radios in three categories: Commercial (2), Community (2) and Religions(7). There are three pending applications for TV licences.

The foregoing represents an overview of the Communications sector in Malawi.

D.E. KADWA
General Counsel

**Mozambique**
**Mozambique Telecommunications (INCM)**

## MOZAMBIQUE - Telecommunication Sector Reform

The Mozambique Government is committed to the Telecommunications sector reform that we consider essential for successful implementation of a sustained development of the Telecommunications Sector.

### I. Telecommunications Policy Objectives

The overriding objective of the Mozambique Telecommunications Policy is to achieve the modernisation and rapid expansion of telecommunications networks and services. This will enhance national economic and social development, and integrated Mozambique internally as well as into the global economy. Telecommunications services should, accordingly, be efficient, affordable, reliable and available to all.

*The Specific Objectives are*:

- Promote widespread access to advanced communications services including the Internet and related capabilities to facilitate the implementation of the Government's ICT strategy;
- Enact necessary Laws and taking other measures promptly in support of the implementation of the Telecommunications Policy and to ensure effective competition and strong and independent sector regulation;
- Promote competition to meet growing demand through the liberalization of the telecommunications market;
- Ensure that the Government divest its interest in the state-owned telecommunications entities, especially Telecomunicaçoes de Moçambique "TDM".

To carry out these responsibilities, the Government has established a Telecommunications Policy Unit at the Ministry with the necessary competence.

### II Independent Regulation

The process of strengthening the regulator started in May 2001 in order to give more power and preparing to face with the process of reform of the sector.

The regulator shall be guided by the overriding objectives of the Telecommunications Policy and the Telecommunications Act, which shall reflect considerations of fairness, equity, and transparency. Such rulings shall not be directly influenced by the Politician or private industry, except in a transparent and open forum.

The Instituto Nacional das Comunicaçoes de Moçambique " INCM " is independent regulatory of all technical and economic issues in the telecommunications industry since 1992. The INCM has full administrative and financial autonomy with its own separate budget. In according with the new process of strengthening the regulator, the INCM will also have an independent board of directors with defined rules for appointment and removal. It shall be empowered to issue licenses, promote and enforce fair

competition, regulate tariffs of dominant operators, monitor and manager the radio-spectrum, protect consumer interest, and regulate all telecommunications licensees and service providers.
It will be the responsibility of the INCM to ensure that interconnection is available on non-discriminatory and cost-oriented basis to all authorized operators.

It shall design and maintain a national numbering plan and perform such other regulatory functions as may be consistent with its mandate to promote the development of Mozambique Communications.

The INCM will accordingly be restructured so that it can undertake these responsibilities.

## III Telecommunications Industry Structure

The objective of the Policy is ultimately to establish a long-term telecommunications market structure in Mozambique in which multiple private operators provide services on a competitive basis to the broadest range of customers. Accordingly, the INCM shall be authorized, pursuant to the Telecommunications Act, to issue operating licenses or a registration certificate ( depending on the services covered ) to all telecommunications services-providers to participate in all market segments, in accordance with the objectives of the Telecommunications Policy. Services may be provided, and where necessary licenses issued, according to any of the following modalities, or such other modality as INCM may be authorized under the Telecommunications Act: public tender invitation; competitive bidding; open application with minimum requirements; and unregulated entry.

The INCM shall make the establishment of transparent licensing process a priority among its functions, with the goal of awarding new licenses within the shortest possible time-frame.

The current Telecommunications Law grants a transitional monopoly to the Incumbent Operator "TDM" starting on the day of its privatization.

Also the Law 14/99 liberalized the value added services and the cellular mobile services.

The INCM will move rapidly to increase competition and large-scale private investment in the sector by authorizing competitive new entry to provide cellular mobile services by financially and technically capable firms through a competitive, timely and transparent license award process, by March – June 2002. The tender documents for the selections of these firms was released by the INCM on March 2002.

The introduction of the private sector to the ownership and operation of all segments of the market is a vital element of the establishment of an effective and efficient telecommunications sector. The Government will therefore actively liberalize the telecommunications market and encourage the participation of the private sector at all levels, with no limits on foreign ownership. The Government plans to divest its ownership in all telecommunications operators.

The process to privatize the incumbent operator "TDM" should start immediately. Prior to privatization and in preparation for the planned competition, TDM will be restructured to a corporate state-owned company (i.e., limited liability company) and will receive a new license issued by INCM, which among other things, should specify the company's service markets, and obligations in a liberalized, market.
The TDM will establish its mobile, Internet and international services as separate business units from the rest of its business. The new business units will have their own separate accounts.

## IV Tariff and Interconnections Policy

Under the competitive industry structure described above, competitive market forces would be the best determinant of the appropriate and sustainable levels of prices charged by various carriers for their services. However, it is likely that for some interim period active competition will not fully develop throughout the market, leaving one or more dominant operators with the power to control pricing. In these circumstances it is appropriate for INCM to establish tariff regulation requirements for such dominant operators, which will ensure that service price are cost-oriented, that consumers and competitors interests are protected, and that the industry develops in the most efficient manner possible. The INCM will allow TDM to complete the tariff-rebalancing plan, which it has already started.

The achievement of the goals of market-based competition in telecommunications requires also that every operator has mandatory access to technically adequate and economically efficient interconnection with all other operators, especially those operating long distance and local access facilities. It is the responsibility of the INCM to ensure that such interconnection is available on establishes a transparent set of interconnection rules.

## V Universal Access

The long-term objective of this policy is to enable all the people of Mozambique to have access to all form of modern information and communications services. This would support the economic, social, and political development of the country and its integration into the global information society. The Government will encourage the development of telecommunications and Internet services in the rural areas to promote rapid socio-economic development. Furthermore, educational institutions will be afforded access to basic and advanced telecommunications services in order to enhance and sustain educational standards nationwide.

Toward these ends, the Government, INCM and other public agencies, as well as all operators and market participants, would collaborate on the development and implementation of policies and strategies to achieve these goals as rapidly and effectively as possible.

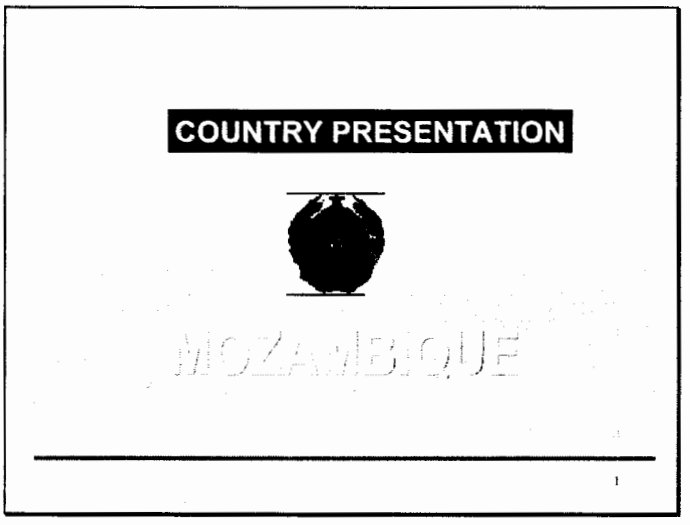
The Government shall formulate policies on universal access, including specific targets to be achieved over a given period of time. The INCM is responsible for promoting specific regulatory and market initiatives, including defining development targets and other interim and long term goals for national communications access. Any obligatory contributions to financing universal access by regulated telecommunications operators shall be administered in a transparent, non-discriminatory, and competitively neutral manner, and shall be applicable to, and imposed on all participants in the relevant market segments.

A Universal Service Fund will be established to help support the rapid development of universal access in areas that are inadequately served by present operator networks, and that may be perceived as uneconomic by the market. All licensed and authorized telecommunications operators and service providers will be required to contribute to the development of universal access.

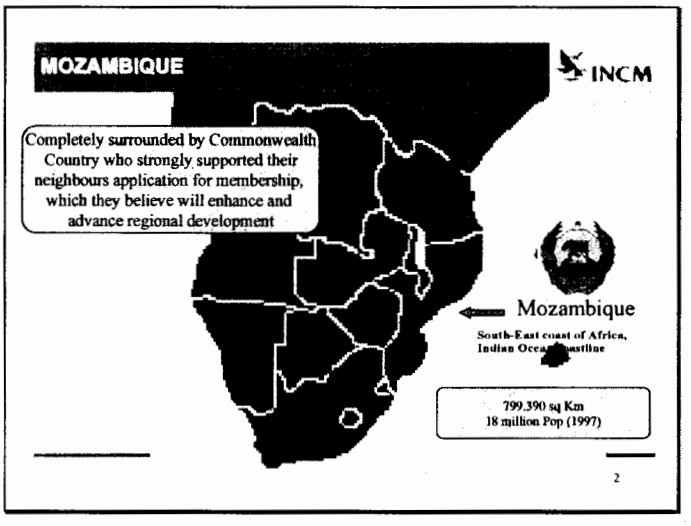
**Mozambique**
**Mozambique Telecommunications (INCM)**

**POWERPOINT PRESENTATION**

Slide 1




Slide 2



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Slide 3

MOZAMBIQUE

## The Economy

- 1987 - Economic Rehabilitation Programme (PRE);
- Privatization as foundation of the economic recovery programme;
- Government sold its interest in almost 700 companies;
- Two privatization agencies:
  - UTRE - for large industry;
  - GREI - small & medium industry and tourism.
- 1993 - Investment Law
  - - all investment projects should be proposed to and approved by the Investment Promotion Centre;
  - Investors are guaranteed the right to remit profits abroad and repatriate capital.

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MOZAMBIQUE

## BACKGROUD

**EVOLUTION OF THE TELECOMMUNICATIONS SECTOR REFORM**

| | |
|---|---|
| 1992 | INCM - Independent Communications Regulator Body |
| 1998 | Begun the evaluation of Telecommunications Sector |
| 1999 | New Telecommunications Law passed by Parliament (14/99) |
| 2000 2001 | Implementation of Law 14/99 |

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**MOZAMBIQUE** INCM

## AIM OF LAW 14/99.

**Open of Telecommunications market to private initiative;**

**Promote access to Telecommunications and Information Technologies;**

**Promote the development of telecommunications as catalyst for social and economic development of Mozambique.**

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**MOZAMBIQUE** INCM

**Telecommunications Sector Reform Process was launched in 2000, aiming to:**

- **Promote universal service access and increase teledensity from 0.5/100 in 2000 ? 2-3/100 in 2007;**
- **In the medium and long term, ensure an increase in the country's competitiveness in the regional and global markets through improved service quality;**
- **Encourage private sector investment in the development of the telecommunications sector;**
- **Promote access to new and advanced information technologies particularly in the rural areas;**
- **Ensure greater coverage of the mobile telephone service throughout the country.**

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**MOZAMBIQUE**

**This process comprises the following components:**

- ☒ **1. Drafting of the Sector Policy (Completed);**
- ☒ **2. Legal Reform;**
- ☒ **3. Institutional Strengthening of the Regulator - I.N.C.M.;**
- ☒ **4. Restructuring TDM E.P. allowing Private Sector Investment;**
- ☒ **5. Introduce competition in Mobile Telephone Services.**

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**MOZAMBIQUE**

## 1. Telecommunications Policy

***OBJECTIVES:***

- **Promote widespread access to advanced communications services;**
- **Promote competition to meet growing demand through the liberalization of telecommunications market;**
- **Divest the state-owned telecommunications entities;**

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## 2. Legal Instruments

- **Parliament approved Law 6/2001 that introduces changes to the exclusivity provisions provided in article 40 of Law 14/99.**

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## 2. Legal Instruments (cont.):

**Council of Ministers approved :**

- **Decree reviewing INCM's role;**
- **Decree on Access to Telecommunications Services;**
- **Decree on Interconnection.**

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## Legal Instruments under preparation:

- Draft Decree on Universal Service Fund;
- Draft Decree on Numbering;
- Draft Decree on Tariffs;
- Draft Decree on spectrum management and use of radio-communication equipment.

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INCM

## 3. Strengthening of the Regulator Body

INCM is in the process of restructuring - a consultant company to assist in preparing an institutional development plan, training program, review of existing legislation and development of new regulatory framework.

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MOZAMBIQUE

## 3. Strengthening of the Regulator Body (cont.)

*2001 - strengthening of the regulator Law 14/99:*

- to give more power and preparing to face with the process of reform of the sector;
- full administrative and financial autonomy with its own separate budget;
- Independent board of directors empowered to:
  - issue licenses, promote and enforce fair competition, monitor and manager the radio spectrum, protect consumer interest.

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## 4. Telecommunication Industry Structure

- The Law grants a transitional monopoly to the incumbent;
- Liberalize value added services and the cellular Mobile services;
- Govern actively liberalize the market and encourage the participation of the private sector, with no limits on foreign ownership;
- License award process for mobile - March - June 2002;

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## 5. Universal Access

***Long Term objectives:***

- **to enable all citizen to have access to all of modern information and communications services.**

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INCM

## 5. Universal Access (cont.)

***Government***

- **shall formulate policies on universal access;**

***Regulatory Body***

- **is responsible for promoting specific regulatory and market initiatives;**
- **development targets and goals for national communications access,**

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**MOZAMBIQUE** INCM

## Universal Service Fund

- Universal Service Fund will be established to support the rapid development of universal access
- All licensed and authorized telecommunications operators and service providers will be required to contribute to the development of universal access.

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**MOZAMBIQUE** INCM

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**Seychelles**
**Ministry of Information, Technology and Communication**

## SEYCHELLES SECTOR DESCRIPTION - TELECOMMUNICATIONS

There is very little doubt that Telecommunications has become a very important part of any country's socio-economic progress. This fascinating and fast paced industry affects every aspect of our lives including simple voice telephone calls, access to the Internet, high speed data communications, satellite communications, surfing the World Wide Web, fax transmissions, video conferencing and cable TV. Seychelles has one of the most advanced telecommunication networks in our region with very high levels of access the telephone with a teledensity of 26.32 % and the cellular density stands at 54.33 %. The Seychelles national telecommunications infrastructure presently consists of two modern, digital fixed telecommunications networks, which are interconnected, two mobile networks and a cable television network. Telecommunications services are also offered to the public through a Private Mobile Radio (PMR) network and two Internet service providers. As such, to date there is a duopoly in the fixed, mobile and Internet services.

This has been possible due to the small size of the country as well as rising level of investment by private companies and Government's commitment to telecommunication excellence. This is reflected by the structural approach adopted by the Government whereby; the Ministry of Information Technology and Communication (MITC) is responsible for both policy and regulatory matters and the provision of telecommunication services has been left in the hands of the private sector. Licenses are issued by Seychelles Licensing Authority (SLA).

As part of the telecommunication reform following the introduction of competition (November 1997) the incumbent operator was authorised to re-balance its tariffs. In addition, a new Broadcasting and Telecommunication Act was approved and assent by the President in April 2000. The new legislation addressed the following key issues:

### 1. Numbering System

Numbering is an essential condition to fulfil Equal Access to telephone services. In order to ensure that this is the case the Government after consultation with the telecommunication operators formulated a new numbering scheme. The act makes provision for the incorporation of the number portability into the existing plan however the telecommunication has been reluctant to provide this service because they feel that such venture would not viable. Therefore, the MITC intends to carry out detailed technical and financial studies to determine the viability of the service. It is worth noting that publication of telephone directory in Seychelles is through a tendering process coordinated by MITC.

### 2. Universal Service Obligation/Fund

The vision of the Government is one phone in every house in other words 100 % residential penetration. With the view of working towards vision the Universal Service Obligation (USO) policy was effected in 2000. The policy is based on a play or pay basis and the following issues among others are addressed in the policy:



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i) Defines the universal service in terms of penetration of lines and payphone.
ii) Creation of a Universal Service Fund (USF).
iii) Identifies the universal service providers.
iv) Setting the targets and their time scales.

In view of the explosive growth of the mobile terminals the telecommunication operators have requested that mobiles be taken in consideration when the issue of accessibility to telecommunication services.

**3. Interconnection**

Fair and effective interconnection arrangements are essential to the development of a telecommunications service market. For this purpose, operators are required to provide interconnection in a timely fashion, at any technically feasible point, under non-discriminatory terms and conditions and at cost-oriented rates. Any dispute that arises with respect to interconnection of telecommunication networks is reverted the regulator for final determination.

For over year now, carrier pre-selection has been available to customers of both telecommunications operators. Customers are therefore able to make international calls on the other operator Gateway through International Indirect Access (IIA) facilities from fixed line subscribers.

**4. Co-location**

Telecommunication operators are required to grant permission to other telecommunication service providers to collocate its equipment within the former's facilities. Telecommunication operators can only be exempted from this requirement only if they satisfy the Ministry that, due to technical reasons or limitations of space, they are unable to comply. In addition, the Ministry has effected a communication antennae policy to encourage sharing of towers amongst telecommunication operators.

Presently, the two fixed and Mobile operators have a tower sharing agreement and negotiations are well underway for them to share underground ducts.

**5. Filling of tariff**

As required by the Broadcasting and Telecommunication Act, tariffs for telecommunication services must be submitted to Ministry for approval. The submission includes all relevant information concerning rates, charges of services including deposits, non-recurring charges, monthly charges, advertisement, as well as terms and conditions applicable to the provision of services. The Ministry usually approves tariffs within seven days.

Tariffs proposed by the operator should be effective within thirty business days after filing with the Ministry unless within that period the Ministry issues a counter proposal or notice of modification to the operator.

## 6. Anti-competitive practices

The following practices are considered to be in contravention with the principle of free and fair competition:

a) Collusion between potential operators of telecommunication services in applying for or exploiting; a licence for such service;

b) Restraining access by any operator or user of a telecommunication service in applying for, or exploiting, a licence for such service;

c) Charging tariffs which are not in accordance with the applicable tariff structure; or

d) The use of a dominant positioning the market to restrict, prevent or deter the entry of another person into the market, or to oust a person from the market.

MITC has investigated and successfully resolved complaints of anti-competitive practices and in some cases we have requested for the assistance of foreign telecommunication authorities. Most of the complaints were related to promotional packages that were being offered.

However, from the experience gained from these past cases, the Ministry may consider introducing additional regulations to ensure fair competition.

Finally, the Government has recently issued the first draft of the National Telecommunications Policy (NTP) for comments/ views from all stakeholders in the sector. The policy is to serve as guidelines to all parties involved, including providers and investors, particularly with regards to the requirements of investment, human resource development, network and service facilities and absorption of new technology.

- Universal Service Policy was effected last year

i) Defines the Universal Service
ii) Setting the targets and their time scales
iii) List of service to be included in the provision of Universal Service
iv) Creation of a Universal Service Fund (USF)

- First Draft of Telecommunication and Information Technology Policy

## TELECOMMUNICATION AND COMMUNICATION INFRASTRUCTURE

Public Switched Telephone Network (PSTN):

i) Teledensity at present is 24 % (Fixed lines and Fixed cellular terminal)
ii) Households penetration of 70%. USO target: 90% by April 2004
iii) 4.08 Public Payphones per 1000 inhabitants. USO targets: Installation of one additional payphone in each district every year.
iv) Outlying Island Domestic Satellite (DomSat) system (limited to 9660 bps) recently upgrade to VSAT

Mobile GSM Service:

i) Mobile phone penetration is 12%
ii) Explosive Growth of Mobile subscribers 100 % growth annually
iii) Prepaid Service (Low income and Low usage users)
iv) Increase access to basic telephone service.

Maritime Communication System:

i) Being an Island State Maritime communication is vital for emergency and socio-economic development of the country
ii) Member of the International Maritime Organisation (IMO)
iii) Measures are currently being undertaken to ensure that Seychelles Coast Station is Global Maritime Distress Safety System (GMDSS) compliant

In order to further the Broadcasting and Telecommunication Act 2000, Information Technology and Communication is responsible for both policy and policy and regulatory matters. That would allow the formulation of a new set of policies to ensure that the nation possesses the necessary infrastructure and regulatory framework to take full advantage of the changing global environment. The policy will lay the foundation for an accelerated expansion of services and networks to the benefits of users and the stakeholders. It is further likely to diversify the range of basic services and promote the introduction of new technologies.

**Zambia** – joint presentation by:
**Zambia Competition Commission (ZCC) and**
**Communications Authority of Zambia**

## DESCRIPTION OF THE COMPETITION AND REGULATION OF THE ZAMBIAN TELECOMMUNICATION SECTOR

### OVERVIEW

In Zambia, the telecom sector comprises one Fixed Line Operator who also provides cellular, and two other cellular operators. In its quest to enhance competition and raise the standard of service a fourth mobile operator is being introduced in to the sector.

There are currently nine licenced ISP's, though only 5 are already functional.

### INSTITUTIONS

The executive arm of the Zambian government is divided into ministries, each headed by a minister. Parliament keeps a check on the executive by, inter alia, scrutinizing ministerial reports presented during parliamentary sessions. Telecommunication falls under the Ministry of Communication and Broadcasting.

The Communications Authority, a statutory body, regulates the telecom sector. The telecommunications Act, Chapter 469 of the Laws of Zambia, gives the Authority power to, among other things, demand for information from and give directives to operators. Appeals against decisions of the Authority generally lie to the High Court of Zambia.

### ECONOMIC REGULATION

Other than the Telecommunications Act 1994, two other statutes regulate the sector – namely the Radio Communications Act Chapter 169 of the Laws of Zambia and the Competition Act.

It is required that at companies seeking to have a licence should have a given minimum Zambian ownership.

As regards number of licences, companies providing services such as mobile cellular and Internet are restricted to one licence in a given category. This means a company cannot have two mobile cellular or two Internet service licences. However, companies are not precluded from having both Mobile Cellular as well as an ISP Licence.

### ACCESS PRICING

Access terms and conditions are generally not regulated as such but are left to the parties to agree upon. There are however plans to follow guidelines to be adopted by the SADC region.

As regards final pricing, there is a requirement that a go ahead be always sought from the regulator before the proposed prices are effected. Upon submission for approval the regulator scrutinizes the proposed charges advises the operator to advertise the same in the national press. The regulator then further scrutinizes the proposed charges taking in to account public reaction. A decision is then made whether to effect the new charges or not.

## UNIVERSAL SERVICE

The Communications Authority seeks to ensure the provision of telecommunications and its related services at reasonable charge to all without distinction. Universal service in Zambia is to be funded through the National Telecommunications development Fund. Part of what the operators pay to the Authority is destined to this fund. The Authority also contributes to this fund in question.

The Authority encourages operators to invest in rural areas as a way of ensuring universal service. The regulator seeks to give incentives to operators seeking to enhance Universal Service.

Communication's Authority's decision to issues another mobile cellular licence was prompted by the need to move towards universal service. The Authority includes a clause in the operator's licence ensuring services are provided to a given geographical area within a given time. This, it is hoped will help in the quest for universal service.

## NUMBER PORTABILITY AND PRE SELECTION

Number portability is currently not available in Zambia. Subscribers have to obtain a totally new number upon switching providers. There being only one carrier, subscribers have no choice but to have their calls carried by Zamtel.

## COMMERCIAL ACTIVITIES

The Zambian telecommunications sector is structured as follows:

Zamtel has the monopoly in fixed national traffic. It also has a monopoly in international service as well. The monopoly is de facto, sustained by current government policy. Things are however in the process of changing with a new piece of legislation outlining licence fees payable for international service having been passed.

Where as there used to be a de facto monopoly in Public Payphones there is now competition. The said competition began with the coming of a second provider of that service.

There is currently no monopoly, de facto or otherwise, in the provision of Mobile Cellular services. There are currently three providers of the service with the fourth in the process of coming.
Similarly, as regards ISP's there is no monopoly. There are nine licenced ISP's though only five are currently operational as mentioned earlier.

## REFORM

One area of reform in the sector has been the formation of an association of utility regulators. It is hoped that regulators can through the association share experiences and thus learn from each other.

There had been talk of restructuring the government owned operator. The goal was to enhance both efficiency and competition. The said restructuring is now dependant on the current government's policy on the matter.

## COMPETITION

The Communications Authority (CA) granted a communications company with basic local voice telephone services (B1). Further, the CA approved the requirement that Zamtel interconnects the licensee for purposes of activating the license. On this basis Zamtel was required to sign an interconnection agreement. Zamtel at first did not oblige and were apparently very active in the other licensee's catchment area. The Commission regarded the above conduct as a possible contravention of the anti-competitive provisions of the Act. The Commission was of the view that Zamtel's conduct may have been aimed at foreclosing competition in the sector. Thankfully, the matter is as good as resolved with the parties being in the process of effecting an agreement.

Further, Zamtel has allegedly engaged itself in several market place activities which are largely indicative of abuse of dominant position of market power in the internet service provision. For instance, due to the requirement to interconnect with or install equipment in Zamtel premises, the other ISPs submit that they have found themselves to be revealing business details before services are provided and Zamtel seems to be taking advantage of this. The complainants have alleged that Zamtel has either replicated the installations, or simply delayed the processing of installation applications of the ISPs.

The Zambia Privatization Agency (ZPA) proposed a plan of privatizing Zamtel which, among other things, grants Zamtel exclusive right, for seven years, to provide all basic telecommunications services comprising both the domestic and international voice traffic over the public switched network.

The granting of seven year exclusive rights to Zamtel to provide all basic telecommunications services both domestic and international voice telephony through the privatization of Zamtel, in its present form, could result in concerns with regard to foreclosure and distortion of competition in Zambia.

In this regard the Commission has laid out its preferred mode of privatization of the telecommunications company. This basically entails unbundling the value added segments of Zamtel. Essentially it means unbundling the telecommunications company into different firms operating independently and in competition with each other.

Thomas Malama
Communications Authority
Zambia

Banji Milambo
Competition Commission
Zambia

**Zimbabwe**
**Postal & Telecommunications Regulatory Authority of Zimbabwe (POTRAZ**

## ZIMBABWE TELECOMMUNICATIONS SECTOR DESRIPTION

### SUMMARY

The Postal and Telecommunications Act (Chapter 12:05) of 2000 fully deregulated the postal and telecommunications sectors. The Act of 2000 enabled licensing in fixed, mobile, data, internet services and private network services; and repealed the Acts of 1970 that had created the Posts and Telecommunications Corporation (PTC).

### INSTITUTIONS

The Postal and Telecommunications Regulatory Authority of Zimbabwe (POTRAZ) is an Independent body responsible for regulating both the postal and telecommunications sectors. The Authority is funded from the income generated by its activities such as fees and charges.

The sector policy comes from the government through the Ministry of Transport and Communications.

The Authority can request for as much information as required especially when it comes to license applications and Regulatory reports. Where licensee or applicants are aggrieved by the decisions of the Authority they can appeal to an Administrative Court through the Minister of Transport and Communications

### ECONOMIC REGULATION

The telecommunications sector in Zimbabwe is governed by the Postal and Telecommunications Act Chapter 12:05 of 2000. There are some Statutory Instruments (S.I.) that provide the supporting regulations to the main Act. These include:

i) SI 11A of 2001 Licensing, Registration and Certification
ii) SI 16A of 2001 Fees for Licenses
iii) SI 262 of 2001 Internet Services

The companies or organisations applying for service license need to be incorporated under the Zimbabwe Companies Act. For public licenses foreign shareholding is limited to forty nine percent (49%).

A public service licensee may not hold more than ten percent (10%) shares in another public license. A company that does not meet the requirement has to indicate its plans to meet the specification within three years.



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The pricing of services is the sole responsibility of the License. However, all tariffs have to be submitted to the Authority for approval. The Authority's position is that all tariff ought to be cost based, therefore the tariff submissions need to identify the various cost components and their contribution to the tariffs; the assumptions made in deriving the tariffs; the profit margins and return on investment achieved by the proposed tariffs.

Among the mandates of the Authority are encouraging fair competition and consumer protection. In analysing the tariff submissions the tries to ensure that there are no uncompetitive elements and that the tariffs are reasonable for the consumers. It is often difficult to balance the two.

Universal Service provision is the responsibility of all public licensed operators. The objects of the Universal Service Fund include to finance or assist in financing the extension of telecommunication services to under-serviced areas, where under-serviced area means any area that is not, in the opinion of the Minister formed in consultation with the Authority, adequately provided with telecommunication services.

The Universal Service Fund (USF) is funded through prescribed annual contribution to the fund by licensed public operators. The prescribed annual contributions are currently a percentage of the audited gross turnover of the licensed operator.

The Authority is currently working on regulations that govern the dispensing of the funds.

Number portability should be introduced by licensed operators by the end of 2002. Location portability where a customer can keep their number when changing location; and service portability when changing service; and service provider portability are defined in Zimbabwe.

Carrier selection is to be introduced gradually by licensed operators and each operator will have introduced carrier selection by end of 2003. The licensees are expected to cooperate with other network operators in the specification and development of carrier selection to allow a choice of routing.

ACCESS PRICING

FINAL PRICING

UNIVERSAL SERVICE

COMMERCIAL ACTIVITIES

REFORM

COMPETITION CONCERNS

**Zimbabwe**
**Industry and Trade Competition Commission**

## THE TELECOMMUNICATIONS SERVICES SECTOR; ZIMBABWE

### Introduction

This paper outlines the reforms in the Telecommunications Services Sector of Zimbabwe that are currently underway. The reforms include the enactment of an appropriate legal framework and the setting up of appropriate institutions to spearhead developments in the sector. It is anticipated that the institutional framework for telecommunications in Zimbabwe will emerge to become a modern, liberalized sector with active and distinct roles for policy-maker, regulator, service provider and user.

### I. Summary

In line with the economic reform programme, of which privatisation is an integral component, Government approved a policy to reform and restructure the telecommunications services sector. The development has been necessitated by the desire to expand the sector and open it up to competition through new investments in order to meet demand. The reforms include the enactment of an appropriate legal framework and the setting up of appropriate institutions to spearhead developments in the sector. The restructuring exercise entails the unbundling of The Posts and Telecommunications Corporation (PTC) a former state monopoly into successor companies in the postal (ZimPost), fixed telecommunications (Tel*One) and mobile telecommunications (Net*One).

### II. Institutions

The new Postal and Telecommunications Act of 1999 established the Postal and Telecommunications Authority ('the Authority"), a statutory body responsible for regulatory functions in the sector. The Authority is responsible among others, for licensing, setting tariffs, allocating frequency, setting standards and regulating operations in the sector.

The sector ministry's main role (Transport and Communication) is now development of a supportive policy framework. It is however, vested with powers to give the Authority policy direction, giving directions to the licensee on matters of public interest and national security, and prescribes any matters requiring prescription. If there is need for any legislative changes in the sector, the Authority will submit proposals to the sector ministry, which in turn takes the matter to parliament for debate. Parties aggrieved by the decision of the Authority first appeal to the Minister, and may appeal against the Minister's orders to the Administrative Court.

## III. Economic regulation

### A. Main laws that govern the sector

The sector is now governed by the new Postal and Telecommunications Act [12:02] of 1999. This Act supercedes the Postal and Telecommunications Services Act [Chapter 12:02], which granted the PTC a monopoly in the fixed wire services. The new Act amended the Broadcasting Act [Chapter 12:02]. The Posts and Telecommunications Corporation Act [Chapter 12:03] which established the Posts and Telecommunications Corporation and defined its composition and functions and the Radiocommunication Services Act (Chapter 12:04) which empowered the Posts and Telecommunications Corporation to allocate, monitor, and manage the frequency spectrum and to grant permits and other business operators of radio services were repealed.

### B. What restrictions are there on:

i). Ownership

The restriction regarding ownership is that no foreigner will be allowed to hold more than 49% in a company intending to operate in the telecommunications services sector of Zimbabwe.

ii). The number of licenses for various activities?

There are no explicit restrictions on the number of licenses for various activities. The limiting factors would be the technical capacity of the system to take more operators and the size of the market. New operators are invited through the tendering process.

### C. Access pricing

Telecommunication Operators are obliged to interconnect their networks with others, without discrimination, to ensure accessibility of services and networks. Operators negotiate their Interconect Agreements. The agreements are scrutinized by the Authority to ensure that they comply with requirements. The Authority also provides guidelines and intervenes in case of disputes or disagreements.

### D. Final pricing

Licensees for a cellular telecommunication, postal and fixed wire services submit to the Authority for approval proposed tariffs at the commencement of the licensing period. Similarly proposals to amend or replace the tariff that was approved have to be notified to the Authority for its approval. The aim of the Authority is to ensure that the tariff levels encourage private sector investment and at the same time protecting the consumer. If the tariff regime proves to be distorted, the Authority may intervene by introducing flow prices and or price caps.

**E. Universal service.**

The new Authority administers the Universal Service Fund (also established by the Act) whose purpose is to fund training, research and development and the delivery of telecommunications services to under serviced and economically unattractive areas.

Funds are raised through contributions levied on license holders i.e operators. This however, may not generate adequate resources, additional funds would have to be added by Government from moneys appropriated by Act of Parliament and moneys appropriated from the funds of the Authority.
The Authority identifies providers of universal services and these will mainly be local authorities or their appointed agents. However, operators interested in the provision of these services are also considered.

## IV. Commercial activities

Although there is now a new Act in the sector the successor Telecommunications Company was granted a period of exclusivity for a period not exceeding three years over the installation and operation of Public Switched Telephone Network. However, operators of value adding services such as internet, storage and forwarding of facsimile messages etc still can be authorized. The period of exclusivity will therefore be characterized by lack of competition.

The cellular mobile telecommunications services was opened up in 1996 after the Supreme Court of Zimbabwe declared the PTC's monopoly in the provision of mobile telecommunications services unconstitutional. The first company to provide cellular services was Net*One, 100% government owned through PTC a public monopoly. Econet Wireless (Pvt) Limited, a private entity, came in 1998 and Telecel (Pvt) Limited, another private operator, also started services around 1998. All the mobile companies have Interconnect Agreements with the sole provider of fixed wire services.

The successor mobile company (Net*One) is now competing with other licensed mobile operators. There are at the moment three mobile operators. More players in the mobile sector will be licensed as and when the need arises.

**POWERPOINT PRESENTATION**
**RICHARD YORK, AUSTRALIAN COMPETITION AND CONSUMER COMMISSION**

Slide 1

## Overview of access regime reforms

OECD seminar on competition policy and regulation, June 2002

Richard York
Director - Regulatory
Telecommunications Branch
Australian Competition and Consumer Commission

Slide 2

## Overview

- Introduction;
- rationale for regulating telecommunications;
- the rationale for access regimes;
- features of effective access regimes;
- challenges in implementing access regimes;
- emerging access issues; and
- conclusions.

Slide 3

## Telecommunications before access regimes

- Access regimes - major telecommunications regulatory reform of last 15 years;
- prior to formalised access regimes:
  - Aust and UK: initially government owned and controlled fully-integrated monopoly, followed by corporatisation and external retail price control;
  - US: privately owned monopoly local exchange carriers (LECs) and limited competition in long-distance services (inter-exchange carriers, or IXCs).

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## Why regulate telecommunications?

- Large fixed costs/low marginal costs leads to "natural monopoly" characteristics in telecommunications;
- regulation needed to ensure natural monopolists don't set excessively high prices;
- achievement of certain social policy objectives - eg. Universal service obligations (USOs).

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## Why have access regimes?

- Whilst nat. monopolies had prices regulated, they were subject to very little (if any) competition;
- shift to access regimes a response to concerns that price regulation was not sufficient to encourage nat. monopolies to seek productive efficiencies
  - ie. felt some form of competition would provide better incentives to seek productive efficiencies

Slide 6

## The over-riding goal of access regimes

- How can you introduce competition in the presence of nat. monopolies?
- whilst some stages of the production process may exhibit nat. monopoly characteristics (eg. local loops); other stages may not (eg. switching, retailing etc);
- goal of access regime:

  enable competitors in downstream markets to gain access to those essential inputs which it would be inefficient for them to duplicate

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## Outcomes of access regimes

- Expected outcomes of access regimes:
  - introduction of more competition;
  - prices pushed closer towards underlying costs;
  - greater range of service offerings for consumers.
- Actual outcomes in Australia since the introduction of the access regime:
  - increase in service providers from 2 in 1991 to over 100 in 2001-02 (and over 800 ISPs);
  - significant decreases in the price of many telecommunications services.

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## Making access regimes work

- Implementing access regimes is extremely challenging;
- 2 key features of a good access regime:
  1. Competitors (access seekers) can actually get access to essential inputs;
  2. Access is priced appropriately.

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## Features of appropriate access prices

- Access seekers can compete if they are equally efficient in downstream stages of production process;
- competitors have appropriate build/buy incentives;
- promote efficient use of infrastructure;
- compensate access providers for efficient investment.

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## Features of appropriate access prices (cont.)

- Argued this is best achieved when access prices reflect costs;
- incentive regulation requires these costs should reflect efficient costs;
- examples include forward-looking cost estimates.

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## Some challenges for the regulator

1. Is there an incentive for access providers to delay providing access?
2. How does one determine efficient costs?
3. Which cost types should be estimated?
4. Should prices be geographically de-averaged?
5. Should prices be per minute, per packet, flat, uniform etc?

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## The issue of structural separation

- Can access regimes work if a fully vertically (and horizontally) integrated incumbent ex-monopolist remains in the market?
- is there a need for some form of vertical and horizontal separation of the incumbent's activities?
- Would this lead to losses of economies of scale and scope?

Slide 13

## Access and "next generation networks"

- Many new services require the interconnection of many different types of network;
  - eg. High speed data services provided by ISPs
- as new technologies and network types emerge, interconnection arrangements are likely to become more complex;
  - likely to create new challenges for the regulator

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## Conclusions

- Access regimes are an attempt to introduce competition into previously monopoly markets;
- competitors require access to essential bottleneck inputs, and at efficient, cost-based, prices;
- implementation of a successful regime is highly challenging;
- more challenges are likely in the future as "next generation networks" emerge.

**POWERPOINT PRESENTATION:**
**CHRISTOPHER LIBERTELLI, UNITED STATES FEDERAL COMMUNICATIONS COMMISSION**

Slide 1

# Competition and Regulation in Telecommunications

Christopher Libertelli
Special Counsel for Competition Policy
United States Federal Communications Commission
June 13-14
Pretoria, South Africa

Slide 2

## Overview

- Benefits of Competition
- Methods of Introducing Competition
- Interconnection Issues
- Access Issues and Competitive Safeguards
- Pricing Issues

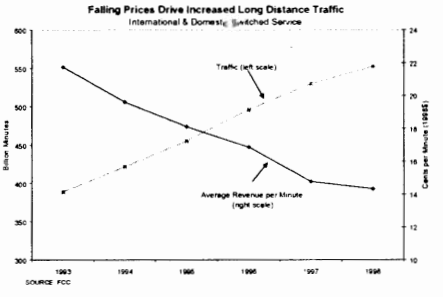
Slide 3

## Benefits of Competition

- Lower Prices / Better Choices
- More Rapid Innovation
- Faster Diffusion and Deployment of Innovation
- Reduced Need for Regulation
- Spur to General Economic Development

Slide 4

## Benefits of Competition



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## Methods of Introducing Competition

- Forms of Competition
  - Full Facilities Based Competition
  - Unbundled Network Elements
  - Resale
- Critical Issues
  - Interconnection
  - Pricing
  - Quality

Slide 6

## Methods of Introducing Competition

- Full Facilities-based Competition
  - Ultimate goal is to achieve full facilities-based competition. This minimizes the need for regulation, while maximizing innovation and consumer benefits.
  - Facilities-based competitors include wireless carriers.
    - In fact in many areas, wireless technology may be the least-cost, most efficient technology for providing voice and data services.

Slide 7

## Methods of Introducing Competition

- Reasons for Not Relying Totally on Full Facilities-Based Competition
  - Takes a long-time to develop.
  - High entry barriers, including sunk costs and high risks
  - Problem of residential competition

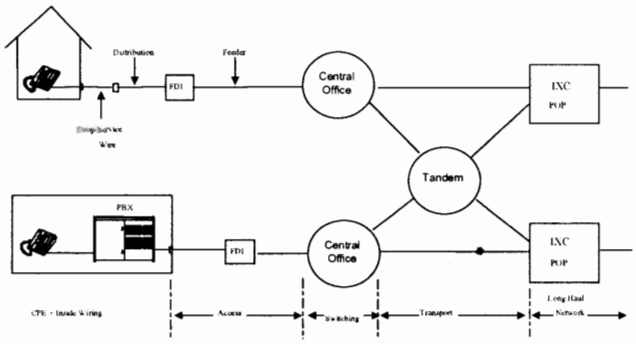
Slide 8

## Methods of Introducing Competition

- Thus, in the U.S., relied on Resale and UNEs as well.

Slide 9

## Local to Long Distance Interconnection




Slide 10

## Unbundling and Access to Physical Facilities

- Definition and Statement of the Issue
  - Bundling occurs when two services (or products) are sold as a package for a single price
    - Pure Bundling v. Mixed Bundling
  - Bundling allows a firm with monopoly power over one service to effectively monopolize the second by tying the sale of the potentially competitive service (or product ) to the purchase of the monopoly service

Slide 11

## Unbundling and Access to Physical Facilities

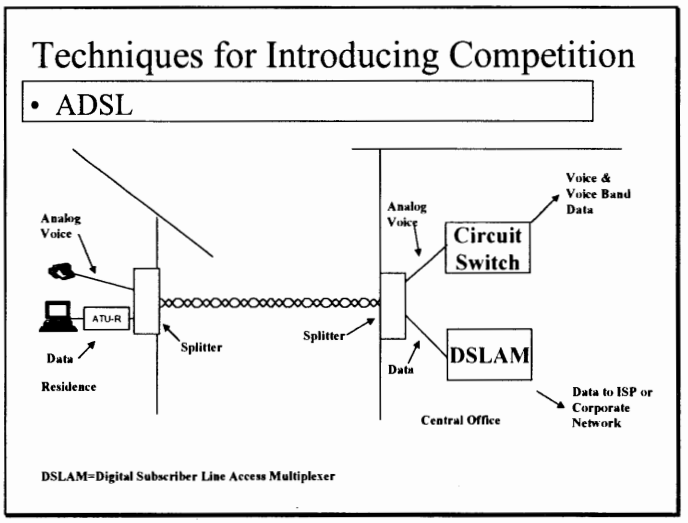
- Definition and Statement of the Issue (cont.)
  - Bundling can also raise the cost of a competitor by forcing the competitor to buy both essential facilities and services and those that are not needed.

Slide 12

## Unbundling and Access to Physical Facilities

- Potential unbundled elements:
  - Local loops
    - Entire loop, physical parts of loop, bandwidth
  - Local and tandem switches (including vertical features)
  - Interoffice transmission facilities
  - Network interface devices
  - Signaling and call-related data base facilities
  - Operations support systems (OSS) functions
  - Operator and Directory Assistance

Slide 13

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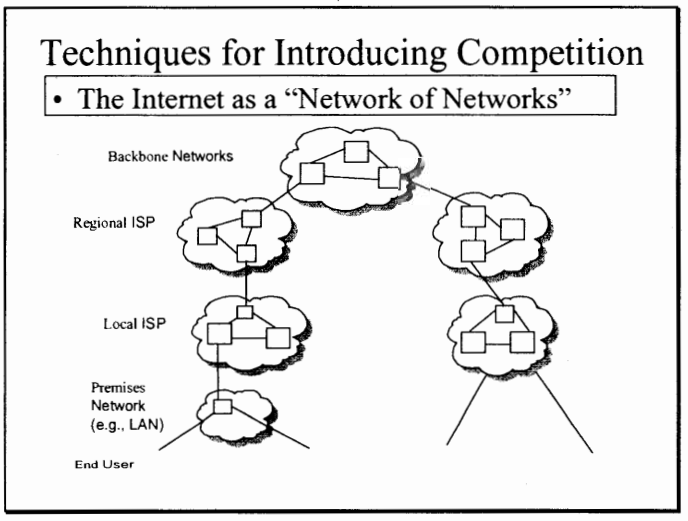

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## Access Requirements and Incumbent Responses

- Other access issues:
  - Problem of Legacy OSS
  - Problem of Physical Changes to incumbent CO
  - Line Sharing example?
  - Enforceability of "ascertainably clear rules"?

Slide 16

## Unbundling and Access to Physical Facilities

- Other access issues:
  - Eminent domain
  - Rights-of-way
  - Pole attachments
  - Duct space
  - Inside wiring
  - Roof rights
  - "Dry" copper/dark fiber

Slide 17

# Pricing Issues

- General Pricing Principles -- *Rate Structure*
  - *Dedicated facilities*: Charges should be flat-rated (e.g., charges for unbundled loops, dedicated transport, and collocation).
  - *Shared Facilities*:
    - If shared facilities are subject to congestion, peak-load pricing is most efficient. There are practical problems with peak-load pricing, including difficulty in identifying peaks, geographical variations in peaks, and shifting peaks.
    - Second best solutions include: (1) per-minute rates; and (2) flat, capacity-based rates.

**POWERPOINT PRESENTATION**
**RICHARD YORK, Australian Competition and Consumer Commission (ACCC)**

Slide 1

# Telecommunications access regulation in Australia

OECD seminar on competition policy and regulation, June 2002

Richard York
Director - Regulatory
Telecommunications Branch
Australian Competition and Consumer Commission

Slide 2

## Overview of presentation

- Brief history of telecommunications reform in Australia
- Australian Competition and Consumer Commission's (ACCC) role in telecommunications regulation
- Telecommunications services subject to third-party access regulation by the ACCC
- Pricing principles applied for access to telecommunications services
- Indicative prices determined for access to key services
- ACCC's arbitration function
- Changes in prices at the retail level



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Slide 3

## Telecommunications reform in Australia

Pre-1991 - Government monopoly

1991 - limited entry

- Optus provided fix carrier licence
- Vodafone and Optus provided mobile carrier licences

1997 - open entry

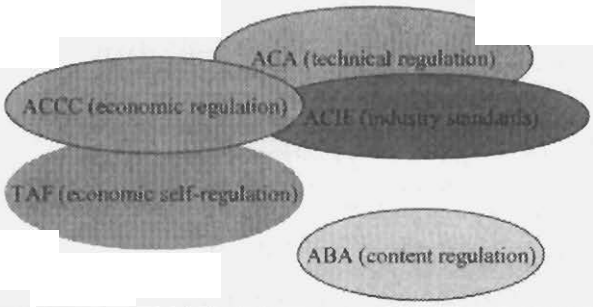
Telecommunications-specific access provisions (Part XIC of the Trade Practices Act)

Telecommunications-specific competitive conduct provisions (Part XIB of the Trade Practices Act)

S

## Current regulatory framework

Co-regulatory framework, with reliance on various government regulators and self-regulation



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## Australian Competition and Consumer Commission (ACCC)

- Independent Federal Government agency - formed in 1974
- General competition regulator
- Traditionally responsible for enforcement of/compliance with:
  - restrictive trade practices laws
  - misleading and deceptive conduct laws
- In 1996 the ACCC given new responsibilities by the Government
  - prices surveillance
  - access regulation

Slide 6

## Australian Competition and Consumer Commission (ACCC)

- In 1997 the ACCC given responsibility for competition regulation for telecommunications
  - telecommunications specific access regime
  - telecommunications specific anti-competitive conduct (or enforcement) functions
  - information gathering and record keeping powers
  - power to give directions to the ACA on number portability, electronic addressing and technical standards on interconnection
- Why deemed necessary?
  - Importance of industry to economy as a whole
  - degree of market power held by incumbent Telstra
  - Competitors highly dependent on access to function
  - rapid technological change

Slide 7

## ACCC role in telecommunications access

- No general right of access to services
- ACCC 'declares' services to which access is made available
- Commencement of regulatory regime in 1997 certain services were 'deemed' to be declared
  - those covered by access agreements under the 1991 access regime

Slide 8

## Deemed declared services

- domestic public switched telephone network (PSTN) originating and terminating services;
- domestic GSM originating and terminating services;
- transmission;
- digital data access service;
- conditioned local loop service; and
- analogue broadcasting access service.

Slide 9

## ACCC declarations

- Currently two other ways services can be declared:
  - recommendation from an industry self-regulatory body
  - by the ACCC after it has held a public inquiry and is satisfied that declaration would promote the 'long-term interests of end-users' (LTIE)
- The LTIE is a legislative 'test' which requires consideration of whether declaration of a service will:
  - promote competition;
  - encourage efficient investment; and
  - achieve any-to-any connectivity.

Slide 10

## ACCC declarations

- If a service is declared, the provider of the service must conform with legislated 'standard access obligations'
- ACCC also has power to vary, revoke or provide exemptions to service declarations in accordance with the LTIE test

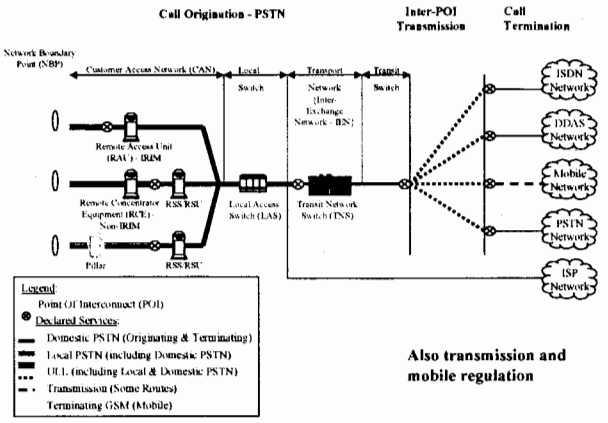
Slide 11

# Services declared by ACCC

- unconditioned local loop service
- local PSTN originating and terminating services
- local carriage service
- integrated services digital network (ISDN) originating and terminating services
- domestic transmission capacity service
- analogue subscription television broadcast carriage service

Slide 12

## Service declarations and the telecommunications network



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## Revocations, variations and exemptions

- Transmission capacity service - removal of access regulation between major capital cities (variation)
- Analogue mobile phone service (AMPS) originating and terminating access service (revoked following close-down of the service)
- Local carriage service - flagged removal of access regulation in CBD areas of major capital cities (draft exemption decision)

Slide 14

## ACCC role in specifying access prices for declared services

- Accept an access 'undertaking' submitted by an access provider
- Set prices in an arbitration and power to publish determinations
- Publication of pricing principles including actual prices
- But only apply where access provider and access seekers cannot agree on a commercial basis

Slide 15

## Access undertakings

- The ACCC can accept or reject an access undertaking
- Accepting an undertaking means that it must be applied by the ACCC in an access arbitration
- An access seeker and access provider can still negotiate different terms and conditions
- No undertakings have been accepted by the ACCC to date

Slide 16

## General access pricing principles

- The Commission released its general access pricing principles for telecommunications in July 1997
- It decided that a Total Service Long-run Incremental Cost (TSLRIC) approach was most appropriate, having regard to the legislative criteria
  - in particular, promotes efficient build-buy decision
- The decision of what pricing principles to apply to particular services is determined on a case-by-case basis.
- The Commission noted the TSLRIC approach was appropriate for telecommunications services:
  - that are necessary for competition in dependent markets;
  - where the forces of competition, or threat of competition works poorly to constrain the price of access to efficient levels; and
  - that are well-developed in the market.

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## Pricing principles applied for specific services:

- **TSLRIC**
  - Domestic PSTN originating and terminating services (strictly TSLRIC++)
  - Unconditioned local loop service (strictly TSLRIC+)
- **Retail minus retail costs**
  - Local carriage service
- **Benchmarking against average retail price movements**
  - Domestic GSM originating and terminating services

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## Pricing principles applied for particular services

- Differences in approaches between services reflect:
  - consideration of impact of particular Government retail price controls (not under the control of the ACCC)
  - level of competition
  - level of maturity of markets
  - regulatory costs

Slide 19

## Indicative prices issued by the ACCC (excluding GST):

- Domestic PSTN originating and terminating services
  - 1.3 cents per minute
- Unconditioned local loop service
  - $13 per month (CBD areas)
  - $21 or $35 per month (Metropolitan areas)
  - higher in regional and remote areas
- Local carriage service
  - retail costs for calls 2.74 cents
  - retail costs for basic access $57.71
- Domestic GSM terminating service
  - 24.5 cents per minute (starting price)

Slide 20

## Arbitrations conducted by ACCC

- 46 arbitrations conducted to date
- Most notified by access seekers
- Most involve Telstra as the access provider
- Most have not required final determinations by the ACCC ie settled commercially by the parties during the arbitration
- 3 currently in progress



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## Arbitration statistics

| Service | No. of arbitrations | No. settled by parties | No. settled by ACCC |
|---|---|---|---|
| PSTN originating and terminating access | 14 | 5 | 8 |
| Digital data access service | 2 | 1 | 1 |
| ISDN access | 1 | 1 | - |
| Freephone and local number portability | 3 | 2 | 1 |
| GSM originating and terminating access | 9 | 9 | - |
| Local carriage service | 9 | 9 | - |
| Anologue subscription broadcast carriage service | 2 | - | - |
| Unconditioned local loop | 4 | 4 | - |
| Domestic transmission capacity service | 2 | 2 | - |

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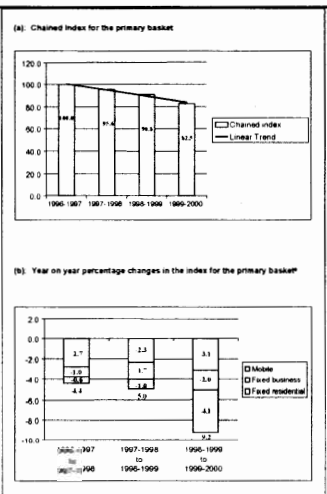
## Retail telecommunications price changes

Index developed using data supplied by main carriers in Australia: AAPT, C&W Optus, OneTel, Telstra & Vodafone



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# Further information

- Detailed outline of 1997 reforms
  - http://www.dcita.gov.au/nsapi-text/?MIval=dca_dispdoc&ID=507
- ACCC website
  - http://www.accc.gov.au
- Australian legislation
  - http://scaleplus.law.gov.au/
- Contact me directly
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**Seminar on Competition Policy and Regulation – Telecommunications Sector**

**Pretoria, 13-14 June 2002**

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OECD

competitiontribunal
south africa

# Workshop for Adjudicators in Competition Cases

## Pretoria, South Africa
## 28-30 June 2002

# Agenda, Documentation and Participants List

## Competition Tribunal of South Africa
## and
## OECD Centre for Co-operation with Non-Members


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**The opinions expressed herein are those of the authors and do not necessarily reflect the views of the U.S. Agency for International Development.**



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In re Independent Service Organizations Antitrust Litigation, U.S. Court of Appeals, Federal Circuit (2000)
"Antitrust Analysis in High-Tech Industries," speech, Robert Pitofsky, Chairman, U.S. Federal Trade Commission (2000)
"Competition and Intellectual Property Policy: The Way Ahead," speech, Timothy Muris, Chairman, U.S. Federal Trade Commission
Executive Summary, Report of the International Competition Policy Advisory Committee (2000)
Recent Developments in EC and UK Competition Law, 1.10.00 – 28.2.02, Richard Whish
Report on the Nature and Impact of Hard Core Cartels and Sanctions Against Cartels Under National Competition Laws, OECD (2002)

**Session 2: Judicial review of competition cases**

OECD Committee on Competition Law and Policy Seminar on Judicial Enforcement of Competition Law, Background Document, John Clark
Highmark, Inc. v. UPMC Health Plan, Inc., U.S. Court of Appeals, 3d Circuit (2001)
United States v. Microsoft Corp., U.S. Court of Appeals, District of Columbia Circuit (1995)
U.S. Federal Rule of Civil Procedure 52
United Kingdom Competition Act 1998, Schedule 8
United Kingdom Competition Act 1998, Sections 46-47
Institute of Independent Insurance Brokers v Director General of Fair Trading, U.K. Competition Commission Appeal Tribunal (2001)
Aberdeen Journals Ltd v Director General of Fair Trading, U.K. Competition Commission Appeal Tribunal (2002)

**Session 3: The accommodation of multiple criteria in competition cases**

Goldwasser v. Ameritech Corp., U.S. Court of Appeals, 7th Circuit (2000)
Gordon v. New York Stock Exchange, Inc., U.S. Supreme Court (1975)
Square D Co. v. Niagara Frontier Tariff Bureau, Inc., U.S. Supreme Court (1986)
European Treaty, Article 81 (ex Article 85)

**Session 4: Standards of proof –restrictive agreements**

Board of Trade of City of Chicago v. United States, U.S. Supreme Court (1918)
Continental T.V., Inc. v. GTE Sylvania Inc., U.S. Supreme Court (1977)
Valley Liquors, Inc. v. Renfield Importers, Ltd., U.S. Court of Appeals, 7th Circuit (1982)

United States v. Andreas, U.S. Court of Appeals, 7th Circuit (2000)
United States Sentencing Guidelines (antitrust offenses)
Broadcast Music, Inc. v. Columbia Broadcasting Sys., Inc., U.S. Supreme Court (1979)
Palmer v. BRG of Georgia, U.S. Supreme Court (1990)
SCFC ILC, Inc. v. VISA USA, U.S. Court of Appeals, 10th Circuit (1994)
U.S. Antitrust Guidelines for Collaborations Among Competitors
Toys R Us, Inc. v. Federal Trade Commission, U.S. Court of Appeals, 7th Circuit
Business Electronics Corp. v. Sharp Electronics Corp., U.S. Supreme Court (1988)
Paddock Publications, Inc. v. Chicago Tribune Co., U.S. Court of Appeals, 7th Circuit

**Standards of proof – abuse of dominance**

NAPP Pharmaceutical v Director General Fair Trading, summary of judgement, and excerpts from judgement, U.K. Competition Commission Appeal Tribunal (2002)
United States v. Microsoft Corp., U.S. Court of Appeals, District of Columbia Circuit (2001)

**Standards of proof – mergers**

Federal Trade Commission v. Staples, Inc., U.S. District Court, District of Columbia (1997)
Federal Trade Commission v. H.J. Heinz Co., U.S. Court of Appeals, District of Columbia Circuit (2001)
U.S. Horizontal Merger Guidelines, efficiency section

**Remedies**

National Society of Professional Engineers v. United States, U.S. Sup,reme Court (1978)
Parker and Balto, "The Evolving Approach to Merger Remedies" (2000)

**LIST OF PARTICIPANTS**

**CURRICULUM VITAE OF FAC ILITATORS**

**AGENDA**

**Workshop for Adjudicators in Competition Cases**
**Pretoria, South Africa**
**28-30 June 2002**

**Friday, 28 June**

**1200 – 1500 Check-in and registration**

**1300 – 1430 Lunch**

**1500 – 1730 Session 1: Recent developments in competition law**

Judge Diane Wood: Recent developments in the United States

Professor Richard Whish: Recent developments in the United Kingdom and European Union

John Clark: Current work in the OECD

Discussion

**1900 Dinner**

**Saturday, 29 June**

**0830 – 1030 Session 2: Judicial review of competition cases**

Judge Wood: The U.S. experience

Professor Whish: New developments in the UK

John Clark: Experiences in countries new to competition policy

Discussion

**1030 – 1050 Coffee**



302

**1050 – 1300 Session 3: The accommodation of multiple criteria in competition cases**

Judge Wood: Multiple criteria in the competition analytical framework; multiple criteria in the application of regulatory and public policy in specific sectors

Professor Whish: Article 81(3) in the EU

Discussion

**1300 – 1430 Lunch**

**1430 – 1600 Session 4: Standards of proof – restrictive agreements**

Judge Wood

Discussion

**1600 – 1730 Standards of proof – abuse of dominance**

Professor Whish

Discussion

**1900 Dinner**

**Sunday, 30 June**

**O830 – 1000 Standards of proof – mergers**

John Clark

Sally van Siclen: Economic evidence

Discussion

**1000 – 1020 Coffee**

**1020 – 1200 Remedies**

John Clark: A brief overview of available remedies and their most common applications

Discussion

**1200 – 1300 General discussion and closure**

**1300 Lunch**

## FEDERAL REGISTER NOTICE

**AGENCY:** Federal Trade Commission

**ACTION:** Notice of Public Hearings and Opportunity for Comment

**SUMMARY:**

The Federal Trade Commission ("FTC" or "Commission") announces public hearings beginning in January 2002 on "Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy." The hearings will focus primarily on the implications of antitrust and patent law and policy for innovation and other aspects of consumer welfare. Copyright and trademark issues as they arise in particular high-tech contexts also may be considered. The hearings will be held at and administered by the FTC and co-hosted with the Antitrust Division of the Department of Justice.

The knowledge-based economy has grown in economic significance over the past few decades. It is increasingly important that competition and intellectual property law and policy work in tandem to support and encourage ongoing innovation underlying that economy. Policies for both competition and intellectual property raise legal and economic questions that are substantially interlinked.

* * * *

**SUPPLEMENTARY INFORMATION:**

The issues that juxtapose competition and intellectual property policy are ones that have potentially broad implications for the development of the U.S. economy and consumer welfare. Courts have recognized that "[although] the aims and objectives of patent and antitrust laws may seem, at first glance, wholly at odds[, . . .] the two bodies of law are actually complementary, as both are aimed at encouraging innovation, industry, and competition."[(1)]

Yet the question of how to balance intellectual property and competition policy in particular circumstances has generated significant debate and discussion over the decades. During the 1970's, federal antitrust enforcement received justified criticism for certain policies - since revised[(2)] - overly hostile to the appropriate use of patents. More recently, some have questioned whether certain intellectual property policies, practices, and doctrines incorporate a proper appreciation of competitive issues, including ways in which intellectual property protection may impede - rather than encourage - innovation. Others have raised questions on whether certain antitrust approaches are properly appreciative of the need to promote innovation. The intersection of antitrust and intellectual property law continues to present difficult questions, and the debate may have intensified as the knowledge economy has increased in its importance to consumer welfare.

Thus, a series of hearings to explore the issues raised in this ongoing debate is timely. We approach these issues with open minds and in a spirit of learning. The hearings that are announced in this notice will, it is hoped, further fact gathering, learning, dialogue, and discussion among the affected parties, and will result in a greater understanding of and consensus about the approaches to policy in these areas that are most likely to benefit U.S. consumers.

The hearings will include consideration of the following general issues. This list is not exhaustive, and parties submitting written comments do not have to address each issue.

***General Issues for Consideration***

What roles do competition and intellectual property law and policy play in fostering initial and follow-on innovation? From a practical business perspective, how does each contribute to or impede ongoing innovation? What do empirical studies show?

What is the frequency of cross-licensing, patent pooling, and other arrangements for the transfer or

joint use of intellectual property? Does their use or usefulness vary across industries? What business reasons most typically underlie their creation? What intellectual property and competition issues do they typically raise? Have the guideposts for antitrust analysis established by the *DOJ/FTC Antitrust Guidelines for the Licensing of Intellectual Property* proved useful?

To what extent does commercialization of new technology require multiple licenses from multiple patentees - that is, to what extent do "patent thickets" exist? How do they affect both practices with respect to intellectual property and competition among innovator companies? How should policymakers take this into account?

What competition issues arise in the settlement of patent disputes and in the context of other agreements, such as standard setting, that involve patent rights? What should be the standards for assessing the antitrust significance of a unilateral refusal to deal, an issue recently addressed by the Federal Circuit's decision in *CSU v. Xerox*?[3] To what extent has the Federal Circuit become an increasingly important source of antitrust doctrine?

To what extent do questions about the scope and types of patents (e.g., business methods patents), and the procedures and criteria under which they are issued, raise competition issues? To what extent do substantive and procedural rules, both at agency and judicial levels, have implications for initial and sequential innovation, competition, and appropriability? What are the facts in this area?

To what extent is the assessment of these and other intellectual property-related questions different for new technologies? How does the globalization of the economy affect the assessment of these and related issues? What further insights can be offered to both intellectual property and antitrust doctrine from economics and other disciplines?

To what extent should, and if so, how might, fact gathering and other learning from the hearings be incorporated into competition and intellectual property practices, doctrine, and procedures?

The hearings will be transcribed and placed on the public record. Any comments received also will be placed on the public record. A public report that incorporates the results of the hearings, as well as other research, will be prepared after the hearings.

By direction of the Commission.

Donald S. Clark
Secretary

**Endnotes:**

1. *Atari Games Corp. v. Nintendo of Am., Inc.*, 897 F. 2d 1572, 1576 (Fed. Cir. 1990).

2. *See generally*, U.S. Department of Justice and Federal Trade Commission, *Antitrust Guidelines for the Licensing of Intellectual Property* (1995).

3. *In re Independent Service Organizations Antitrust Litigation*, 203 F. 3d 1322, 1327 (Fed. Cir. 2000), *cert. denied*, *CSU, L.L.C. v. Xerox Corp.*, 121 S.Ct. 1077 (2001).

203 F.3d 1322
2000-1 Trade Cases P 72,795, 2000 Copr.L.Dec. P 28,026, 53 U.S.P.Q.2d 1852
**(Cite as: 203 F.3d 1322)**

United States Court of Appeals,
Federal Circuit.

In re INDEPENDENT SERVICE ORGANIZATIONS ANTITRUST LITIGATION
CSU, L.L.C., [*et al.*], Plaintiff-Appellant,
v.
Xerox Corporation, Defendant-Appellee.

**No. 99-1323.**

Feb. 17, 2000.
Rehearing and Rehearing En Banc Denied April 13, 2000.

Before MAYER, Chief Judge, ARCHER, Senior Circuit Judge, and PLAGER, Circuit Judge.

MAYER, Chief Judge.

CSU, L.L.C. appeals the judgment of the United States District Court for the District of Kansas, dismissing on summary judgment CSU's claims that Xerox's refusal to sell patented parts and copyrighted manuals and to license copyrighted software violate the antitrust laws. *See* CSU, L.L.C. v. Xerox Corp., 23 F.Supp.2d 1242 (D.Kan.1999) (final judgment order). Because we agree with the district court that CSU has not raised a genuine issue as to any material fact and that Xerox is entitled to judgment as a matter of law, we affirm.

*Background*

Xerox manufactures, sells, and services high-volume copiers. Beginning in 1984, it established a policy of not selling parts unique to its series 10 copiers to independent service organizations ("ISOs"), including CSU, unless they were also end-users of the copiers. In 1987, the policy was expanded to include all new products as well as existing series 9 copiers. Enforcement of this policy was tightened in 1989, and Xerox cut off CSU's direct purchase of restricted parts. Xerox also implemented an "on-site end-user verification" procedure to confirm that the parts ordered by certain ISOs or their customers were actually for their end-user use. Initially this procedure applied to only the six most successful ISOs, which included CSU.

To maintain its existing business of servicing Xerox equipment, CSU used parts cannibalized from used Xerox equipment, parts obtained from other ISOs, and parts purchased through a limited number of its customers. For approximately one year, CSU also obtained parts from Rank Xerox, a majority-owned European affiliate of Xerox, until Xerox forced Rank Xerox to stop selling parts to CSU and other ISOs. In 1994, Xerox settled an antitrust lawsuit with a class of ISOs by which it agreed to suspend its restrictive parts policy for six and one-half years and to license its diagnostic software for four and one-half years. CSU opted out of that settlement and filed this suit alleging that Xerox violated the Sherman Act by setting the prices on its patented parts much higher for ISOs than for end-users to force ISOs to raise their prices. This would eliminate ISOs in general and CSU in particular as competitors in the relevant service markets for high speed copiers and printers.

Xerox counterclaimed for patent and copyright infringement and contested CSU's antitrust claims as relying on injury solely caused by Xerox's lawful refusal to sell or license patented parts and copyrighted software. Xerox also claimed that CSU could not assert a patent or copyright misuse defense to Xerox's infringement counterclaims based on Xerox's refusal to deal.

The district court granted summary judgment to Xerox dismissing CSU's antitrust claims and holding that if a patent or copyright is lawfully acquired, the patent or copyright holder's unilateral refusal to sell or license its patented invention or copyrighted expression is not unlawful exclusionary conduct under the antitrust laws, even if the refusal to deal impacts competition in more than one market. The court also held, in both the patent and copyright contexts, that the right holder's intent in refusing to deal and any other alleged exclusionary acts committed by the right holder are irrelevant to antitrust law. This appeal followed.

*Discussion*

The issue is whether the district court erred in granting Xerox's motion for summary judgment on CSU's antitrust claims. We review a grant of summary judgment de novo. *See* Petrolite Corp. v. Baker Hughes Inc., 96 F.3d 1423, 1425, 40 USPQ2d 1201, 1203 (Fed.Cir.1996) (citing *Meyers v. Asics*

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Corp., 974 F.2d 1304, 1306, 24 USPQ2d 1036, 1037 (Fed.Cir.1992)). Summary judgment is appropriate when there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. *See id.* (citing *Transmatic, Inc. v. Gulton Indus., Inc.*, 53 F.3d 1270, 1274, 35 USPQ2d 1035, 1038 (Fed.Cir.1995)).

[1][2][3] As a general proposition, when reviewing a district court's judgment involving federal antitrust law, we are guided by the law of the regional circuit in which that district court sits, in this case the Tenth Circuit. *See Nobelpharma AB v. Implant Innovations, Inc.*, 141 F.3d 1059, 1068, 46 USPQ2d 1097, 1104 (Fed.Cir.1998). We apply our own law, not regional circuit law, to resolve issues that clearly involve our exclusive jurisdiction. *See Pro-Mold & Tool Co. v. Great Lakes Plastics, Inc.*, 75 F.3d 1568, 1574-75, 37 USPQ2d 1626, 1631 (Fed.Cir.1996). "Whether conduct in procuring or enforcing a patent is sufficient to strip a patentee of its immunity from the antitrust laws is to be decided as a question of Federal Circuit law." *Nobelpharma*, 141 F.3d at 1068, 46 USPQ2d at 1104; *see Midwest Indus., Inc. v. Karavan Trailers, Inc.*, 175 F.3d 1356, 1360, 50 USPQ2d 1672, 1676 (Fed.Cir.1999) (en banc in relevant part) ("*Pro-Mold* and *Nobelpharma* make clear that our responsibility as the tribunal having sole appellate responsibility for the development of patent law requires that we do more than simply apply our law to questions of substantive patent law. In order to fulfill our obligation of promoting uniformity in the field of patent law, it is equally important to apply our construction of patent law to the questions whether and to what extent patent law preempts or conflicts with other causes of action."). The district court's grant of summary judgment as to CSU's antitrust claims arising from Xerox's refusal to sell its patented parts is therefore reviewed as a matter of Federal Circuit law, while consideration of the antitrust claim based on Xerox's refusal to sell or license its copyrighted manuals and software is under Tenth Circuit law.

A.

[4] Intellectual property rights do not confer a privilege to violate the antitrust laws. *See Intergraph Corp. v. Intel Corp.*, 195 F.3d 1346, 1362, 52 USPQ2d 1641, 1652 (Fed.Cir.1999). "But it is also correct that the antitrust laws do not negate the patentee's right to exclude others from patent property." *Id.* (citation omitted). "The commercial advantage gained by new technology and its statutory protection by patent do not convert the possessor thereof into a prohibited monopolist." *Abbott Lab. v. Brennan*, 952 F.2d 1346, 1354, 21 USPQ2d 1192, 1199 (Fed.Cir.1991). "The patent right must be 'coupled with violations of § 2', and the elements of violation of 15 U.S.C. § 2 must be met." [FN1] *Id.* (citations omitted). "Determination of whether the patentee meets the Sherman Act elements of monopolization or attempt to monopolize is governed by the rules of application of the antitrust laws to market participants, with due consideration to the exclusivity that inheres in the patent grant." *Id.* at 1354-55, 952 F.2d 1346, 21 USPQ2d at 1199 (citations omitted).

FN1. Section 2 of the Sherman Act, 15 U.S.C. § 2, prohibits monopolization or attempts to monopolize: "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony...."

[5] A patent alone does not demonstrate market power. *See id.* at 1355, 952 F.2d 1346, 21 USPQ2d at 1199. The United States Department of Justice and Federal Trade Commission have issued guidance that, even where it exists, such "market power does not 'impose on the intellectual property owner an obligation to license the use of that property to others.' " *Intergraph*, 195 F.3d at 1362, 52 USPQ2d at 1652 (citing United States Department of Justice and Federal Trade Comm'n Antitrust Guidelines for the Licensing of Intellectual Property 4 (1995)). There is "no reported case in which a court ha[s] imposed antitrust liability for a unilateral refusal to sell or license a patent...." *Id.* (citing *Image Technical Servs. v. Eastman Kodak Co.*, 125 F.3d 1195, 1216, 44 USPQ2d 1065, 1079 (9th Cir.1997)). The patentee's right to exclude is further supported by section 271(d) of the Patent Act which states, in pertinent part, that "[n]o patent owner otherwise entitled to relief ... shall be denied relief or deemed guilty of misuse or *illegal extension of the patent right* by reason of his having ... (4) refused to license or use any rights to the patent ..." 35 U.S.C. § 271(d) (1999) (emphasis added).

[6] The patentee's right to exclude, however, is not without limit. As we recently observed in *Glass Equipment Development Inc. v. Besten, Inc.*, a patent owner who brings suit to enforce the statutory right to exclude others from making, using, or selling the claimed invention is exempt from the antitrust laws, even though such a suit may have an anticompetitive effect, unless the infringement defendant proves one of two conditions. 174 F.3d 1337, 1343, 50 USPQ2d 1300, 1304 (Fed.Cir.1999) (citing *Nobelpharma*, 141 F.3d at 1068, 46 USPQ2d at 1104). First, he may

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prove that the asserted patent was obtained through knowing and willful fraud within the meaning of *Walker Process Equipment, Inc. v. Food Machinery & Chemical Corp.*, 382 U.S. 172, 177, 86 S.Ct. 347, 15 L.Ed.2d 247 (1965). *See Glass Equip. Dev.*, 174 F.3d at 1343. Or he may demonstrate that the infringement suit was a mere sham to cover what is actually no more than an attempt to interfere directly with the business relationships of a competitor. *See id.* (citing *Eastern R.R. Presidents Conference v. Noerr Motor Freight, Inc.*, 365 U.S. 127, 144, 81 S.Ct. 523, 5 L.Ed.2d 464 (1961)). Here, CSU makes no claim that Xerox obtained its patents through fraud in the Patent and Trademark Office; the *Walker Process* analysis is not implicated.

"[I]rrespective of the patent applicant's conduct before the [Patent and Trademark Office], an antitrust claim can also be based on [an] allegation that a suit is baseless; in order to prove that a suit was within *Noerr* 's 'sham' exception to immunity, [see *Noerr*, 365 U.S. at 144, 81 S.Ct. 523], an antitrust plaintiff must prove that the suit was both *objectively* baseless and *subjectively* motivated by a desire to impose collateral, anti-competitive injury rather than to obtain a justifiable legal remedy." *Nobelpharma*, 141 F.3d at 1071, 46 USPQ2d at 1107 (citing *Professional Real Estate Investors, Inc. v. Columbia Pictures Indus., Inc.*, 508 U.S. 49, 60-61, 113 S.Ct. 1920, 123 L.Ed.2d 611, 26 USPQ2d 1641, 1646 (1993)). "Accordingly, if a suit is not objectively baseless, an antitrust defendant's subjective motivation is immaterial." *Id.* at 1072, 46 USPQ2d at 1107. CSU has alleged that Xerox misused its patents but has not claimed that Xerox's patent infringement counterclaims were shams.

To support its argument that Xerox illegally sought to leverage its presumably legitimate dominance in the equipment and parts market into dominance in the service market, CSU relies on a footnote in *Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451, 480 n. 29, 112 S.Ct. 2072, 2089 n. 29, 119 L.Ed.2d 265 (1992), that "[t]he Court has held many times that power gained through some natural and legal advantage such as a patent, ... can give rise to liability if 'a seller exploits his dominant position in one market to expand his empire into the next.' " Notably, *Kodak* was a tying case when it came before the Supreme Court, and no patents had been asserted in defense of the antitrust claims against Kodak. Conversely, there are no claims in this case of illegally tying the sale of Xerox's patented parts to unpatented products. Therefore, the issue was not resolved by the *Kodak* language cited by CSU. Properly viewed within the framework of a tying case, the footnote can be interpreted as restating the undisputed premise that the patent holder cannot use his statutory right to refuse to sell patented parts to gain a monopoly in a market *beyond the scope of the patent*. *See, e.g., Atari Games Corp. v. Nintendo of Am., Inc.*, 897 F.2d 1572, 1576, 14 USPQ2d 1034, 1037 (Fed.Cir.1990) ("[A] patent owner may not take the property right granted by a patent and use it to extend his power in the marketplace improperly, i.e. beyond the limits of what Congress intended to give in the patent laws.").

The cited language from *Kodak* does nothing to limit the right of the patentee to refuse to sell or license in markets within the scope of the statutory patent grant. In fact, we have expressly held that, absent exceptional circumstances, a patent may confer the right to exclude competition altogether in more than one antitrust market. *See B. Braun Med., Inc. v. Abbott Lab.*, 124 F.3d 1419, 1427 n. 4, 43 USPQ2d 1896, 1902 n. 4 (Fed.Cir.1997) (patentee had right to exclude competition in both the market for patented valves and the market for extension sets incorporating patented valves).

CSU further relies on the Ninth Circuit's holding on remand in *Image Technical Services* that " 'while exclusionary conduct can include a monopolist's unilateral refusal to license a [patent] or to sell its patented ... work, a monopolist's 'desire to exclude others from its [protected] work is a presumptively valid business justification for any immediate harm to consumers.' " 125 F.3d at 1218, 44 USPQ2d at 1081 (citing *Data General Corp. v. Grumman Sys. Support Corp.*, 36 F.3d 1147, 1187, 32 USPQ2d 1385, 1417 (1st Cir.1994)). By that case, the Ninth Circuit adopted a rebuttable presumption that the exercise of the statutory right to exclude provides a valid business justification for consumer harm, but then excused as harmless the district court's error in failing to give any instruction on the effect of intellectual property rights on the application of the antitrust laws. *See id.* at 1219-20, 44 USPQ2d at 1081. It concluded that the jury must have rejected the presumptively valid business justification as pretextual. *See id.* This logic requires an evaluation of the patentee's subjective motivation for refusing to sell or license its patented products for pretext. We decline to follow *Image Technical Services.*

[7] We have held that "if a [patent infringement] suit is not objectively baseless, an antitrust defendant's subjective motivation is immaterial." *Nobelpharma*, 141 F.3d at 1072, 46 USPQ2d at 1107. We see no more reason to inquire into the subjective motivation of Xerox in refusing to sell or license its patented works than we found in evaluating the subjective motivation of a patentee in bringing suit to enforce

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that same right. In the absence of any indication of illegal tying, fraud in the Patent and Trademark Office, or sham litigation, the patent holder may enforce the statutory right to exclude others from making, using, or selling the claimed invention free from liability under the antitrust laws. We therefore will not inquire into his subjective motivation for exerting his statutory rights, even though his refusal to sell or license his patented invention may have an anticompetitive effect, so long as that anticompetitive effect is not illegally extended beyond the statutory patent grant. *See Glass Equip. Dev.*, 174 F.3d at 1343, 50 USPQ2d at 1304. It is the infringement defendant and not the patentee that bears the burden to show that one of these exceptional situations exists and, in the absence of such proof, we will not inquire into the patentee's motivations for asserting his statutory right to exclude. Even in cases where the infringement defendant has met this burden, which CSU has not, he must then also prove the elements of the Sherman Act violation.

We answer the threshold question of whether Xerox's refusal to sell its patented parts exceeds the scope of the patent grant in the negative. [FN2] [Omitted.] Therefore, our inquiry is at an end. Xerox was under no obligation to sell or license its patented parts and did not violate the antitrust laws by refusing to do so.

B.

The Copyright Act expressly grants a copyright owner the exclusive right to distribute the protected work by "transfer of ownership, or by rental, lease, or lending." 17 U.S.C. § 106(3) (1996). "[T]he owner of the copyright, if [it] pleases, may refrain from vending or licensing and content [itself] with simply exercising the right to exclude others from using [its] property." *Data General*, 36 F.3d at 1186, 32 USPQ2d at 1416 (citing *Fox Film Corp. v. Doyal*, 286 U.S. 123, 127, 52 S.Ct. 546, 547, 76 L.Ed. 1010 (1932)).

The Supreme Court has made clear that the property right granted by copyright law cannot be used with impunity to extend power in the marketplace beyond what Congress intended. *See United States v. Loew's, Inc.*, 371 U.S. 38, 47-48, 83 S.Ct. 97, 103-04, 9 L.Ed.2d 11 (1962) (block booking of copyrighted motion pictures is illegal tying in violation of Sherman Act). The Court has not, however, directly addressed the antitrust implications of a unilateral refusal to sell or license copyrighted expression.

The Tenth Circuit has not addressed in any published opinion the extent to which the unilateral refusal to sell or license copyrighted expression can form the basis of a violation of the Sherman Act. We are therefore left to determine how that circuit would likely resolve the issue; the precedent of other circuits is instructive in that consideration. The Fourth Circuit has rejected a claim of illegal tying, supported onlyby evidence of a unilateral decision to license copyrighted diagnostic software to some but not to others. *See Service & Training, Inc. v. Data General Corp.*, 963 F.2d 680, 686, 23 USPQ2d 1102, 1106 (4th Cir.1992). In reaching this conclusion, the court recognized the copyright owner's exclusive right to "sell, rent, lease, lend, or otherwise distribute copies of a copyrighted work," *id.* (citing 17 U.S.C. § 106(3)), and concluded that "Section 1 of the Sherman Act does not entitle 'a purchaser ... to buy a product that the seller does not wish to offer for sale.' " *Id.* (citing *Jefferson Parish Hosp. Dist. v. Hyde*, 466 U.S. 2, 24 n. 40, 104 S.Ct. 1551, 80 L.Ed.2d 2 (1984)).

Perhaps the most extensive analysis of the effect of a unilateral refusal to license copyrighted expression was conducted by the First Circuit in *Data General Corp. v. Grumman Systems Support Corp.*, 36 F.3d 1147, 32 USPQ2d 1385. There, the court noted that the limited copyright monopoly is based on Congress' empirical assumption that the right to "exclude others from using their works creates a system of incentives that promotes consumer welfare in the long term by encouraging investment in the creation of desirable artistic and functional works of expression.... We cannot require antitrust defendants to prove and reprove the merits of this legislative assumption in every case where a refusal to license a copyrighted work comes under attack." *Id.* at 1186-87, 36 F.3d 1147, 32 USPQ2d at 1416. The court went on to establish as a legal standard that "while exclusionary conduct can include a monopolist's unilateral refusal to license a copyright, an author's desire to exclude others from use of its copyrighted work is a presumptively valid business justification for any immediate harm to consumers." *See id.* at 1187, 36 F.3d 1147, 32 USPQ2d at 1417. The burden to overcome this presumption was firmly placed on the antitrust plaintiff. The court gave no weight to evidence showing knowledge that developing a proprietary position would help to maintain a monopoly in the service market in the face of contrary evidence of the defendant's desire to develop state-of-the-art diagnostic software to enhance its service and consumer benefit. *See id.* at 1188-89, 36 F.3d 1147, 32 USPQ2d at 1418.

As discussed above, the Ninth Circuit adopted a modified version of this *Data General* standard. Both courts agreed that the presumption could be

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rebutted by evidence that "the monopolist acquired the protection of the intellectual property laws in an unlawful manner." *Image Technical Servs.*, 125 F.3d at 1219, 44 USPQ2d at 1082 (citing *Data General*, 36 F.3d at 1188, 32 USPQ2d at 1418). The Ninth Circuit, however, extended the possible means of rebutting the presumption to include evidence that the defense and exploitation of the copyright grant was merely a pretextual business justification to mask anticompetitive conduct. *See id.* The hazards of this approach are evident in both the path taken and the outcome reached. The jury in that case was instructed to examine each proffered business justification for pretext, and no weight was given to the intellectual property rights in the instructions. *See id.* at 1218, 1220 n. 12, 44 USPQ2d at 1082 n. 12. This permitted the jury to second guess the subjective motivation of the copyright holder in asserting its statutory rights to exclude under the copyright laws without properly weighing the presumption of legitimacy in asserting its rights under the copyright laws. While concluding that the failure to weigh the intellectual property rights was an abuse of discretion, the Ninth Circuit nevertheless held the error harmless because it thought the jury must have rejected the presumptive validity of asserting the copyrights as pretextual. *See id.* at 1219-20, 125 F.3d 1195, 44 USPQ2d at 1081-82. This is in reality a significant departure from the First Circuit's central premise that rebutting the presumption would be an uphill battle and would only be appropriate in those rare cases in which imposing antitrust liability is unlikely to frustrate the objectives of the Copyright Act. *See Data General*, 36 F.3d at 1187 n. 64, 1188, 32 USPQ2d at 1417 n. 64.

[8] We believe the First Circuit's approach is more consistent with both the antitrust and the copyright laws and is the standard that would most likely be followed by the Tenth Circuit in considering the effect of Xerox's unilateral right to refuse to license or sell copyrighted manuals and diagnostic software on liability under the antitrust laws. We therefore reject CSU's invitation to examine Xerox's subjective motivation in asserting its right to exclude under the copyright laws for pretext, in the absence of any evidence that the copyrights were obtained by unlawful means or were used to gain monopoly power beyond the statutory copyright granted by Congress. In the absence of such definitive rebuttal evidence, Xerox's refusal to sell or license its copyrighted works was squarely within the rights granted by Congress to the copyright holder and did not constitute a violation of the antitrust laws.

*Conclusion*

Accordingly, the judgment of the United States District Court for the District of Kansas is affirmed.

AFFIRMED

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**Antitrust Analysis in High-Tech Industries:**
**A 19th Century Discipline Addresses 21st Century Problems**

**Prepared Remarks of Robert Pitofsky[1]**
**Chairman**
**Federal Trade Commission**

**American Bar Association**
**Section of Antitrust Law's Antitrust Issues in High-Tech Industries Workshop**
**February 25-26, 1999**
**Scottsdale, Arizona**

One of the most interesting sets of issues facing policy makers today concerns the appropriate application of the antitrust laws to high-tech industries.

Most would agree that balanced antitrust enforcement - challenges to monopoly, cartels and practices that unfairly create or maintain monopoly power, facilitate cartels or otherwise restrain trade - has served the country well throughout the 20th Century. Indeed, after considerable ideological warfare about over-enforcement and under-enforcement of antitrust, there appears to have emerged in the most recent decade a rough consensus about appropriate levels of antitrust enforcement. Also the rest of the world seems to be following the American lead by initiating or augmenting competition enforcement regimes.

But should antitrust apply in comparable ways to high-tech industries, particularly those industries where the products or services are primarily the embodiment of intellectual property? Public attention has focused upon the Department of Justice's proceedings against Microsoft and the Federal Trade Commission's challenge to behavior by Intel, but "high-tech" applies well beyond the computer hardware and software industries. Comparable problems arise in applying the antitrust laws to industries as diverse as pharmaceuticals, biotechnology, communications, international credit and finance, and various delivery systems for entertainment and news.

The importance of these industries to the economy, and limited antitrust experience and precedent with regard to some uses of intellectual property, suggests that there ought to be careful antitrust attention to be certain that critical economic growth is not compromised by the abuse of private market power. On the other hand, it leaves open the question of whether antitrust principles, developed primarily in the context of smokestack industries, should apply comparably and with equal force to new problems that emerge in connection with high-tech industries. Some would argue that it is dangerous to undermine investment incentives in these dynamic industries, and therefore that antitrust should have no role at all.[2] A less confrontational approach suggests that because of the robust pace of innovation in high-tech industries, government should not intervene "unless certain that doing so will benefit consumers and the economy."[3] A variation on that theme argues that litigation lags are likely to be longer than the time it would take for competitive forces to reconfigure an industry, and therefore that antitrust should intervene only in the most unusual circumstances.[4] Even under these last two approaches, antitrust would have

a modest role.

If antitrust enforcement is to play a constructive role, I believe it is essential to acknowledge that high-tech industries are different and enforcement must take those differences into account. That does not mean there will not be old-fashioned predatory strategies or cartel behavior from time to time in high-tech industries; indeed I am confident that does occur. But more subtle problems of antitrust enforcement must adjust to the special circumstances of high-tech industries. That was the conclusion of the FTC's Report on Global and High-Tech Competition,[5] published in 1996 after a very extensive set of hearings on those subjects.

What are the differences that call for adjusted antitrust treatment in the high-tech sector? Among others, they include the following:

1. Technical Issues. Many high-tech industries involve questions that are challenging for lawyers and judges who typically lack a technical background. For example, defining relevant markets, *i.e.,* the process of identifying those firms that compete so closely with other firms that they can substantially influence the exercise of market power, is difficult enough under any circumstances. But it can become far more difficult in high-tech industries such as biotechnology, where products that might curtail the market power of a dominant incumbent firm are not in existence yet, and will not reach the market for several years;[6] or in the cable industry where the essential question is when satellite transmission will become a real competitive force in the cable market.[7] Similar problems arise with respect to telecommunications, a sector of the market where many believe competition for local operating companies will eventually be offered by electric utilities through their existing grid and electricity wires into the home. Each of these issues raises questions in the realm of science and technology that often will be difficult to address.

2. Speed of Market Transition. New generations of products, undermining existing market power, appear more frequently in high-tech than in mature industries. In the first one-half of the 20th Century, firms in steel, oil and aluminum remained dominant for generations, but that is often not the case in many high-tech industries. An often-cited example involves IBM, which probably was a dominant firm if not a monopolist in certain markets when the government initiated its case in 1969, but which had lost monopoly power in many of these markets 13 years later when the case was abandoned.[8]

3. Need for Collaborative Activities. In high-tech industries, joint research and development is often essential to share the risks of innovation and to combine complementary technologies. Collaboration and later coordination on standards may be essential to allow products to work at all. As a result, some have suggested that antitrust must abandon its entrenched skepticism of cooperative arrangements and allow more leeway in high-tech markets.

4. Barriers to Entry. Because competition in high-tech industries so often depends upon the implementation of ideas, and ideas have little respect for geographic

borders or entrenched market power, many predict that existing market power will be transitory. Put another way, competitive problems that may occur in high-tech industries are said to be "self-correcting" through the rapid and seemingly perpetual introduction of new products.

5. Output and Price Effects. The traditional profile of a monopolist is of a firm that will curtail output in order to raise price. But that model often does not hold in high-tech markets. Partly because the front-end investment in new forms of technology is so great, and the marginal cost of additional copies or products modest, high-tech firms often price aggressively at the outset to achieve dominant market positions and ultimately to take advantage of economies of scale. There may also be unusually substantial learning efficiencies, sometimes described as an "experience curve" that result in production costs declining along with increased output. Also, the orthodox idea that monopoly is a narcotic and that the reward of monopoly is to enjoy the "quiet life"[9] hardly describes many of the aggressive, dynamic, innovative high-tech firms in today's American economy.

6. Network Efficiencies. Finally, and most perplexing, there is the question of how to deal with network efficiencies. These efficiencies occur when the value of a product or service is positively correlated with the number of individuals who use the product or service. This can occur directly when a product's value is determined by the number of users in the network - for example, fax machines. It also can occur indirectly where a product achieves dominance and producers of essential complementary products (for example, application software firms that write programs for a dominant platform) overwhelmingly devote their resources in a way that is useable only with the dominant system. On the one hand, such networks are efficient and occasionally inevitable; on the other hand, they increase the likelihood that one firm, by achieving a critical mass, will dominate a market or retain market power for an extended period of time.

Because of these and other differences, some would argue that allowing firms with market power in high-tech industries to exploit that market power is a sensible price to pay for a vibrant innovative economy. Vast returns to the innovator, in that view, are thought to be worth it.

But even if one acknowledges the validity of these and other differences between high-tech and more mature industries, the essential question remains: should antitrust's conventional role as enforcer of competitive principles be abandoned because it is unnecessary or counter-productive, or should basic antitrust principles apply in a modified form, after taking due notice of different characteristics of the high-tech sector of the economy?

I believe antitrust should - indeed must - continue to apply. None of the "high-tech differences" justifies a complete or even substantial exemption.

While it is true that the technology of high-tech industries is often complex, that should be a reason for antitrust officials and judges to understand the technology, not to abandon the field. Speed of change in the high-tech sector is indeed impressive, but that often occurs at

the margin of the industry; large firms can still obtain and maintain dominant positions, and extract monopoly rents, for extended periods of time for reasons or through practices unrelated to the enhancement of consumer welfare.[10] Collaborative efforts are often essential, but antitrust traditionally has taken a very lenient view of research and development cooperation and standard setting across the economy,[11] and, in almost all cases, production cooperation as well. There are important situations in which barriers to entry in high-tech industries are low - indeed where new entrants can leap-frog incumbent technology and quickly come to dominate a market - but that is not the whole story. Because high-tech industries so often are based on intellectual property, patent and copyright laws can insulate a dominant firm (sometimes legitimately; sometimes not) behind the barricade of hundreds and even thousands of those forms of protection. And, as I will discuss shortly, a network, once it achieves dominance through network efficiencies, can preclude competition for extended periods.

Finally, while it is true that aggressive high-tech firms often (though not always) enter the market at low prices, and many high-tech firms are admirably innovative and hardly can be said to seek the "quiet life," the question remains whether two or more firms vying for the consumer's allegiance would offer even lower prices or higher levels of innovation. A second concern is that the high-tech firm, once it gains a monopoly or dominant position, will gradually raise price as the market matures. There is simply no evidence at this point that this nation's preference for competition over monopoly, where competition is feasible and monopoly is achieved or maintained through unnecessarily exclusionary practices, should be abandoned in the high-tech sector.

That leaves us with what I have already described as the most perplexing question in this area: what to do about firms that achieve dominant and almost unassailable market positions legally, but maintain those positions for extended periods as a result of network efficiencies. While such situations occur across the economy, they do seem to occur more frequently in high-tech markets characterized by rivalry based on research and innovation. I have elected to discuss this difficult issue not because I believe it will often be the proper subject of antitrust review, but rather because it raises in the most stark way the conflicting values at work in this emerging area of the law.

As noted earlier, there are instances where it may be efficient for a single firm to become the only supplier of related products or services. Once that occurs, consumers are more likely to remain with the established network because of their sunk costs (sometimes referred to as "lock-in"), and suppliers of complementary products will tailor them to the established network and resist preparing products for would-be challengers. When that occurs, market power, far from being transitory, can be retained by a dominant firm for an extended period of time.

Network monopolies or near monopolies are not unassailable. Occasionally, a new technology can completely leap-frog the market position of the incumbent network and quickly attract customers and suppliers. Sega's success with a 16-bit video game, quickly surpassing Nintendo's 8-bit format, demonstates this point. Challengers may invest heavily in a loss leader strategy, subsidizing efforts to challenge a dominant firm, and can win at least a portion of the market. But there are situations presently, and surely others will arise, where a network obtains market power legally, triumphs over all others, and is

far more efficient in marketing its products or services than any existing or likely challengers.

There are substantial costs to a "hands-off" policy. Once a network monopoly is in place, it often is a simple matter for the monopolist to exclude would-be challengers. A network monopolist may have the ability to monopolize successive generations of product, or complementary products or services, simply by adopting a policy of allowing only those products manufactured by it to connect with the existing network. One result may be that over time, the best products or services may not win out. Also, potential competitors, recognizing the enormous difficulties of challenging an incumbent network monopolist, may lose incentives to compete.

In that situation, does antitrust have any constructive role to play?

One possible approach, consistent with traditional if not recent antitrust principles, would be to break up the network. Assuming that is not feasible, or that diseconomies (and resultant injury to consumer welfare) are substantial, another possible approach is to mandate access to the network for all qualified suppliers, customers and competitors on fair, reasonable and non-discriminatory terms. That is the sort of remedy that has been imposed occasionally on bottleneck monopolies and would be supported by some (but by no means extensive) precedent.[(12)]

Why or why not impose mandatory access?

Two questions that need to be addressed are, first, what are the pros and cons of a mandated access remedy and, second, assuming some sort of remedy is appropriate for some but not all network situations, what is the rule of law that distinguishes between beneficial and benign network positions on the one hand, and counter-productive network situations on the other? These are issues that in one form or another are before the Commission in several investigations and cases. For that reason, and also because learning in this area is an ongoing process, I will limit myself in the remainder of this paper to a review of factors pro and con with respect to a mandated access remedy, and of possible rules and standards, but will offer no firm conclusions. Let me examine some of the arguments for and against required access.

First, denial of mandatory access may generate incentives whereby applicants would be encouraged to either set up their own competitive network, or join smaller rival networks, that might challenge the dominant network firm. But that makes no sense in those extreme network situations in which an incumbent passes a "tipping point" - *i.e.*, a degree of penetration that leads inevitably to a single network dominating the field. In that event, there will be no viable alternative networks that can be organized or joined.

Second, profits derived from dominating a network may be a fair return to innovators who achieve dominance. Certainly, it is a factor that rivals would take into account when they compete for the dominant position, and would encourage innovators to compete aggressively. Mandating access to late-comers or "free-riders" seems to reward the passive and less energetic at the expense of those who pioneered a field. The best response to that - and I am not sure it is a complete answer - is that few would recommend

royalty free mandated access. The late-comers can be charged a royalty, including a premium that takes into account the risks the network incumbent took in achieving its dominant position.

Third, mandating access introduces all sorts of coordination and fairness

problems that would not otherwise exist. Mandatory access is hardly self-executing. For example, some third-party - - administrator, regulator, judge - - would have to supervise on a continuing basis the entire arrangement to see that access is not denied on unfair or discriminatory terms. That concern is less weighty where the network is controlled by a joint venture, since the participants in the joint venture would already have worked out many coordination problems likely to arise. It could be a serious problem when the network is controlled by a single dominant firm.

Finally, there is a sort of overarching philosophical concern that mandated access is a form of "confiscation"of property, to be avoided in most or all circumstances within any legal system that respects intellectual property and other property rights.

Arrayed against these considerable and formidable arguments is the simple fact that a dominant network, by exploiting its position, cannot only perpetuate its domination over substantial period of time, but can extract very substantial monopoly rents from consumers. There also should be a concern that by excluding from the network all except the dominant firm or its partners, potential participants who themselves may be innovators and who might carry technology beyond the level of the initial network arrangement are denied an opportunity to innovate so as to improve or actually surpass the initial network arrangement.

My own tentative view in light of these pros and cons is that antitrust enforcers should proceed cautiously in breaking up or mandating access to an existing network, even when that network is dominant. For the time being, until we know more about the origins and significance of network efficiencies, antitrust should probably concentrate in most situations on its traditional role of ensuring that companies achieve network monopolies through legitimate competitive conduct, and that they maintain the network dominance only through superior skill, foresight and industry - not by unnecessarily exclusionary conduct. That is particularly true when the network derives from intellectual property, a concept that has traditionally influenced antitrust policy which recognizes the wisdom of encouraging innovation.

Assuming a cautious approach is appropriate, there remains the problem of identifying which are the unusual situations in which antitrust enforcement is required. Chapter 9 of the Commission's report on its 1996 hearings on Competition Policy in High-Tech and Global Markets sets out three possible positions, and it seems to me those serve well to define the possible approaches. I do not endorse any of these but cite them only to illuminate a discussion.

Access is "essential." A cautious approach would be to reject any possibility of mandatory access except where it is "essential" to the existence of competition. If applicants for access can plausibly invent around the network monopoly, establish their own competitive

networks, or join other networks that may not be equivalent but are acceptable alternatives to the dominant network, that arguably might eliminate any consideration of court-ordered access. There is some precedent that would point to a more aggressive approach. In the Supreme Court's 1945 decision in Associated Press,[13] an early "essential facilities" case with overtones of network efficiencies, the Court rejected the standard of mandating access only if it is "essential," requiring access even when the network confers only a significant competitive advantage and there was no good business reason to exclude. Some have criticized the Supreme Court's analysis in Associated Press as unnecessarily sweeping in view of the facts of the case.[14]

Purpose and intent. A second approach would be to ask the controllers of access to the network why they have refused access on reasonable terms. If they could assert a plausible efficiency, and if there were no evidence of a primary purpose to exclude, then access would not be required. In effect, the burden of explaining exclusionary behavior would shift to the party or parties controlling the network. Incidentally, the efficiency probably would have to be substantial, though not necessarily greater in consumer value than the anticompetitive effect.[15] Balance. In the end, focusing on any single factor - "essentiality," intent, efficiency and, of course, the exclusionary effect of denying access - may simply not be enough for a full evaluation of the issue. Professor Steven Salop of Georgetown Law School framed the issue with particular clarity in a recent, as-yet-unpublished paper about antitrust and monopoly power.[16] He raised the question about how to deal with a situation in which exclusion of competition might allow sellers to raise price 50 cents on a product, but mandating access might deprive consumers of 5 cents per unit in efficiencies. The issue could as well be put the other way - *i.e.*, 5 cents increase in price because of lost competition vs. 50 cents of lost efficiencies if access is required by law. Either way the question properly raised is whether the right result can be reached by looking at any one factor and one factor alone.

## CONCLUSION

Proper application in the antitrust laws to high-tech industries raises some of the most challenging questions that we have seen in a long time. As with any adjustment to new facts or proposed law, a cautious approach is called for. But abandoning antitrust principles in this growing and increasingly important sector of the economy seems like the wrong direction to go.

1. Chairman of the United States Federal Trade Commission. The views expressed are my own and do not necessarily reflect the views of the Commission or other Commissioners.

2. Barro, "Why the Antitrust Cops Should Lay Off High-Tech," BusinessWeek, August 17, 1998, p. 20.

3. Priest, *The Law and Economics of* U.S. v. Microsoft, AEI Newsletter, August 1998.

4. Teece and Coleman, *The Meaning of Monopoly: Antitrust Analysis in High-Technology Industries,* 43 Antitrust Bull. 801, 843, 846 (1998).

5. Anticipating the 21st Century: Competition Policy in the New High-Tech Global

Marketplace (May 1996).

6. For example, see Ciba-Geigy Ltd., Dkt. No. C-3735 (March 24, 1997).

7. *See* Time Warner Inc., Dkt. No. C-3709 (February 3, 1997).

8. *See, e.g., United States v. IBM*, 1997-1 Trade Cas. (CCH) ¶ 71,786 (S.D.N.Y. 1997) ("It has been established beyond any real question that, whereas IBM formerly had a great degree of market power in an antitrust sense, that market power has been substantially diminished, and is continuing to diminish, to the point of its disappearance in the sense of a threat of antitrust violation."), *aff'd* 1998 U.S. App. Lexis 32577 (2d Cir. Dec. 30, 1998); *ILC Peripherals Leasing Corp.v. IBM*, 458 F.Supp. 423, 430-31 (N.D. Cal.1978) (granting directed verdict to IBM where declining market share showed that IBM lacked monopoly power), *aff'd per curiam sub nom. Memorex Corp.v. IBM*, 636 F.2d 1188 (9th Cir. 1980).

9. *United States v. Aluminum Co. of Am.*, 148 F 2d 416, 427 (2d Cir.1945) ("Many people believe that possession of unchallenged economic power deadens initiative, discourages thrift and depresses energy; that immunity from competition is a narcotic, and rivalry is a stimulant, to industrial progress; that the spur of constant stress is necessary to counteract an inevitable disposition to let well enough alone.")

10. *See Allen-Mylan, Inc. v. IBM*, 33 F.3d 194, 211 (3d Cir. 1994) ("IBM also contends that price reduction and product improvement are inconsistent with the existence of monopoly power. But rapid technological progress may provide a climate favorable to increased concentration of market power rather than the opposite. Moreover, a decline in price does not necessarily imply an absence of monopoly power; a fair profit might have been made at even lower cost to users.")

11. For example, federal enforcement has brought exactly one case against a research and development joint venture in the 109 years that the Sherman Act has been the law. *See United States v. Automobile Manufacturers Ass'n*, 1969 Trade Cas.(CCH) ¶ 72,902 (C.D. Cal. 1969), *modified sub nom. United States v. Motor Vehicle Manufacturers Ass'n*, 1982-83 Trade Cas. (CCH) ¶ ¶ 65,088, 65,175 (C.D. Cal. 1982).

12. *United States v. Terminal R.R. Ass'n*, 224 U.S. 383 (1912); *Associated Press v. United States*, 326 U.S. 1 (1945); *Otter Tail Power Co. v. United States*, 410 U.S. 366 (1973).

13. *Associated Press v. United States,* 326 U.S. 1 (1945).

14. In *Asssociated Press*, the bylaws of an association of major newspapers barred members from supplying news to competing newspapers, clearly with an anticompetitive intent, so that requiring access to an "essential facility" may not have been necessary to the decision. That case and others dealing with access questions are analyzed in Boudin, *Antitrust Doctrine and the Sway of Metaphor,* 75 Geo. L.J. 395 (1986). See also Areeda, *Essential Facilities: An Epithet in Need of Limiting Principles*, 58 Antitrust L.J. 841 (1990).

15. This may have been the approach of the D.C. Court of Appeals in dismissing the

government's charge that Microsoft had violated an earlier order by integrating its browser technology into its Windows software. The Court appeared to find that Microsoft's behavior could not have been a violation because "plausible benefits" followed upon its integration of the browser. See *United States v. Microsoft Corp.*, 147 F. 3d 935, 951-52 (D.C. Cir. 1998).

16. Salop, *Preserving Monopoly: Economic Analysis, Legal Standards and* Microsoft, Geo. Mason U. L. Rev.___ (1999).

# Competition and Intellectual Property Policy: The Way Ahead

***Prepared Remarks of***

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***Before***

**American Bar Association**
**Antitrust Section Fall Forum**

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## I. Introduction

I am delighted to be here to discuss issues that involve both competition and intellectual property, or "IP," policy. Like many of you, I have followed closely issues at the intersection of antitrust and intellectual property and have also written about the proper nexus between antitrust and intellectual property.[1]

Today, I want to describe a new initiative by the federal antitrust authorities to develop a better understanding of how to manage the issues at the intersection of competition and intellectual property law and policy. Beginning early next year, the FTC and the Department of Justice will conduct hearings on the competition/intellectual property relationship. I will begin today by sketching the relationship between the antitrust and intellectual property regimes and the role of our hearings in contributing to the harmonization of these doctrines to maximize benefits for consumers. I will then describe some policy issues that we hope to address during the hearings. I will finish by reviewing current FTC initiatives that should benefit from the knowledge gained during the hearings. I note that the views expressed are my own and do not necessarily reflect the views of the Commission or other Commissioners.

## II. The Antitrust/Intellectual Property Relationship

Antitrust law and policy have dramatically improved since the 1970s. That decade saw the infamous "Nine No-Nos,"[2] which many of us argued lacked both a sound economic foundation and a sufficient appreciation of the incentives for innovation that intellectual property and intellectual property licensing can provide. As in other areas of antitrust law, economic and legal scholarship have advanced the law in this area to make it now much more in accord with the public interest.[3] The 1995 *DOJ/FTC Antitrust Guidelines for the Licensing of Intellectual Property*[4] reflected antitrust law's recognition that policy should be consistent with the state of the law and economic learning. The *Guidelines* provide a balanced view of how to apply antitrust law to conduct involving the licensing of intellectual property.

Where are we now, in 2001, when so much of the world seems to be changing so quickly? There are those observers - including my predecessor, Robert Pitofsky - who ask whether we might be at yet another crossroads in the relationship between the two doctrines. Only this time, they say, perhaps it is intellectual property doctrine that is not showing a proper appreciation for the innovation that competition may spur. They argue that overly broad grants, interpretations, or applications of intellectual property rights may unduly limit competition. Still others question whether antitrust doctrine and antitrust enforcers have yet found the right balance between the two doctrines -

especially in particular cases.

The tensions between the doctrines tend to obscure the fact that, properly understood, IP law and antitrust law both seek to promote innovation and enhance consumer welfare.[5] The goal of patent and copyright law, as enunciated in Article I section 8 of the Constitution, is "To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." IP law, properly applied, preserves the incentives for scientific and technological progress - i.e., for innovation. Innovation benefits consumers through the development of new and improved goods and services, and spurs economic growth. Similarly, antitrust law, properly applied, promotes innovation and economic growth by combating restraints on vigorous competitive activity. By deterring anticompetitive arrangements and monopolization, antitrust law also ensures that consumers have access to a wide variety of goods and services at competitive prices.

Matters that involve both IP and antitrust can be exceedingly complex, both legally and factually. In important respects, the issues involve concepts of property rights. It is now well understood that an effective legal regime defining and protecting property rights is essential to a well-functioning competitive economy. IP law plays an important role in this overall property rights regime. As can other holders of property rights, a patent holder can attempt to preclude misappropriation of his IP rights.

Similarly, IP rights have limits. For example, one cannot assert ownership rights over property for which he lacks a valid title. Moreover, the doctrine of nuisance sometimes bars property owners from using their property to interfere with the rights of other property owners. Other limits on IP rights include prohibitions on abuse of the patent process and overbroad assertion of patent claims. Both of these prohibitions raise potential antitrust issues. Acquisition of patent rights also may raise Clayton Act Section 7 issues, just as with the acquisition of other property rights. In addition, there are broader public policy issues involving IP law. For example, if the patent review process is too permissive - *e.g.*, patents are granted too easily for trivial or non-existent improvements that do not meet statutory requirements for patentability - competition through entry and expansion by others may be impeded.

Many of these and other issues cannot be addressed solely by enforcing the antitrust laws. They profitably can be addressed in our upcoming hearings, in which we anticipate that we will receive valuable input from business, consumer, and government representatives; the antitrust and intellectual property bars; economists; and academics. To develop appropriate policy, we must better understand a variety of practical considerations - that is, what are the practical business issues that companies confront on a regular basis, and what are the practical implications of various policy decisions? As always, our guiding consideration in developing policy is the impact on consumer welfare in both the short and long run.

As I have said, matters that combine IP and antitrust issues are likely to be complex. As usual, the devil is in the details.[6] We have learned much, but we need to know more. The FTC has a distinguished history in studying important public policy issues related to competition and consumer protection. The Commission's activities in recent years have been particularly notable.[7]

Because these issues present pressing public policy concerns, we will hold extensive hearings, starting this winter, to address issues that involve both competition and intellectual property policies. We are pleased that the Antitrust Division will join us in hosting these hearings. These hearings will help develop a greater understanding of how to manage concerns at the intersection between intellectual property and competition. The hearings will focus primarily on the implications of antitrust and patent law and policy for innovation and other aspects of consumer welfare. Copyright and trademark issues, as they arise in particular high-tech contexts, may also be considered. Let me turn now to a brief overview of some of the issues that have led to these hearings.

### III. Brief Summary of Developments in Law and Policy

In the past two decades, several developments in the antitrust and IP systems may have had

significant implications for competition and innovation in the American economy. I would like to highlight some of the more notable developments.

**A. *The Increasing Number of Patents***

First, in recent years, the number of patents issued annually by the Patent and Trademark Office ("PTO") has increased substantially.[8] In 1980, for example, the PTO issued roughly 66,000 patents.[9] Twenty years later, the number had increased more than two and a half times to over 175,000.

Commentators have suggested many explanations for this increase, including the growth in innovation spurred by changes in the management of research;[10] the need for companies to protect themselves against infringement suits with blocking patents;[11] the increased consciousness among the business community of the financial gains to be achieved through patent mining;[12] and creation of the Federal Circuit.[13] Regardless of the reasons underlying this increase, we should consider whether there are implications for innovation and competition. On the one hand, some observers believe that this patent explosion could injure competition by making it more difficult for rival inventors to sell competing products. According to Professor Carl Shapiro, a "patent thicket" has formed, which he describes as "a dense web of overlapping intellectual property rights that a company must hack its way through in order to actually commercialize new technology."[14] Firms in certain industries are said to fear that it is "all too easy" to infringe another patent accidentally and thereby risk liability.[15] On the other hand, some observers believe that innovation currently is not hindered.[16] Moreover, even if there were a "patent thicket" problem, others state that firms have found a range of means to overcome these obstacles, including cross-licenses and patent pooling.[17]

We need to understand the recent trend of patent proliferation: What are the factors underlying the trend - an explosion of innovation, changes in business approaches to intellectual property, patent procedures at the PTO, or other causes? How does this trend affect the commercialization of new technology? If the central approaches to navigating a patent thicket involve cross-licenses and patent pooling, how should antitrust enforcement react to these practices? To the extent that such a patent thicket exists, how does it affect standard setting, for example when access to multiple patents in the hands of different patentees may be required to develop and implement a technological standard?

**B. *The Economic Life and Significance of Patents***

Another dimension worthy of attention is the length of time a patent is economically important. A patent may be measured in terms of its "legal life" which, for utility patents, is 20 years from the date of filing the application.[18] As a practical matter, however, patent terms may also be considered in terms of "economic life," which measures the period during which the legal protection produces a positive cash flow.[19]

An issue to consider is whether, in practice, there may be a divergence between the legal life and the economic life of a patent. For instance, a patent's economic life may be shorter than its legal life if the patent is rendered obsolete by other technological advances prior to the expiration of its legal life.[20] In some industries, moreover, the economic life of patents may be increasingly shortened due to the pace of innovation. If so, does this phenomenon have competitive implications? Another issue to consider is whether, in some industries, strong technology companies can extend the economic significance of patents beyond their corresponding legal lives.[21] We need to understand how the economic significance of patents can be extended to determine whether conduct that extends economic significance benefits consumers.

**C. *The Changing Scope of Patents***

Another development is an increased attention to how IP rights are defined and protected. The National Academies of Science ("NAS"), for example, has begun its own project about intellectual property rights in the knowledge-based economy.[22] In initiating this project, the NAS noted that intellectual property rights have been strengthened in this country since the early 1980s through

legislation and judicial interpretations.

With respect to definitions, some observers allege that, all too often, important patents - especially in biotechnology and software - are overbroad, and that overbroad patents can inhibit follow-on innovation.[23] Others contend that broad patents are essential to encourage high-risk research in entirely new fields.[24] This debate has been particularly heated in the context of basic research, about which it has been alleged that patents on particular genes or receptors will wall off entire fields of research without generating any marketable product development.[25]

The explosion of business method patents is also controversial.[26] The PTO sees the recognition of business method patents as the logical continuation of "an unbroken evolutionary path from mechanical technology."[27] Others have contended that the PTO has "allowed a number of patents on ideas that would not appear offhand to meet the usual standards for novelty and non-obviousness, such as the patent held by Sightsound.com which reputedly covers 'the sale of audio or video recordings in download fashion over the Internet.'"[28] Obvious questions arise: Has the recent explosion of business method patents reflected a commensurate increase in innovation? Or are such patents stifling, rather than promoting, innovation? What changes in procedure and presumptions have strengthened intellectual property rights during the past two decades? What have been the implications of these changes for both competition and intellectual property policy?

**D. *The Role of the Federal Circuit***

The creation of the Federal Circuit in 1982 has affected the development of case law in both intellectual property and competition. The Federal Circuit was created to promote doctrinal uniformity in patent law.[29] It has exclusive jurisdiction over appeals from the PTO with respect to patent applications and from judgments in civil actions for patent infringement.[30] Since its inception, the Federal Circuit's scope has grown in at least two ways: through its expanding jurisdiction over antitrust issues and through the court's application of its own law rather than regional circuit law.[31] Because patent and competition issues frequently arise together, the Federal Circuit can play an increasingly important role in the development of competition law.[32] During the hearings, we will consider the Federal Circuit's substantive impact on competition law. That impact is defined, in the first instance, by its decisions regarding its jurisdictional scope. In the second instance, the court's choice of law defines its impact. I will discuss each point briefly.

By statute, the Federal Circuit has exclusive appellate jurisdiction over any district court case in which the district court's jurisdiction was based "in whole or in part"[33] upon "any civil action arising under any Act of Congress relating to patents."[34] Where is the jurisdictional line to be drawn? The Federal Circuit, while sitting *en banc* in *Atari v. JS & A Group*, has itself stated that "Achievement of increased uniformity in the substantive law of patents does not require that this court get its hands on every appeal involving an allegation that a patent law issue is somehow involved."[35] My purpose here is not to revisit how that line has been drawn in any one case, but rather to underscore what the Federal Circuit itself recognizes: some of its own jurisdictional rulings could promote forum shopping with regard to non-patent issues, including antitrust issues.[36]

Once the Federal Circuit asserts jurisdiction over a case with non-patent issues, the question then becomes which body of law the court will apply - the law from the regional circuit or Federal Circuit law? The Federal Circuit's initial response was to apply the regional circuit law,[37] but during the past few years it has changed its position. The court now states that it has "abandon[ed its] practice of applying regional circuit law in resolving questions involving the relationship between patent law and other federal and state law rights. Henceforth, [the Federal Circuit] will apply [its] own law to such questions."[38] Consistent with that general approach, the Federal Circuit had already issued a more specific ruling that "all antitrust claims premised on the bringing of a patent infringement suit" will be decided as a question of Federal Circuit law.[39]

The Federal Circuit's role in adjudicating competition matters is both complex and evolving.[40] It is thus appropriate to examine how the creation of the Federal Circuit, the development of its law and policy, its expansion of its jurisdiction, and its application of its own law affect the balance between

intellectual property and antitrust.

### E. *Refusals to Deal*

Finally, tensions can also arise between antitrust and IP doctrines when a patent or copyright holder unilaterally refuses to license its intellectual property. The Federal Circuit's recent decision in *Independent Service Organizations Antitrust Litigation*[41] ("*CSU v. Xerox*") has highlighted this issue. In that case, Xerox unilaterally decided to stop supplying patented replacement parts and diagnostic software to a group of independent service organizations ("ISOs"). The ISOs challenged this conduct as an antitrust violation, alleging that Xerox's purpose was to undermine the ISOs' capacity to compete effectively in the service aftermarket. On appeal, the Federal Circuit upheld the district court's grant of summary judgment for Xerox, observing that:

[i]n the absence of any indication of illegal tying, fraud in the Patent and Trademark Office, or sham litigation, the patent holder may enforce the statutory right to exclude others from making, using, or selling the claimed invention free from liability under the antitrust laws.[42]

Commentators have had varied responses to this decision. Under one view, when faced with a monopolist patent holder's refusal to deal, antitrust doctrine may ask whether the monopolist "sacrificed profit available from exercising that monopoly power in order to exclude competition and thereby to create additional market power."[43] Areeda and Hovenkamp are more supportive of the Federal Circuit decision, observing that:

the patentee who has not engaged in other "misuse" of its patent by such devices as improper infringement suits or unlawful tying has an absolute right to refuse to license to others. If this rule should ever be less absolute, it would be when the patents at issue have been acquired, and even more when they are both acquired and unused.[44]

Some have argued that the Federal Circuit's decision appears to find substantial support in the plain language of 35 U.S.C. § 271(d)(4),[45] providing that "[n]o patent owner otherwise entitled to relief for infringement . . . of a patent shall be denied relief or deemed guilty of misuse or illegal extension of the patent right by reason of his having . . . (4) refused to license or use any rights to the patent." Nevertheless, perspectives on *CSU v. Xerox* continue to provoke debate: under what circumstances should there be limits on the rights of patent or copyright holders to refuse to deal? Should 35 U.S.C. § 271(d)(4) be changed or reinterpreted to reflect competition considerations? What are the implications for competition policy and innovation? These are among the issues that we will study in our upcoming hearings.

## IV. Recent FTC Activities Involving Intellectual Property

An increasing number of the FTC's competition matters require the application of antitrust law to conduct relating to intellectual property. I would like to highlight a few of the areas the FTC has investigated, describing our analysis, results, and unresolved issues.

### A. *Pharmaceuticals and The Hatch-Waxman Act of 1984*

The first area is generic drugs. The competitiveness of the pharmaceutical industry is crucial to American consumers.[46] The Hatch-Waxman Act of 1984 reflected an attempt to balance the benefits of greater competition from generic drugs with the benefits of having sufficient intellectual property protection to preserve the incentives to make the large, up-front, and risky expenditures necessary to develop new drugs successfully. The available research indicates that the Hatch-Waxman Act has reduced drug prices. The Congressional Budget Office estimated, for example, that by purchasing generic instead of brand-name drugs, consumers saved $8 billion to $10 billion on prescription drug purchases made at retail pharmacies in 1994.[47]

As is now well known, the FTC has actively investigated patent settlements between the manufacturers of "pioneer" drugs and competing generic drugs. The concern is that some settlements

might limit the ability of a generic to compete *beyond the limitations already imposed, such as by patent law and the Hatch-Waxman Act.* FTC investigations have examined claims that Hatch-Waxman's provisions have been manipulated to delay or deter generic entry. Some makers of brand-name and generic drugs have entered into agreements under which the generic entrant is essentially paid not to compete. In *Abbott/Geneva*,[48] for example, the parties allegedly agreed that the generic manufacturer - in exchange for money paid by the branded manufacturer - would not enter the market until their patent litigation concluded; would not enter the market with any other generic version of the product; and would not relinquish the 180-day period of exclusivity given to it under Hatch-Waxman as the firm first to file an application to make a generic equivalent. Agreements of this type may unreasonably delay the entry of generic drug competition, potentially costing consumers hundreds of millions of dollars annually.

Other investigations involve unilateral conduct by branded manufacturers that may be designed to forestall competition. For example, some branded manufacturers list additional patents in the FDA's "Orange Book," often shortly before their original patents expire, enabling them to file patent infringement suits against generic drug firms poised to enter the market. Under Hatch-Waxman, such litigation triggers an automatic 30-month stay on FDA approval of the generic drug. If the listings do not meet statutory and regulatory requirements, then their inclusion in the Orange Book may constitute unlawful restraints on competition.

To determine whether strategies such as these are isolated examples or represent patterns of anticompetitive conduct, the Commission, as requested by Representative Waxman, currently is conducting a study of the generic drug industry. This study will help provide a more complete picture of how generic competition has developed under Hatch-Waxman. This study is certainly timely. Between 2001 and 2005, brand name drugs with combined U.S. sales approaching $20 billion will go off patent.[49] This change will provide an enormous opportunity for the generic industry and, conceivably, a commensurate challenge to the brand-name pharmaceutical industry, whose members may have an incentive and ability to slow or thwart the entry of competing generic drugs to protect the sales of branded drugs. Moreover, some Congressional representatives have evidenced interest in legislative reform of Hatch-Waxman.[50] Our study and our experience in investigating these issues should provide useful analysis to help policymakers strike an appropriate balance between competition and intellectual property protection.

**B. *Standard Setting***

Standard setting is another area, in which the FTC has conducted investigations, that illustrates the tension between antitrust and intellectual property policy. Standards that rely on intellectual property can raise difficult competition issues. Although such standards are more common in the knowledge-based economy, some of these issues are not new.

I begin with an example of FTC involvement with standard setting and patents that is not from a high-tech setting - quite the contrary, it involved toilet valves. In 1985, at the end of my second tour at the FTC, the Commission entered into a consent agreement with the American Society of Sanitary Engineering ("ASSE").[51] The ASSE develops and sells plumbing product standards and seals of approval. Numerous state and local jurisdictions rely extensively upon ASSE standards and, in fact, many have adopted them into their building codes. Evidence of compliance with an ASSE standard thus confers important competitive benefits.

At issue was a small business that had developed an innovative toilet tank fill valve. The evidence indicated that this new valve protected against backflow, or water contamination. The manufacturers of this new valve also claimed that its unique design conferred a number of performance advantages over existing technology. The critical fact was that the new valve prevented backflow through a device other than the one the that ASSE standard specified. The ASSE refused to develop a standard for evaluating the ability of this new valve to prevent backflow. In fact, the ASSE had "a policy of refusing to develop a standard for a product which is patented or manufactured by only one manufacturer."[52] In essence, "the existing manufacturers did not sanction an innovative product unless they could also produce it."[53] The consent order required, among other things, that the ASSE stop refusing requests

for issuance of a standard or modification of an existing standard for a product merely because only one or a small number of manufacturers patent or make the product.

More recently, anticompetitive issues in standard setting have arisen through attempts to influence the development of standards for which a firm holds relevant intellectual property rights. For example, in *Dell*, the respondent allegedly breached its commitment to disclose patents to a standard-setting organization before the organization developed a standard relying on those patents.[54] To settle the FTC charges, Dell agreed not to enforce its patent rights against computer manufacturers complying with the standard.

Standard-setting issues tend to elicit a wide range of reactions. Some commentators have argued that standards that rely on patents or other intellectual property rights present a great danger to competition (*e.g.*, monopolization or a raising of rivals' costs).[55] "[T]he standard, if adopted, can imbue the technology with market power that it previously lacked."[56] Yet the *ASSE* matter reminds us that anticompetitive conduct also may involve the exclusion of innovative, patented products from the standard-setting process itself. After considering the conduct at issue in *Dell*, some observers concluded that to require members of a standard-setting organization to agree to disclose all relevant patents (or copyrights or patent applications) before a standard is chosen would place too great a burden on businesses and thus deter firms from participating in the standard-setting organization in the first place, thereby hindering innovation.[57] Others disagreed, asserting that the type of conduct alleged in *Dell* undermines the standard-setting process, impeding the innovations that may flow once a standard is established.[58]

The Commission's staff is assessing whether there may be other circumstances analogous to *Dell* that merit challenge. In any event, we could all benefit from a more complete understanding of the standard-setting process. It is important to explore practices in the standard-setting area and the manner in which tensions between competition and intellectual property protection typically get resolved. This is another area that we will further explore at the intersection of competition and intellectual property.

## V. Conclusion

As this discussion suggests, considerable learning has occurred during the past twenty years about the issues at the intersection of antitrust and intellectual property. Yet, the discussion also reveals that we have much more to learn. As America's knowledge-based economy continues to grow, the competition/intellectual property interface will become increasingly more significant. Consequently, it is increasingly important that we ask these questions.

Thus, I return to my initial announcement. The FTC, in conjunction with the Antitrust Division, will hold public hearings beginning in the winter of 2002 on "Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy." The hearings will consider the implications of competition and intellectual property law and policy for innovation and other aspects of consumer welfare. We will explore primarily the interrelationships between competition and patent policy, with some attention to other intellectual property issues as they arise in particular contexts. Standard setting, cross-licensing and patent pools, unilateral refusals to deal, other business practices, the proliferation of patents, the changing scope of patents, and the role of the Federal Circuit will be among the topics on the agenda. More specific topic and panel listings will be provided in upcoming Federal Register notices and press releases.

Through these public hearings, we will seek to gather facts about, and to enhance the understanding of, how the doctrines, practices, and policies of each discipline affect both initial and sequential innovation in today's economy. The goal is to promote discussion, learning, and consensus among the relevant government, business, and legal communities on these topics. I invite you to participate in these hearings. Thank you.

**Endnotes:**

1. *See* Timothy J. Muris, "The FTC and the Law of Monopolization," 67 *Antitrust L.J.* 693 (2000); Timothy J. Muris, "The Federal Trade Commission and the Rule of Reason: in Defense of Massachusetts Board," 66 *Antitrust L.J.* 773 (1998).

2. *See* Bruce B. Wilson, Deputy Assistant Attorney Gen., Remarks Before the Fourth New England Antitrust Conference, Patent and Know-How License Agreements: Field of Use, Territorial, Price and Quantity Restrictions (Nov. 6, 1970) (DOJ official's speech articulating what came to be called the "Nine No-Nos").

3. A significant step in this evolution was the Antitrust Division's repudiation of the "Nine No-Nos." *See, e.g.*, Abbott B. Lipsky, "Current Antitrust Division Views on Patent Licensing Practices," Remarks Before the American Bar Association Antitrust Section (Nov. 5-6, 1981).

4. U.S. Department of Justice & Federal Trade Commission, *Antitrust Guidelines for the Licensing of Intellectual Property* (1995), *available at* <http://www.usdoj.gov/atr/public/guidelines/ipguide.htm>.

5. Consistent with this observation, courts have recognized that "[although] the aims and objectives of patent and antitrust laws may seem, at first glance, wholly at odds, . . . the two bodies of law are actually complementary, as both are aimed at encouraging innovation, industry and competition." *Atari Games Corp. v. Nintendo of Am., Inc.*, 897 F.2d 1572, 1576 (Fed. Cir. 1990).

6. I myself have criticized the FTC's *Intel* case (*In the Matter of Intel Corporation*, Dkt. No. 9288 (1999)) as one where I felt the agency had not "examine[d] the effect of the conduct in detail." Muris, "The FTC and the Law of Monopolization," *supra* note 1, at 718.

7. Timothy J. Muris, "Chairman Robert Pitofsky: Public Servant and Scholar," Remarks Before the American Antitrust Institute, Second Annual Conference (Washington, D.C., June 12, 2001), *available at* <http://www.ftc.gov/speeches/muris/muris010612.htm>.

8. Carl Shapiro, "Navigating the Patent Thicket: Cross Licenses, Patent Pools, and Standard-Setting," *in Innovation Policy and the Economy, Volume I* (Adam B. Jaffe et al. eds., forthcoming 2001), *available at* <http://haas.berkeley.edu/~shapiro/thicket.pdf> (citing the "flood of patents currently being issued by the PTO").

9. *See* United States Patent and Trademark Office, *U.S. Patent Statistics, available at* <http://www.uspto.gov/web/offices/ac/ido/oeip/taf/apat.pdf>.

10. Arti Kaur Rai, "Regulating Scientific Research: Intellectual Property Rights and the Norms of Science," 94 *Nw. U.L. Rev.* 77, 94 (1999).

11. *See* Wesley M. Cohen, Richard R. Nelson, & John P. Walsh, "Protecting Their Intellectual Assets: Appropriability Conditions and Why U.S. Manufacturing Firms Patent (or Not)," (NBER Working Paper, 2000), *available at* <http://papersdev.nber.org/papers/W7552>; Bronwyn H. Hall & Rose Marie Ham, "The Patent Paradox Revisited: Determinants of Patenting in the US Semiconductor Industry, 1980-94," (NBER Working Paper, 1998), *available at* <http://www.nber.org/papers/w7062>.

12. Kevin G. Rivette & David Kline, *Rembrandts in the Attic: Unlocking the Hidden Value of Patents* (1999).

13. Robert P. Merges, "Uncertainty and the Standard of Patentability," 7 *High Tech. L.J.* 1, 8 (1992).

14. Shapiro, *supra* note 8.

15. *Id.*

16. *Cf.* Q. Todd Dickinson, Commissioner of Patents and Trademarks, Remarks at Cardozo School of Law (Oct. 24, 2000).

17. *See* United States Patent and Trademark Office, "Patent Pools: A Solution to the Problem of Access in Biotechnology Patents?" (Jan. 19, 2001), *available at* <http://www.uspto.gov/web/offices/pac/dapp/opla/patpoolcover.html>.

18. Mohammad S. Rahman, "Patent Valuation: Impacts on Damages," 6 *U. Balt. Intell. Prop. L.J.* 145, 147 (1998).

19. *Id.*

20. *Id.* Some have argued, for example, that the economic life of patents in the software industry may be shorter than the legal life of those same patents. Julie E. Cohen & Mark A. Lemley, "Patent Scope and Innovation in the Software Industry," 89 *Cal. L. Rev.* 1, 56 (2001).

21. *See, e.g., infra* Part IV.A.

22. *See generally*, <http://ip.nationalacademies.org>.

23. *See* Suzanne Scotchmer, "Standing on the Shoulders of Giants: Cumulative Research and the Patent Law," 5 *J. Econ. Persp.* 29 (1991).

24. *See, e.g.*, Carmen Matutes et al., "Optimal Patent Design and the Diffusion of Innovations," 27 *RAND J. Econ.* 60 (1996); Howard F. Chang, "Patent Scope, Antitrust Policy, and Cumulative Innovation," 26 *RAND J. Econ.* 34 (1995).

25. *See* Michael A. Heller & Rebecca S. Eisenberg, *"Can Patents Deter Innovation? The Anticommons in Biomedical Research,"* 280 *Science* 698 (1998).

26. *See, e.g.*, Shapiro, *supra* note 8 (computer-related business method patents have risen from 1000 in 1997 to over 2,500 in 1999); Q. Todd Dickinson, Commissioner of Patents and Trademarks, Remarks before the National Academies (Feb. 2, 2000) (noting that business method patent filings doubled between FY 1998 and FY 1999, from 1,300 to 2,600). There appears to be a recent decrease in the approval of such patents. Brenda Sandburg, "Patent Office Approves Fewer Business-Method Applications," 12/21/2000 *N.Y.L.J.* 5 (col. 2).

27. *See* United States Patent and Trademark Office, "Automated Financial or Management Data Process Methods (Business Methods)," *available at* <http://www.uspto.gov/web/menu/busmethp/index.html>.

28. Shapiro, *supra* note 8.

29. "[T]he central purpose [according to the Federal Circuit's enabling act] is to reduce the widespread lack of uniformity and uncertainty of legal doctrine that exist in the administration of patent law." H.R. Rep. No. 97-312, at 23 (1981).

30. *See* 28 U.S.C. § 1295.

31. *See* James B. Gambrell, "The Evolving Interplay of Patent Rights and Antitrust Restraints in the Federal Circuit," 9 *Tex. Intell. Prop. L.J.* 137 (2001); James B. Kobak, "The Federal Circuit as a Competition Law Court," 83 *J.Pat. & Trademark Off. Soc'y* 527 (2001). *See, e.g., Hunter Douglas, Inc. v. Harmonic Design, Inc.*, 153 F.3d 1318 (Fed. Cir. 1998); *Critical-Vac Filtration Corp. v. Minuteman Int'l, Inc.*, 233 F.3d 697 (2d Cir. 2000); *Nobelpharma AB v. Implant Innovations, Inc.*, 141 F.3d 1059 (Fed. Cir. 1998).

32. Rochelle Cooper Dreyfuss, "The Federal Circuit: A Case Study in Specialized Courts," 64 *N.Y.U. L. Rev.* 1 (1989). *See also* Rochelle C. Dreyfuss, *Forums of the Future: The Role of Specialized Courts in Resolving Business Disputes*, 61 *Brook. L. Rev.* 1, 17-18 (1995).

33. 28 U.S.C. § 1295(a)(1).

34. 28 U.S.C. § 1338(a).

35. *Atari, Inc. v. JS & A Group, Inc.*, 747 F.2d 1422, 1429 (Fed. Cir. 1984), overruled on other grounds in *Nobelpharma AB v. Implant Innovations, Inc.*, 141 F.3d 1059 (Fed. Cir. 1998).

36. *Atari*, 747 F.2d at 1437.

37. *Id.*

38. *Midwest Indus., Inc. v. Karavan Trailers, Inc.*, 175 F.3d 1356, 1358-59 (Fed. Cir. 1999), *overruling Cable Elec. Products, Inc. v. Genmark, Inc.*, 770 F.2d 1015 (Fed. Cir.1985). *See also Interpart Corp. v. Italia*, 777 F.2d 678 (Fed. Cir.1985); *Hunter Douglas*, 153 F.3d at 1318.

39. *Nobelpharma AB*, 141 F.3d at 1068, *overruling Cygnus Therapeutics Systems v. ALZA Corp*, 92 F.3d 1153 (Fed. Cir. 1996); *Loctite Corp. v. Ultraseal Ltd.*, 781 F.2d 861 (Fed. Cir. 1985); *Atari, Inc.*, 747 F.2d at 1422.

40. Most recently, it has come to the fore in *In re Independent Service Organizations Antitrust Litigation*, 203 F.3d 1322 (Fed. Cir. 2000), *cert. denied, CSU, L.L.C. v. Xerox Corp.*, 121 S.Ct. 1077 (2001), discussed below.

41. *Id.*

42. *Id.* at 1327 (the Federal Circuit, reaching essentially the same conclusion in relation to copyrights, observed that "the owner of the copyright, if [it] pleases, may refrain from vending or licensing and content [itself] with simply exercising the right to exclude others from using [its] property," *Id.* at 1328).

43. Brief for the United States as Amicus Curiae at 11-12, *CSU, L.L.C. v. Xerox*, 121 S.Ct. 1077 (2001) (No. 00-62) (quoting *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 605 (1985) *and citing* Robert H. Bork, *The Antitrust Paradox* 144 (2d ed. 1993) on predatory conduct). *See also* Robert Pitofsky, "Challenges to the New Economy: Issues at the Intersection of Antitrust and Intellectual Property," 68 *Antitrust L.J.* 913, 921-22 (2001).

44. Phillip Areeda & Herbert Hovenkamp, *Antitrust Law*, (Supplement 2001) at ¶704.1. I have cited approvingly Professor Hovenkamp's discussion of the closely-related Kodak opinion in the Ninth Circuit (*Image Technical Servs. Inc. v. Eastman Kodak Co.*, 125 F.3d 1195 (9th Cir. 1997)). *See* Muris, "The FTC and the Law of Monopolization," *supra* note 1, at 707-08, n. 57 (2000) ("Hovenkamp has predicted that the Ninth Circuit's rule [in *Kodak*], if widely adopted, would be 'incapable of administration' and likely to 'create a litigation nightmare.'") (quoting Herbert Hovenkamp, "Antitrust Remedies for Intellectual Property Bottlenecks," Presented at the European University Institute's 1998 EU Competition Policy Workshop: Competition Policy in Communications Network Markets (Nov. 13-14, 1998)).

45. *Cf.* Brief for the United States as Amicus Curiae at 9-11, *CSU, L.L.C. v. Xerox*, 121 S.Ct. 1077 (2001) (No. 00-62).

46. Timothy J. Muris, "Antitrust Enforcement at the Federal Trade Commission: In a Word - Continuity," Remarks Before the American Bar Association, Antitrust Section Annual Meeting (Chicago, Ill., Aug. 7, 2001), *available at* <http://www.ftc.gov/speeches/muris/murisaba.htm>.

47. Congressional Budget Office, "How Increased Competition from Generic Drugs Has Affected Prices and Returns in the Pharmaceutical Industry" (July 1998), *available at* <http://www.cbo.gov/showdoc.cfm?index=655&sequence=0>.

48. *In re Abbott Laboratories and Geneva Pharmaceuticals, Inc.*, Dkts. C-3945 and C-3946 (March 16, 2000), *available at* <http://www.ftc.gov/os/2000/03/index.htm#16>.

49. National Institute for Health Care Management, "Prescription Drugs and Intellectual Property Protection," 3 (Aug. 2000).

50. The Senate Judiciary Committee recently approved the Drug Competition Act of 2001, S. 754, a bill that requires drug companies to file with the federal antitrust agencies certain agreements that might delay generic entry. Kristen Hallam, "Cipro Debate Prompts Approval of Generic-Drug Bill," Bloomberg, Oct. 18, 2001, *available at* <http://www.bloomberg.com>.

51. *American Society of Sanitary Engineering*, Dkt. C-3169, 106 F.T.C. 324 (1985). The members of the ASSE businesses include plumbing equipment manufacturers and designers.

52. *Id.* at 329.

53. James L. Langenfeld & Louis Silvia, "Federal Trade Commission Horizontal Restraint Cases: An Economic Perspective," 61 *Antitrust L.J.* 653, 664 (1993).

54. *Dell Computer Corp.*, Dkt. C-3658,121 F.T.C. 616 (1996).

55. James J. Anton & Dennis A. Yao, "Standard-Setting Consortia, Antitrust, and High-Technology Industries," 64 *Antitrust L.J.* 247, 261 (1995).

56. *Id.*

57. *See, e.g.*, *Dell*, 121 F.T.C. at 632-33 & n.11, 635-36 (Dissenting Statement of Commissioner Mary L. Azcuenaga).

58. *Id.* at 626.

INTERNATIONAL COMPETITION POLICY ADVISORY COMMITTEE
TO THE ATTORNEY GENERAL AND ASSISTANT
ATTORNEY GENERAL FOR ANTITRUST

FINAL REPORT
February 28, 2000

EXECUTIVE SUMMARY

# CHAPTER 1
# GLOBALIZATION AND ITS IMPLICATIONS FOR ANTITRUST COOPERATION AND ENFORCEMENT

In the last several decades, more and more nations have come to recognize the value of competition as a tool for spurring innovation, economic growth, and the economic well-being of countries around the world. This recognition is evident in the economic liberalization that is taking place and in the dynamic technological change that is not only made possible by liberalization, but is itself an engine for liberalization. Both of these phenomena -- economic liberalization and technological development -- are in turn driving economic integration.

Competition policy can help to facilitate economic liberalization. If working properly, competition policy can produce more goods and services from scarce resources and provide a set of rules and disciplines that are not based on privilege and that are conducive to and responsive to efficient marketplace behavior.

A century ago, only the United States had comprehensive antitrust laws in place. Today, more than 80 countries have adopted antitrust laws, most of which were introduced in the 1990s. Yet, the emergence of competition policy regimes has not meant a uniformity of substantive rules or institutional approaches around the world. Competition policies of nations differ within a range that is in keeping with differences in legal systems. Moreover, even within established antitrust jurisdictions such as the United States, antitrust law evolves and changes. Technological development, the drive for competitiveness in the world environment, and economic analysis all contribute to changes in competition policy.

## The Mandate of the International Competition Policy Advisory Committee

What new tools, tasks, and concepts will be needed to address the competition issues that are emerging on the horizon of the global economy? To answer these questions, Attorney General Janet Reno and Assistant Attorney General for Antitrust Joel I. Klein formed the International Competition Policy Advisory Committee in November 1997. The Advisory Committee was asked specifically to give particular attention to three topics: multijurisdictional merger review; the interface of trade and competition issues; and future directions in enforcement cooperation between U.S. antitrust authorities and their counterparts around the world, particularly in their anticartel prosecution efforts. The reasons for these points of focus are quite clear. The large number of mergers being reviewed by a multitude of competition

authorities, the international controversy over barriers to market access stemming from allegedly anticompetitive private barriers to trade, and the significant increase in the number of international cartel cases being prosecuted by the Antitrust Division have come to make these international matters of mainstream significance to U.S. antitrust policy. At the same time, some issues were consciously excluded from the Advisory Committee's work. For example, the Advisory Committee did not review domestic trade remedies, such as antidumping measures. In addition, the Advisory Committee did not address a variety of practices that may be reprehensible, illegal, or offensive under U.S. or foreign law or policy that can affect the nature of competition within a market or internationally. These include matters such as substandard wage and employment standards, the use of child labor, and lax environmental regulations, among others.

For two years the Advisory Committee, seeking the views of antitrust officials, businesses, scholars, practitioners, and other interested parties, has tried to identify initiatives that the U.S. Department of Justice and the U.S. government could undertake over the short and medium term and that would contribute to achieving the integration of markets through:

- *Increased transparency and accountability of government actions.*
- *Expanded and deeper cooperation between U.S. and overseas competition enforcement authorities.*
- *Greater soft harmonization and convergence of systems.*

**The Global Economy and Competition Policy**

In considering competition policy and the international marketplace, a key challenge stems from the recognition that law is national but markets can extend beyond national boundaries. If markets are broader than national boundaries, are national laws and their enforcement sufficient to deal with the market problems of the new century? Further, is it possible to rely upon national law, yet at the same time work toward the development of a more seamless international system that facilitates the workings of global markets?

Of all these challenges, the international community has made the most headway in increasing cooperation and networking among the competition agencies of the world. International cartel enforcement and other forms of international enforcement cooperation in merger review are notable areas of success, particularly in recent years. Furthermore, both the number of bilateral antitrust cooperation agreements between the United States and other jurisdictions, and the number of new international initiatives have increased markedly. These cooperative solutions hold great potential, but, of course, it is predictably the case that they work well only when the cooperating agencies are jointly sympathetic to an approach regarding the particular antitrust enforcement matter.

A second challenge is now being observed: with more than 60 nations now having antitrust merger control laws that require (or provide for) antitrust notification, the overlapping regulations are at times unduly burdensome and costly to the merging parties and can cause unnecessary frictions between nations. The question arises whether the systems can be rationalized and still ensure that enforcers have the tools necessary to identify and remedy

anticompetitive transactions.

A third challenge is linked to the world trading system itself and the promise of open markets: Nations may promise open markets as far as the state is concerned and undertake substantial liberalization commitments with respect to governmental practices, but at the same time allow, by action or inaction, blockage of their markets by firms' anticompetitive restraints. If there is an international interest in removing those restraints and thus freeing up the world markets, can this interest be fully satisfied by national antitrust law? Is a new approach needed that does not split the state role from the private role and that does not test the limits of national jurisdiction?

In addressing these challenges, the Advisory Committee has considered the role for competition policy in the global economy broadly and with a view to improving approaches not only within the United States but also around the world. This Report considers problems that transcend nations, problems within individual nations, and problems between particular systems. It is not possible to predict how the global economy will evolve, but this Report starts from the premise that the United States should try to provide an environment conducive to the further expansion of international commerce, tolerant of the diversity of nations with respect to their own evolving law, and hospitable to the enhancement of world welfare.

## CHAPTERS 2 AND 3
## MULTIJURISDICTIONAL MERGERS

Competition issues raised by the growth of cross-border trade and investment and the simultaneous proliferation of antitrust merger control laws are at the cutting edge of economic globalization. The world currently is experiencing an unprecedented level of merger activity. In 1999 global mergers and acquisitions were at an all-time high, with approximately $3.4 trillion in activity announced worldwide. As the volume of international merger activity has increased, so too has the number of jurisdictions around the world with antitrust merger control laws. Merging parties with international business operations potentially must review their sales, assets, subsidiaries and market shares in more than 60 jurisdictions to determine whether notifications to the competition authorities in those jurisdictions are necessary or advisable. These trends make it increasingly likely that mergers involving firms doing business in several jurisdictions will be reviewed by multiple competition authorities. It is not unheard of for merging parties to file antitrust notifications with a dozen or more jurisdictions.

The spread of merger control law has the potential to create significant benefits. Merger review regimes with notification requirements give competition authorities the ability to identify and remedy potentially problematic transactions, thereby benefiting consumers and competition. At the same time, the growing tendency of nations to apply their laws to offshore mergers and the sheer volume of law that firms undertaking mergers must now consider present challenges for the merging parties and for the reviewing authorities. These challenges range from dealing with heightened uncertainty and increased transaction costs to ensuring consistent outcomes and compatible remedies.

In Chapter 2 the Advisory Committee considers ways to bridge the differences between systems and minimize the risk that differing substantive standards will give rise to diverging evaluation on the merits of a transaction, incompatible or burdensome remedies, and international friction. The unifying theme of these recommendations is that cooperation among antitrust enforcement authorities is not only desirable, but necessary if the challenges in this arena are to be addressed effectively.

Chapter 3 examines those problematic features within merger review systems that give rise to uncertainty and unnecessary transaction costs. The Advisory Committee believes that an improved environment for mergers globally is where individual merger control regimes focus on those transactions that raise competitive concerns within their territory and refrain from unduly burdening transactions, particularly those that lack anticompetitive potential.

## CHAPTER 2
## STRATEGIES FOR FACILITATING SUBSTANTIVE CONVERGENCE AND MINIMIZING CONFLICT

Inconsistent outcomes and conflicting or burdensome remedies imposed by multiple jurisdictions may significantly increase transaction costs. In the worst-case scenario these burdens may result in the abandonment of transactions that are procompetitive. Although much attention has been focused on the potential for divergent outcomes when proposed transactions are reviewed by multiple agencies, multijurisdictional merger review for the most part has resulted in consistent outcomes and compatible remedies. The possibility of divergent outcomes will remain, however, as long as underlying substantive differences in merger control law exist and multiple agencies continue to review a single transaction.

The Advisory Committee believes that these challenges can best be addressed by facilitating, where possible, substantive harmonization and convergence among merger review regimes. Complete harmonization and convergence will be achieved only in the long run, if ever. This point should not, however, deter policymakers from taking steps to support and facilitate efforts at harmonization and convergence both in the short and medium term.

There are at least three concrete areas where nations can take steps to facilitate the convergence process and further minimize transaction costs and conflicts: Facilitating greater transparency; developing disciplines to guide the review of mergers with significant transnational or spillover effects; and continuing to enhance cross-border cooperation. In addition, the Advisory Committee recommends a number of approaches to work sharing to deepen cooperation further and to develop more seamless merger review systems internationally.

### Facilitate Greater Transparency

One of the first steps toward facilitating greater substantive convergence is the development of a better understanding of each jurisdiction's framework for analyzing proposed mergers. This process would highlight differences in merger control laws and could stimulate international discussion and adjustments. The Advisory Committee discusses several steps to

improve transparency:

1. Greater transparency in the application of each jurisdiction's merger review principles could be enhanced by the *publication of guidelines and notices* explaining the manner in which mergers will be analyzed; *annual reports* (including case examples), *statements, speeches, and articles* describing changes in relevant legislation, regulations, and policy approaches; and *case-specific decisions, releases, and press interviews*.

2. At a multinational level, greater transparency may be achieved by conducting a survey and compiling an explanatory report of all jurisdictions with merger regulations to identify the principles they employ.

3. Each jurisdiction also should facilitate achievement of greater transparency by articulating clearly its rationales for challenging, or refraining from challenging, significant transactions (that is, decisions that set precedent or otherwise indicate a shift in doctrine or policy).

**Develop Disciplines for Merger Review**

Nations should work together to develop what this Advisory Committee calls disciplines that nations could usefully agree upon to guide the review of mergers with significant transnational or spillover effects. The Advisory Committee outlines disciplines that are simple yet aspirational and may not be feasible to implement in many jurisdictions at this juncture. The Advisory Committee believes, however, that if disciplines are adopted, they should be set at a high standard. That is, these disciplines are designed to promote best practices under any system as opposed to creating rules that would bring about convergence to the "lowest common denominator." What follows are intended to be illustrative and applicable to all jurisdictions with competition regimes. Other principles of law as well as disciplines can and should be developed through international discourse.

1. Nations should apply their laws in a nondiscriminatory manner and without reference to firms' nationalities.

2. As a best practice or discipline, with limited exceptions (such as national security), noncompetition factors should not be applied in antitrust merger review. If a jurisdiction's law recognizes noncompetition factors (such as preservation of jobs, promotion of exports, or international comparative advantage), such factors should be applied transparently and in a manner narrowly tailored to achieve their ends. Further, if a jurisdiction's merger regime explicitly permits noncompetition factors to trump traditional competition analysis, those noncompetition factors should be applied after the competition analysis has been completed.

3. Competition agencies do not operate in a political vacuum, but enforcement agencies must nonetheless establish their independence, and "parochial" political concerns should not play a role in the merger review process.

4. Nations should recognize that the interests of competitors to the merging parties are not necessarily aligned with consumers' interests. Accordingly, authorities should minimize the problems that may arise in competitor-driven processes, including the disruption of potentially procompetitive mergers.

5. When a transaction has a significant anticompetitive effect on the local economy in any given jurisdiction, the local antitrust authority has a legitimate interest in reviewing the transaction and imposing a remedy notwithstanding the fact that the transaction's "center of gravity" (whether determined by reference to the nationality of the parties, location of productive assets, or preponderance of sales) lies outside its national boundaries. At the same time, in the face of a clash between jurisdictions, remedies with extraterritorial effects should be tailored to cure the domestic problem. Further, when fashioning a remedy with extraterritorial effects, the agency should take into account local practices and procedures in the foreign jurisdiction.

**Continue to Enhance Cross-Border Cooperation**

To advance substantive convergence in the near term, and avoid or minimize divergent analyses and outcomes, it is important for the United States and other jurisdictions to encourage and further deepen cross-border cooperation in reviewing mergers. Cooperation among reviewing authorities could be enhanced if all jurisdictions were to establish a transparent legal framework for cooperation that contains appropriate safeguards to protect the privacy and fairness interests of private parties. This Advisory Committee has identified several key features of such a framework.

1. In the U.S. context, a framework for cooperation might entail the development of a Protocol with a combination of key features: a description of the way the federal antitrust enforcement agencies in the United States conduct cross-border coordinated merger investigations; model waivers permitting discussions otherwise prohibited by confidentiality laws and authorizing the exchange of statutorily protected information between competition authorities during a merger review; and a policy statement outlining safeguards established in a reviewing jurisdiction to protect confidential information. Other jurisdictions usefully could develop comparable protocols.

2. The idea behind the model waivers is that they would not impose on an agency any obligations beyond acting in accordance with its normal practices and confidentiality rules (as described in its policy statement). To instill further confidence, however, agencies using confidentiality waivers should affirm in the policy statement the agency's intention to refuse to disclose information except to the extent it is legally required to do so, to use best efforts to resist disclosure to third parties (including the assertion of any privilege claims or disclosure exemptions that may apply), and to provide such notice as is practicable before disclosing to a third party any confidential business information obtained pursuant to a waiver. The policy statement also should explain how concepts such as using best efforts to resist disclosure to third parties are implemented in the

jurisdiction.

3. Jurisdictions also should consider adopting a policy to provide notice to a party -- either before or after the fact -- when they share documents of that party with another jurisdiction. The Advisory Committee can well understand why an enforcement agency would be unwilling to agree to a blanket commitment to provide notice. However, when an agency has the authority to exchange information and adverse enforcement consequences are not present, then notice to the parties seems reasonable and proper. Alternatively, parties could provide select documents directly to other reviewing jurisdictions and waive confidentiality with respect to those documents or identify beforehand which documents or categories of documents may and may not be shared, although in certain cases this approach might limit the benefits that potentially could be realized through the cooperative process.

**Develop Work-Sharing Arrangements**

Looking to the future, the Advisory Committee believes that the international community should be striving to develop more nearly seamless merger review systems internationally, and particularly with those jurisdictions that have mature merger review regimes. The most integrated approach the Advisory Committee envisions is work sharing in cases in which the enforcement efforts of one agency are likely to be sufficient to remedy the antitrust concerns of other jurisdictions. Work sharing may be accomplished in incremental steps with each step reflecting a different degree of cooperation and each step built upon successful approaches to cooperation and coordination that enforcement authorities have already implemented. An important objective is to reduce duplication, while preserving the right for the United States and other jurisdictions to take their own measures, as necessary.

Work sharing logically could begin between the United States and the European Union because of their record of cross-border cooperation and the amount of transatlantic merger activity occurring that has its main impact in the United States and Europe. Further, working toward a common position on merger review policy with the European Commission should be a priority. The Advisory Commission envisions the development of work-sharing arrangements along these lines:

1. *In a first step, each jurisdiction conducts its own review of the proposed transaction and participates in the formulation, if not the negotiation and implementation, of remedies.* Under this approach, some or all reviewing jurisdictions would jointly negotiate remedies with the merging parties, while each would implement its own consent decree that incorporates the jointly negotiated remedies. In some cases it may be feasible for one jurisdiction to negotiate remedies with the merging parties that will address concerns of both that jurisdiction and other interested jurisdictions. Such cooperation and coordination at the remedies phase has been successfully employed in several cases, and the Advisory Committee believes that these approaches should be emulated in future cases whenever the legal and factual situations indicate that such coordination and cooperation will be useful.

2. In appropriate cases, it may be feasible to take cooperation to the next level and *limit the number of jurisdictions conducting second-stage reviews* of a proposed transaction. For example, where the concerns of Country A are likely to be the same as and subsumed by the concerns of a more distinctly affected investigating jurisdiction, it may be appropriate for Country A to refrain from independent investigation. At present, such an arrangement may not always be feasible in an environment with statutorily mandated review periods if the agency could lose the right to review the transaction at all. This approach likely would preclude a jurisdiction from being able to negotiate its own remedies if it felt that the preceding jurisdiction did not adequately address its concerns or imposed a remedy that diverged from its approach. Such impediments would have to be resolved if this degree of cooperation were to become feasible in more than a handful of cases. In the meantime, this approach may be useful in situations in which there is no available remedy to the reviewing jurisdiction or there is a sufficient level of confidence in the reviewing jurisdiction.

3. One way to safeguard against this possibility is to ensure sufficient participation in the process by the other jurisdictions. One jurisdiction would *coordinate the investigation of a proposed transaction*, take into account the views of each interested jurisdiction, and recommend remedies to address the concerns of all interested jurisdictions. The assessment of the coordinating agency would be binding on the coordinating agency but either could serve as a recommendation to other interested jurisdictions (with a presumption in favor of accepting the coordinating jurisdiction's recommendation) or could be binding on those jurisdictions as well.

4. The Advisory Committee considered whether, given a sufficient amount of substantive and procedural convergence among merger review regimes, an even higher level of work sharing might be feasible someday. At this advanced level of work sharing, the coordinating agency would evaluate procompetitive and anticompetitive effects of a proposed transaction on a global scale, taking into account all of the merger's costs and benefits to competition, not only the net effects within its borders. The coordinating jurisdiction could then design remedies to address the concerns of all interested jurisdictions.

This advanced level of work sharing is a distant vision. At present, it is the view of this Advisory Committee that while no agency should be obligated to take into consideration competitive harm or benefits that may be achieved outside the reviewing jurisdiction, competition authorities should consider that the transactions they review also have the potential to generate spillover effects in other jurisdictions. As the level of convergence in antitrust enforcement increases, however, agencies should consider analyzing the benefits and anticompetitive effects of a proposed transaction on a global scale.

## CHAPTER 3
## RATIONALIZING THE MERGER REVIEW PROCESS

## THROUGH TARGETED REFORM

Many of the transaction costs imposed by merger regimes are rationally related to the efficient review of transactions that have the potential to create appreciable anticompetitive effects within the reviewing jurisdiction and therefore should be taken in stride by companies as a cost of doing business. At the same time, the Advisory Committee believes that while merger regimes have the potential to create benefits for society, those same review processes also impose significant transaction costs on international transactions. It is therefore important to focus on those *unnecessary* and *unduly burdensome* costs imposed by merger control regimes that have little or no relationship to antitrust enforcement goals.

This second category of proposed reform efforts seeks to reduce transaction costs by rationalizing the merger review process through targeted problem solving in individual merger regimes. Broadly speaking, the Advisory Committee identifies a number of best practices that fall within two major categories: ensuring that each jurisdiction's merger review regime examines only those mergers that have a nexus to and the potential to create appreciable anticompetitive effects within that jurisdiction; and ensuring that each jurisdiction refrains from unduly burdening those transactions during the course of the merger review process. At the same time, these reform efforts seek to ensure that the antitrust authorities have the tools needed to identify and remedy anticompetitive mergers.

### Casting the Merger Review Net Appropriately: Notification Thresholds

The Advisory Committee has learned that one significant category of unnecessary transaction costs stems from the overly broad application of merger control law that relies on exceedingly low notification thresholds and that requires antitrust notification of transactions in the absence of any appreciable domestic effects. To complicate matters, many jurisdictions' filing requirements are vague, subjective, or difficult to interpret. The Advisory Committee recommends several best practices that jurisdictions can use, where necessary, to refine threshold tests for notification. These practices are designed to reduce unnecessary transactions costs without significantly reducing the public benefit from advance notification.

1. In establishing its premerger notification thresholds, each jurisdiction should seek to screen out mergers that are unlikely to generate appreciable anticompetitive effects within the reviewing jurisdiction.

    - This screening can be achieved, first, by implementing threshold tests that require an appreciable nexus to the jurisdiction, such as transaction-related sales or target assets in the jurisdiction.

    - Second, jurisdictions should set notification thresholds only as broadly as necessary to ensure the reporting of potentially problematic transactions. If an indexing mechanism is not employed, the Advisory Committee recommends that jurisdictions review their notification thresholds periodically (at least every four years) to determine whether they should be adjusted.

2. Additional steps that can be taken at this stage to reduce costs for international mergers include establishing objectively based notification thresholds and ensuring their transparency.

3. To better ensure that potentially anticompetitive transactions do not escape scrutiny under merger review systems, the Advisory Committee recommends that competition authorities be given the authority to pursue potentially anticompetitive transactions even if those transactions do not satisfy notification thresholds. Although the federal antitrust agencies in the United States already possess this authority, many existing merger regimes authorize regulators to review transactions only when notification requirements are satisfied.

4. Any efforts to revise notification thresholds also must consider filing fees, which currently constitute a significant source of revenue for numerous competition authorities, including the federal antitrust agencies in the United States. Ideally, no competition agency should be dependent on filing fees for its budget or staff salaries. To ensure that these competition authorities will be able to pursue their enforcement missions vigorously, it is imperative to provide agencies with alternative sources of funding to offset the loss of any funds that may result from revising notification thresholds or "delinking" filing fees from agency budgets.

**Reducing Burdens on Transactions that Come within the Merger Review Net**

Detailed filing requirements and long review periods may impose significant and sometimes unnecessary or unduly burdensome costs on proposed transactions, particularly those that pose no harm to competition. Further, lengthy or indefinite review periods coupled with differing events triggering when a filing may (or must) be made may complicate cooperation among reviewing authorities and heighten uncertainty with respect to transaction planning. To ensure that each jurisdiction refrains from unduly burdening transactions that trigger a notification obligation, merger review should be conducted in a two-stage process designed to enable enforcement agencies to identify and focus on transactions that raise competitive issues while allowing those that present none to proceed expeditiously.

**Review Periods and Timing**

1. The first stage should be conducted within a maximum review period of one month. In many jurisdictions the initial review and waiting period generally runs for either 30 days or one month following notification. By contrast, the initial review period in several other jurisdictions substantially exceeds this base line or is undefined. ICPAC hearings testimony suggests that marginal differences in the initial review periods are inconsequential since they are manageable from a transaction planning standpoint. Reform efforts should focus, therefore, on jurisdictions in which the initial review period either is undefined or substantially exceeds the 30 day-one month baseline.

2. Jurisdictions that are unable to conclude investigations before the expiration of

the initial or second-stage review periods also should be given authority to grant early termination (for example, for transactions that raise no substantive issues or in which the parties are willing to resolve concerns through consent decrees or undertakings).

3. To permit merging parties to coordinate multijurisdictional filings in the most efficient manner and to facilitate cooperation among reviewing authorities, the international community should promote harmonization of rules pertaining to when parties are permitted to file premerger notification. This harmonization can be achieved by targeting reform efforts in jurisdictions with definitive agreement requirements and postexecution filing deadlines so as to permit filings at any time after the execution of a letter of intent, contract, agreement in principle, or public bid.

4. For transactions that raise serious competitive issues and require a more in-depth review, the Advisory Committee concludes that merger review should not be an open-ended process and that companies derive value from certainty with respect to merger review periods. The Advisory Committee believes more deadlines should be employed to provide greater certainty and that jurisdictions with lengthy or open-ended review periods should adopt more expedited time frames for review. The Advisory Committee made a number of suggestions in the U.S. context to address these concerns. One possibility is nonbinding but notional time frames for second-stage review that vary in relation to the relative complexity of the transaction.

**Notification Forms and Information Requests**

1. While the Advisory Committee acknowledges that agencies have a legitimate interest in requiring the submission of information sufficient to ensure that they are able to identify potentially anticompetitive transactions, some jurisdictions impose very substantial and unnecessary burdens through the use of very detailed filing forms. In these jurisdictions, voluminous filings are required for all transactions, including those that pose no harm to competition. To ensure that transactions that trigger notification obligations are not burdened with excessive information requirements, while at the same time giving competition authorities enough information to identify competitively sensitive transactions, the Advisory Committee recommends that initial notification require the minimum amount of information necessary to make a preliminary determination of whether a transaction raises competition issues sufficient to warrant further review.

2. Recognizing that there is a trade-off between the amount of information initially provided and the time frame in which clearance is to be granted, mechanisms also should be established to narrow the legal and factual issues presented by mergers as early in the review process as possible. One way to accomplish this goal would be to provide a short form-long form option, leaving it to the notifying parties to choose in the first instance which form to use. Alternatively, reviewing authorities

may encourage merging parties to provide additional information voluntarily, allowing the authorities to resolve any potential antitrust issues quickly or conduct a focused second-stage inquiry that narrowly targets the antitrust issues.

3. Initial filing requirements in many jurisdictions may be statutorily imposed, and revising these requirements through legislative action may be time consuming. Until reform efforts can be achieved, the Advisory Committee recommends that jurisdictions consider permitting parties to submit an affidavit or letter (in lieu of a notification) alleging brief facts explaining why the transaction does not raise competitive concerns.

4. To facilitate quick resolution of potentially problematic transactions deemed worthy of further investigations and focus the issues as soon as possible, there is no substitute for frank information exchange between competition authorities and the parties to a proposed transaction. To that end, each reviewing authority should articulate to the merging parties at the beginning of a second-stage inquiry the competitive concerns that are driving the investigation. This summary could be conveyed orally or in writing.

5. Competition authorities around the world could assess their own performance with respect to those transactions they challenge. One way to do this is to conduct an after-the-fact audit of merger challenges to examine in great detail decisions to prosecute, or to refrain from prosecuting specific matters. The audit also could examine the types of information collected during each investigation. The aim of these audits lies in obtaining an objective and frank assessment of performance in previous investigations, thereby laying the groundwork for improvement in future cases. Audits could be conducted internally in more mature merger regimes or by a group of outside observers in newer regimes.

6. A great deal also can be gained from multilateral efforts to achieve soft procedural harmonization of the type undertaken by the Organization for Economic Cooperation and Development (OECD). The United States should continue to support OECD efforts to further develop a common framework for merger notification, including the development of common definitions. In addition, the OECD should continue to focus its efforts on identifying the minimum information necessary to identify whether mergers raise competitive issues as well as to specify categories of data that may be useful to narrow or resolve potential issues early in the process. As part of this effort, consideration also should be given to ways to reduce unnecessary burden, including translation costs, overly burdensome certification, and other procedural requirements.

**Targeted Reform Efforts in the United States**

In Chapter 3 the Advisory Committee recommends a number of practices designed to rationalize the application of merger review procedures. The Advisory Committee believes that the United States should play a leading role in the effort to implement these proposed reforms in

the international arena. Perhaps one of the most effective ways in which the United States can stimulate global reform is leading by example. It is therefore important that the United States examine its own merger review system in an attempt to identify and correct those aspects of the system that create uncertainty and unnecessary transaction costs. The applicability of the practices recommended in Chapter 3 to the United States is discussed below.

**Targeted Reform in the United States: Notification Thresholds**

The Hart-Scott-Rodino Act (HSR) and implementing regulations that spell out the U.S. merger review process already use exemptions from HSR reporting requirements for certain transactions involving non-U.S. companies (foreign person exemptions) to ensure that the U.S. authorities are notified only of transactions with a nexus to the jurisdiction. In addition, the notification thresholds are objectively based. Finally, the U.S. antitrust agencies ensure the transparency of these thresholds and their application by offering guidance to practitioners and businesses through published rules and regulations, guides, speeches, and press releases, and through the Federal Trade Commission (FTC) Premerger Office's provision of advice.

The foreign person exemptions, however, have not been adjusted for many years. Thus, the Advisory Committee recommends that the FTC review the scope and level of the HSR exemptions for transactions involving foreign persons to ensure that the U.S. authorities are notified only of transactions with an appreciable nexus to the United States. A final area that deserves attention concerns ensuring that the notification thresholds are only as broad as necessary to identify transactions that have the potential to generate appreciable anticompetitive effects within the United States.

1. The thresholds currently employed by the premerger notification system in the U.S. deserve careful review. While recognizing that small transactions are not necessarily competitively benign, the Advisory Committee finds that the notification thresholds currently employed in the United States are too low and capture too many lawful transactions.

2. The most straightforward way to decrease the number of required filings while not materially compromising the agencies' enforcement mission is to increase the size-of-transaction threshold for acquisitions of both voting securities and assets. One method for raising the threshold lies in adjusting for inflation, with periodic future adjustments for inflation. Depending on the base year and deflator used, increasing the size-of-transaction threshold commensurate with inflation would mean increasing the threshold in the $33 million to $43 million range when measured in 1998 dollars. The majority of the Advisory Committee recommends raising the thresholds within this range, although three members advocate raising the size of the transaction threshold even higher, to $50 million.

3. An indexing mechanism has many benefits, but an automatic indexing mechanism also may produce arbitrary results. If an automatic indexing mechanism is not employed, the Advisory Committee recommends that the notification thresholds be reviewed periodically to determine whether they should be adjusted.

4. The Advisory Committee believes that, ideally, filing fees should be delinked from funding for the agencies. A linkage of this nature may skew incentives to revise notification thresholds because of collateral fiscal effects. Another risk is that the ability of the agencies to fund their law enforcement activities may be compromised when the current merger wave subsides. However, because filing fees currently provide 100 percent of the U.S. agencies' enforcement budgets, sufficient funds must be available from other sources before any effort to delink filing fees or raise thresholds occurs. It is critical to the agencies' enforcement mission that resources are not reduced. The antitrust agencies' enforcement efforts could be directly funded from general revenue or indirectly in a variety of ways including increasing the filing fee, creating a sliding scale fee, or assessing a fee based on the amount of work performed by the agencies (although these latter alternatives would not accomplish delinking the budget from fees).

**Targeted Reform in the United States: Review Periods and Timing**

The Advisory Committee commends the flexibility of the U.S. premerger notification system, which permits filing at any time after the execution of a letter of intent, contract, agreement in principle, or public bid. In addition, the Advisory Committee commends the fact that the U.S. competition authorities resolve approximately 97 percent of all notified transactions within the initial 30-day review period. Thus, no reform of the U.S. triggering event or initial review period is needed. The second-stage review process can, however, be improved.

1. A consensus exists among Advisory Committee members on the need for certainty in merger review periods and that merger review should be conducted within reasonable time frames. Advisory Committee members are not of a shared view on the appropriate mechanisms for addressing these concerns, however. Some members of the Advisory Committee believe that fixed maximum review periods are necessary to provide certainty and discipline in the merger review process. Most members of the Advisory Committee feel this would be extremely difficult to achieve under the U.S. system and might result in enforcement errors. There also is concern that maximum time periods would effectively turn into standard or minimum review periods. A majority of Advisory Committee members therefore eschew strict time periods but recommend that alternative steps be taken to provide the greater certainty required for effective transaction planning. For example, the agencies could employ nonbinding but notional time frames for second-stage review that vary in relation to the relative complexity of the transaction.

**Targeted Reform in the United States: Notification Forms and Information Requests**

The Advisory Committee believes that with modest exceptions, the HSR notification form requests only the information required by the agencies to identify competitively sensitive transactions. In other instances, however, it appears that revisions to the HSR form could enhance the agencies' ability to identify potentially problematic transactions. The Advisory

Committee also believes that it is important for the U.S. agencies to implement measures to address some of the problems perceived by the business community and the private bar with respect to the second-request process.

1. The Advisory Committee encourages the FTC to implement changes that better focus the HSR form. In addition, the Advisory Committee recommends that the agencies formalize their current practices that encourage merging parties voluntarily to provide additional information at the initial filing stage in an effort to resolve potential issues without the issuance of a second request. One way to formalize the process is to create an optional long form. Another way lies in creating a model voluntary submission list that identifies the categories of data that merging parties usefully may submit in facially problematic cases.

2. Another useful practice that should be formalized is that of permitting the merging parties voluntarily to withdraw and refile within 48 hours the acquiring person's HSR form (without having to pay another filing fee) in order to give the agencies additional time to resolve the matter without having to issue a second request. In appropriate cases of this nature, the agencies should alert parties to the option of withdrawing and refiling the HSR notification. Publishing statistics on the number of successful (and unsuccessful) attempts to avoid a second request by withdrawing and refiling a notification would demonstrate the viability of this option.

3. When they issue a second request, the agencies should provide the merging parties (either orally or in writing) with their reasons for not clearing the transaction within the initial review period. An explanation of the substantive concerns prompting the second request will facilitate transparency in the merger review process and will expedite the process by further enabling the merging parties to focus on and respond to the agencies' concerns. Further, it will assist parties in understanding that the second request rests on genuine substantive concerns. In designing second requests, moreover, the agencies should avoid overly broad requests and instead tailor their requests for additional information to the issues prompting the need for further review.

4. In 1995 the agencies announced that they had addressed concerns about the second-request process by adopting a model second request. The predominant view of ICPAC hearing participants, among others, however, is that this reform helped reduce burdens only marginally. In attempting to identify the appropriate components of an effective model second request, one useful project might be an internal after-the-fact audit of select merger challenges. Such an audit could consider whether the agencies are requesting the right types of information and whether this information was subsequently used at trial (and whether discovery tools were sufficient). Perhaps the answers to these questions would enable the agencies to revise their model second request to reduce compliance burdens on businesses.

5. Merging parties and agency staff frequently are able to negotiate modifications to the scope of second requests. The level of willingness to engage in productive negotiations of this nature appears to vary among staff members.and counsel for merging parties, and modification requests are sometimes not resolved in a timely fashion. In an attempt to institutionalize productive modification negotiations, the Advisory Committee recommends that the agencies impress on staff the importance of being open to negotiating modifications to the scope of second requests and to do so in a timely fashion. Success in this endeavor also requires merging parties and their advisors to cooperate.

6. When modification negotiations break down, parties should be encouraged to use the appeals process, which currently is used hardly at all. To this end, the Advisory Committee recommends that the agencies implement measures to make the appeals procedure more attractive to merging parties by making the process more expeditious, making its outcome more transparent, and actively encouraging merging parties to use the process. Agencies and parties also should involve direct supervisory officials in the modification negotiation process, when necessary.

7. The Advisory Committee also considered ways to reduce foreign productions and translation requirements. The agencies should continue their current practice of permitting parties, in appropriate cases, to provide summaries of documents and produce full translations of only those documents the agencies deem particulary relevant to the inquiry. However, the parties should not as a matter of course be required to forgo a defensible market definition in order to take advantage of this practice. The Advisory Committee recommends that in appropriate cases, the agencies consider whether the selection of the specifications that apply to foreign offices could be limited to those that are directly relevant to the geographic market or that seek documents that pertain to the specific competitive concerns at issue.

**Targeted Reform in the United States: Multiple Review of Mergers**

The Advisory Committee has identified overlapping responsibilities for review of mergers in the United States as an area warranting consideration in its examination of international competition policy. In the United States, a decision by the DOJ or FTC in a specific transaction does not preclude subsequent or parallel competition reviews, nor does it determine the outcome of such proceedings. Federal and state legislatures and judicial decisions have empowered a wide array of public and private parties to challenge mergers, acquisitions, and joint ventures on competition grounds.

Concurrent jurisdiction among multiple domestic agencies has the potential to generate inconsistent policy approaches within a single jurisdiction. As a result, it can make global harmonization efforts and cross-border cooperation more difficult. In addition, it imposes heightened uncertainty as to timing and outcome and further increases transaction costs. In its deliberations, the Advisory Committee identified a number of possible policy approaches to address these issues. These proposals ranged from granting exclusive federal jurisdiction to

determine competitive consequences of mergers to the DOJ and FTC, to clarifying the roles of the DOJ, the FTC, state, and federal sectoral regulators, to imposing timetables and deadlines on the merger review process, to nonlegislated convergence strategies.

1. The Advisory Committee believes that the federal antitrust authorities are better positioned to conduct antitrust merger review than federal sectoral regulators. *The majority of Advisory Committee members recommend* removing the competition policy oversight duty from the sectoral regulators and vesting such power exclusively in the federal antitrust agencies. Under such a regime, the findings of the federal antitrust agency on the competition issues would be reported to, and binding upon, the specialized agencies. At this juncture, however, *some members recommend* instead creating a presumption in favor of the analyses undertaken by the federal antitrust enforcement agencies in parallel or subsequent proceedings. Additional approaches advocated in the short run consist of soft convergence strategies between agencies exercising concurrent jurisdiction to encourage the adoption of common analytical methods and enhanced cooperation.

2. With respect to overlapping state review, the Advisory Committee encourages the state attorneys general to resist using antitrust laws to pursue noncompetition objectives. Further, the Advisory Committee recommends that the federal antitrust enforcement agencies file an amicus curiae brief in state courts in select private suits challenging international transactions. For example, appropriate cases may be where the DOJ or FTC has either cleared or settled a transaction where there has been significant cross-border cooperation or the parties agreed to waive confidentiality.

3. All members agree that several issues relating to overlapping agency review deserve further study. These studies should include analyzing the relationship among the DOJ, the FTC, and other federal and state regulators; identifying the differences in review processes with respect to both substantive approaches and procedure; assessing the expertise of the federal antitrust agencies to undertake merger analyses in regulated industries on the one hand and the capacity of federal sectoral and state regulators to conduct antitrust analyses on the other; assessing the ramifications of a change in the status quo; and gathering the views of the reviewing agencies.

## CHAPTER 4
## INTERNATIONAL CARTEL ENFORCEMENT AND INTERAGENCY ENFORCEMENT COOPERATION

In the last decade, the U.S. Department of Justice Antitrust Division has aggressively and successfully prosecuted nearly 20 international cartels, filing charges against more than 80 corporate and 60 individual defendants -- both domestic and foreign -- in cases involving price fixing; volume, customer, and market allocation agreements; and bid-rigging -- among other things. These high-visibility prosecutions have involved complex, globally extensive, and

sometime long-lived conspiracies and have resulted in the imposition of record-breaking penalties against domestic and foreign defendants alike. Corporate fines in the tens of millions of dollars have become almost commonplace as have significant fines and, increasingly, prison terms for individual defendants.

Several changes in U.S. enforcement efforts have contributed to the detection and successful prosecution of these cartels. In addition to making enforcement efforts against cartels a top priority, the Antitrust Division has instituted a series of incentives for cartel participants to come forward and cooperate with authorities. Moreover, the recent U.S. enforcement successes appear to be occurring amidst a heightened degree of international consensus that cartels should be detected and prosecuted. Some other jurisdictions have followed the U.S. example and are increasing their anticartel enforcement programs, including their focus on international cartels, and their commitment to cooperating more fully with the United States in its anticartel efforts. Yet there is room for even greater international cooperation.

**Improving Knowledge about International Cartels**

Whether the surge in U.S. prosecutions means that there are more international cartels in operation than ever before is unclear. What is clear is that international cartels present a serious problem with adverse effects on U.S. and foreign consumers, businesses, and governments. With U.S. anticartel enforcement actions generating considerable interest around the world, the time is opportune for U.S. antitrust agencies not only to expand cooperation with antitrust authorities in other jurisdictions, but also to increase public awareness about the detrimental effects of international cartels.

1. A complete assessment of the incidence of private international cartels is beyond the capabilities of the Advisory Committee. Nonetheless, the Advisory Committee believes that the scope and incidence of international cartels are important matters for further examination and recommends that governments and other experts take up this issue.

2. The Advisory Committee also recommends that the United States expand its efforts to increase public knowledge and awareness at home and abroad of the deleterious effects of cartels for consumers, businesses, and governments.

3. To take advantage of the improved environment for international cooperation on rooting out and prosecuting international cartels, the Advisory Committee hopes that the United States will use all opportunities, both formal and informal, to share its recent experiences with foreign enforcement authorities. Actions to ensure that U.S. anticartel enforcement policies are well understood abroad will enhance the credibility of U.S. enforcement efforts and promote interagency cooperation at the same time.

**Increasing Transparency in Handling Confidential Business Information**

The exchange of confidential information between competition authorities is an important

feature of deepening cooperation. The United States and international business communities have expressed concerns about agency accountability and transparency in connection with such information exchanges, particularly with respect to cross-border joint investigations into cartel activities (similar concerns in the context of multijurisdictional merger reviews have also been pressed, and they are addressed in Chapter 3). Another recurring concern from some members of the business community and the private bar is that competition authorities do not provide notice when they transfer confidential information or other protected information in their agency files to another enforcement agency. In the view of the Advisory Committee:

1. Cooperation between competition authorities should feature appropriate safeguards for confidential information. Competition authorities should ensure the transparency of standards applied in their enforcement efforts. Continuing efforts are necessary to instill greater business confidence that exchanges will not result in adverse commercial consequences.

2. U.S. antitrust authorities should consider providing notice -- either before or after the fact -- of their intent to disclose information to antitrust authorities in other jurisdictions unless such notice would violate a treaty obligation of the United States or a court order or jeopardize the integrity of any U.S., state, or foreign investigation.

3. The U.S. antitrust agencies should assess requests from other competition authorities to share confidential information by taking into consideration, among other things, their history of enforcement cooperation with the requesting jurisdiction as well as whether they are confident that the jurisdiction is able to and does protect confidential information under its own laws.

**The Importance of Positive Incentives**

The United States should attempt to identify positive incentives that can deepen cooperation between U.S. antitrust agencies and competition authorities in other jurisdictions, instill greater public confidence in the value of such cooperation, reduce tensions associated with U.S. enforcement, and further develop a shared culture of sound competition policy around the world. To this end, the Advisory Committee recommends that:

1. The U.S. government should expand its ability to provide technical assistance, both bilaterally and in coordination with international organizations, to develop traditional core areas such as anticartel enforcement activities and premerger reviews as well as new initiatives (such as those discussed in Chapters 5 and 6) to support the operating needs and capabilities of authorities that are beginning to introduce or to enhance competition law and policy regimes.

2. U.S. antitrust authorities are encouraged to expand the jurisdictions with which they have modern antitrust cooperation agreements, including those that feature more detailed provisions regarding positive comity. The U.S. authorities should seek cooperative arrangements with qualified jurisdictions that have newer

competition systems as well as with those with more established competition laws.

## CHAPTER 5
## WHERE TRADE AND COMPETITION INTERSECT

In this chapter, the Advisory Committee considers the intersection of trade and competition policy. Notably, the Advisory Committee focuses on anticompetitive or exclusionary restraints on trade and investment that are implemented by firms, governments, or some combination of the two, and that hamper the ability of firms to gain access to or compete in a foreign market. Traditionally, such problems have been considered primarily the responsibility of national competition authorities concerned about anticompetitive effects to markets and consumers on their soil. Some countries, notably the United States, have at times applied their law extraterritorially in an attempt to remedy such practices. As formal governmental barriers to international trade and investment are reduced or eliminated, international attention is turning more to anticompetitive practices occurring within nations that affect trade and investment flows from other nations. As a result, perceived restrictions emanating from exclusionary or anticompetitive practices have generated economic and political tensions between nations and firms.

This chapter reviews the landscape of global problems that implicate both international trade concerns about access to markets and competition policy concerns about anticompetitive practices that block the operation of markets. Many international competition problems are not seen by this Advisory Committee as matters of relevance to international trade policy. As discussed in Chapters 2 and 3, the proliferation of merger control regimes is raising transaction costs and introducing new frictions. As discussed in Chapter 4, international cartels appear to be a serious problem for the U.S. and the global economy. These matters are global competition problems but they are not trade and competition policy issues. Yet, there is an important global competition agenda that needs greater attention by the appropriate policymakers at home and abroad. This is considered most directly in Chapter 6.

Chapter 5 considers a variety of acts of governments and firms that can restrict international trade. Around the world, formal governmental actions immunize some firm conduct. Governments also may take measures that are excessively trade-restricting and anticompetitive. Anticompetitive private arrangements also can have adverse effects on international trade and access to markets. And, in some instances such arrangements occur against a background of governmental restraints that are supportive of private restraints. In this way, practices that may be anticompetitive or exclusionary may not fall neatly into a category of either purely private restraints or governmental practices.

Trade and competition policies are two methods of addressing such problems. Trade law and policy are centrally focused on the actions of governments. Competition or antitrust laws are principally focused on firm conduct. In this way, trade and competition policies are designed to look at restraints that come from different sources. As this chapter discusses, aspects of these policies' tools can be mutually supportive. At the same time, overlapping policy concerns can

lead to different conclusions regarding the effects of a particular restraint. For example, examination of a vertical distribution practice under U.S. antitrust law might find that the restraint is efficiency-enhancing and beneficial to consumers or merely neutral to consumer welfare, while the same restraint might be seen from a trade policy perspective as exclusionary and adversely affecting access to markets.

Neither trade nor antitrust policy tools provide complete solutions to the problems that emanate from this mix of governmental and private restraints. And at present, no international set of rules directly addresses business practices, although some experts are of the view that such disciplines should be developed at the international level.

This chapter considers and evaluates the utility of both old and new approaches to such problems. It starts by defining the scope of the problem internationally, then reviews cases that have animated international attention, and finally considers alternative policy approaches, including bilateral cooperative solutions, U.S. enforcement responses, and expanded international initiatives, at the World Trade Organization (WTO) and elsewhere.

## Defining the Problem

Much of the international discussion on the effect of anticompetitive practices has focused on the impact of *private restraints* on international trade. The Advisory Committee believes that U.S. policy should look beyond purely private business practices, because *governmental practices* and *restraints of a mixed private and public nature* also can have significant trade-distorting consequences. The Advisory Committee therefore considers policy recommendations for the broad ambit of practices that can have an anticompetitive impact on trade and investment.

## Evaluating the Evidence

As a first step in considering appropriate policy responses for addressing exclusionary or anticompetitive practices abroad, the Advisory Committee considers the current record of cases and disputes that have both competition and trade or market access features. *In the view of this Advisory Committee, this record, while uneven, is sufficient to show that private and governmental restraints that inhibit market access are a problem.* While the problems recur as a source of international tension between certain countries, private anticompetitive restraints are *not* geographically limited. The Advisory Committee believes that the current record is sufficient for the U.S. government to make some policy judgments about the nature of the global trade and competition problems.

## Policy Approaches

Through its outreach efforts and public hearings, the Advisory Committee has solicited input from various enforcement officials, business groups, economists, organized labor, lawyers, and other interested parties regarding potential policy options for addressing anticompetitive and exclusionary practices that restrain exports. In general, alternative approaches considered by this Advisory Committee fall into several broad categories:

1. The United States should encourage the development and expansion of bilateral agreements including positive comity provisions. The development of positive comity can be used to address anticompetitive restraints occurring in foreign markets that result in foreclosure. It is a tool to encourage other nations to enforce their competition laws regarding anticompetitive conduct that occurs on their territory and has adverse effects abroad.

2. Where countries are unwilling or unable to address such anticompetitive behavior within their own borders, the harmed nation should, if feasible, use its own laws to reach the offending conduct, if feasible.

3. New or more robust multilateral initiatives could be explored through existing international organizations such as the OECD or the WTO. Alternatively, a new multilateral agreement could develop international rules or initiatives to address such complaints.

*The Advisory Committee believes that there is no single approach that responds to all aspects of competition problems facing the global economy and U.S. firms. Several different approaches may be promising.* Bilateral agreements with positive comity offer a potentially useful instrument for addressing private restraints. The extraterritorial enforcement of U.S. antitrust laws can be necessary and prove effective under some circumstances. Importantly, in the view of this Advisory Committee, economic globalization requires the further development of international competition policy initiatives. Through certain adjustments in each of these approaches, U.S. policy can improve upon its approach to problems that intersect both trade and competition policy concerns.

**Bilateral Agreements with Positive Comity**

The Advisory Committee believes that positive comity remains a useful first step in addressing anticompetitive restraints affecting trade where the territorial party has the authority and the willingness to take effective action. The benefits associated with the positive comity process hold substantial potential for enhanced cooperation and minimization of conflicts that can arise during cross-border investigations of conduct affecting market access. In market access cases, jurisdictional issues and even the theoretical threat of extraterritorial enforcement of antitrust laws have engendered significant levels of tension between governments. The application of positive comity principles can greatly reduce these frictions. However, positive comity is not a replacement for the option to pursue extraterritorial enforcement; it is but one tool within the entire framework of options available to antitrust enforcement officials.

While enhanced cooperation and use of the positive comity instrument can clearly produce benefits, the Advisory Committee recognizes that several shortcomings need to be addressed if positive comity is to become an effective element of international cooperative efforts. The historic enforcement record of antitrust agencies around the world does not instill confidence in those agencies' willingness to pursue antitrust actions against domestic firms in instances where the practices of those firms have allegedly impaired the ability of foreign firms

to compete effectively. In the absence of a nation's serious commitment to undertake such actions, where legally warranted, the benefits of positive comity may remain modest or illusory. Moreover, to be truly effective, positive comity requires correspondence between the parties' antitrust laws and enforcement commitment. Confidence in positive comity can be weakened if the process is delayed and not transparent. And, of course, it remains a relatively new and untested approach.

Recommendations for addressing concerns about positive comity and improving the process include:

1. The U.S. Department of Justice should build on the U.S.-EC positive comity agreement as a model for future agreements and should continue to expand the jurisdictions with which it enters into bilateral cooperation agreements.

2. It may be possible to improve upon the structure of positive comity provisions still further. The Advisory Committee proposes several specific recommendations to increase communication and transparency in the positive comity process.

3. In addition to visible support for positive comity by competition enforcement agencies, international organizations that address trade and competition issues also should endorse the benefits associated with positive comity in their mission. By advertising the advantages reaped from effective positive comity cooperation, international organizations hold the potential to expand such cooperation to nations or jurisdictions that have similar antitrust laws and enforcement policies.

4. As a means to ensure that aggrieved U.S. firms view positive comity tool as a serious policy option for addressing anticompetitive practices in foreign markets, the Department of Justice should make a conscientious effort to implement and test recent bilateral agreements with positive comity provisions as a first response to solve real problems, when meritorious cases arise.

**U.S. Enforcement to Gain Market Access**

The record of U.S. government antitrust enforcement actions against foreign restraints that bar access to markets abroad by U.S. firms is limited. The reasons for this are diverse but suggest that significant legal, evidentiary, and other obstacles are likely to make extraterritorial enforcement, particularly with respect to foreign anticompetitive restraints that limit U.S. exports, only infrequently available as a viable policy response. At the same time, unilateral remedies must remain a part of U.S. antitrust policies, particularly when foreign governments are unwilling or unable to undertake their own enforcement actions. U.S. policymakers should make clear that the United States remains committed to using such instruments when necessary and possible.

1. Although the Advisory Committee believes that it is important for the United States to develop incentives to obtain foreign authorities cooperation, U.S. antitrust laws should not be weakened in an effort to obtain such assistance. For

example, the Advisory Committee believes in maintaining treble damage liability in cases where the only antitrust violation alleged is harm to U.S. export commerce.

2. Private and governmental litigation can raise traditional comity concerns on the part of foreign governments. Improvements should be sought in the process and standards by which competing interests are balanced for comity purposes. To that end, the Advisory Committee recommends that federal, state, and local judges hearing private disputes that raise claims or defenses based on considerations of governmental policy invite concerned governments, including the U.S. Department of Justice, to submit their views at an early stage in the litigation. Such "airing of views" commonly takes the form of amicus curiae submissions.

3. The Advisory Committee recognizes that U.S. extraterritorial antitrust enforcement against foreign market-blocking restraints is a sensitive issue for foreign governments that can affect antitrust enforcement cooperation efforts in particular and law enforcement cooperation more broadly. Because of these concerns and the potential obstacles discussed above, the expected results of extraterritorial enforcement against offshore restraints on U.S. exports should not be overestimated. *Indeed, it is for such reasons that the Advisory Committee recommends that a first step in attempting to address these restraints should be to consider whether it is realistic to approach the foreign nation where the practices occur and seek its cooperation.* Where such cooperation is not forthcoming, a willingness to use U.S. antitrust enforcement tools may have the salutary effect of acting as a lever to encourage excluding nations to pursue their own enforcement actions. A tenable U.S. antitrust enforcement effort against market-blocking restraints may contribute to a greater culture of cooperation and enforcement. *It is also essential to the credibility of U.S. antitrust enforcement that the business community have confidence that the Antitrust Division will vigorously pursue cases, including export restraint cases, wherever possible and when no superior alternatives such as positive comity are available.* Further, the Advisory Committee recommends that the U.S. antitrust agencies continue to have responsibility vis-à-vis trade agencies over legal determinations of the anticompetitive conduct of private firms, at home or abroad.

4. One of the most challenging aspects of U.S. enforcement against market-blocking restraints is developing adequate evidence of anticompetitive conduct. In any case that could result in an enforcement action, that information and analysis will be highly fact specific. Nonetheless, considerable disagreement remains about the merits of particular disputes and the extent to which private, governmental, and mixed public-private restraints inhibit trade. It therefore may be useful to undertake some broader empirical analysis such as a study of the magnitude of global trade problems that stem from private or governmental restraints abroad or an analytical effort to evaluate the effects of recent transnational cases such as in the cartel area. Such inquiries would not establish definitive estimates, but could

provide a foundation of evidence or analysis for informed national decisionmaking and international discourse that could be updated, as needed.

**The Role of International Organizations**

The Advisory Committee believes that in addition to pursuing bilateral cooperation with positive comity, the United States should continue to develop its broader multilateral engagement on competition policy matters. These efforts should encompass a variety of forums and should be aimed at seizing opportunities for developing more seamless markets and expanding meaningful cooperation on practical enforcement problems. The goals for enhanced international engagement should include: (1) developing a more broadly international perspective on competition policy, with the goals of reducing parochial actions by firms and governments; (2) fostering soft harmonization of competition policy systems; (3) developing improved ways of resolving conflicts; and (4) developing a degree of consensus on what constitutes best practices in competition policy and its enforcement.

The World Trade Organization is the multilateral organization most often mentioned in connection with an international effort to develop competition rules. The WTO has a unique place among international organizations and rulemaking bodies by virtue of its inclusiveness (with more than 135 members from developed and developing economies) and its centrality as a forum for negotiating binding rules governing the economic conduct of nations. The WTO's central focus has been on the trade-distorting conduct of governments. With the exception of antidumping and countervailing duty laws, the WTO has not focused on firm conduct. However, while several WTO agreements have elements that implicate competition policy, and while many WTO principles are supportive of competition policy objectives (such as transparency, nondiscrimination, and national treatment), the treatment of competition policy as such in WTO agreements has been only fragmentary.

In thinking about the role that the WTO or another international organization might play with respect to competition policy in the future, the following approaches are not endorsed by the Advisory Committee.

- Specifically, this Advisory Committee sees efforts at developing a harmonized and comprehensive multilateral antitrust code administered by a new supranational competition authority or the WTO as both unrealistic and unwise. This is not an argument against efforts at promoting soft convergence; indeed the Advisory Committee advances several proposals that it believes would be useful along those lines. However, deliberations and consultations on substantive as well as procedural features of competition policy regimes are not the same as negotiating a comprehensive international antitrust code.

- Also unrealistic is the proposition that purely national approaches are sufficient and broader international engagement is unnecessary. This viewpoint ignores both the costs of the current sources of disharmony among nations and equally important, the opportunities that now appear to

exist for productive collaboration among competition authorities as well as trade and competition authorities, including at the WTO.

The Advisory Committee believes that attention should be focused on the substantial middle ground between these two extremes. It is here that the WTO can play a constructive role in developing a common understanding of the issues surrounding the intersection of trade and competition policy. However, not all competition problems are trade problems, and hence not all competition problems that are global will find a natural home at the WTO.

1. The Advisory Committee therefore recommends that the primary focus of the WTO and its area of core competence remain as an intergovernmental trade forum focusing on governmental restraints. There is a great deal of further liberalization of trade to achieve and that agenda can itself have a positive impact on the environment for competition policy around the world.

2. The Advisory Committee also recommends that the U.S. government support and pursue additional incremental steps at the WTO to deepen the work already under way on the intersection of trade and competition policy. The WTO Working Group on the Interaction Between Trade and Competition Policy is a productive intergovernmental initiative engaging trade and competition officials from both developed and developing economies. To foster the work of this group, the Advisory Committee recommends the WTO undertake these illustrative and largely educative steps to make the WTO a more "competition policy friendly" environment.

    - The most obvious move in this direction would be the continuation of the deliberations of the Working Group, which has had a productive start but is still in the early stages of deliberations.

    - The WTO should increase the competition policy expertise at the WTO Secretariat and in the country missions, wherever possible.

    - The WTO should continue to conduct regular summary reports or review of those countries that have competition laws or policies in place, possibly including such reports in the Trade Policy Review Mechanism (TPRM).

3. At this juncture, the majority of the Advisory Committee believes that the WTO as a forum for review of private restraints is not appropriate. Given the possible risks, and the lack of international consensus on the content or appropriateness of rules or dispute settlement in this area, this Advisory Committee believes that the WTO should not develop new competition rules under its umbrella. Various concerns animate the Advisory Committee's skepticism toward competition rules at the WTO, including the possible distortion of competition standards through the quid pro quo nature of WTO negotiations; the potential intrusion of WTO dispute settlement panels into domestic regulatory practices; and the

inappropriateness of obliging countries to adopt competition laws. While recognizing that in some instances it may not be a fully satisfactory result, the Advisory Committee believes that national authorities are best suited to address anticompetitive practices private firms that are occurring on their territory.

4. If anticompetitive practices and market-blocking restraints are occurring in a jurisdiction that does not have a competition authority or that authority is unable or unwilling to remedy the problem, then the harmed nation may be able to apply its own laws effectively in an extraterritorial fashion. If relief is not practicable (because of an inability to obtain necessary evidence or other means), then it may be the case that the harmed nation simply has limited relief available to it under the current system. This may appropriately be a subject of international consultation. However, it seems less appropriately a matter for WTO dispute settlement.

5. Over the longer term, the WTO may be called upon to resolve disputes between nations that hinge on whether private practices that foreclose access to markets are ultimately attributable to governmental practices. The ability of the WTO to resolve such disputes is not fully tested under the WTO's existing rules or jurisprudence and is an area that this Advisory Committee believes needs particular study and consideration by trade and competition policymakers in the years ahead. As the world moves into the next century, and as new countries join the WTO, the problems of market access will surely deepen, and the line between public and private restraints will become increasingly opaque. Hence, it is a particularly important area of attention by trade and competition policymakers.

## CHAPTER 6
## PREPARING FOR THE FUTURE

The Advisory Committee was invited to think broadly and boldly about new tasks and concepts that the United States and the international community should consider in addressing emerging competition issues. This chapter looks at four such areas. First, it examines the possible need for additional multilateral initiatives to deal with competition policy matters that either transcend national boundaries or that would benefit from more international attention. A key recommendation is the proposed "Global Competition Initiative," which is designed to address differences in national approaches to competition that have international consequences. Second, and closely related, the chapter considers the need for an international mechanism that will allow countries to resolve disputes over competition policy. Third, the chapter considers an emerging issue of growing importance, namely, the intersection of competition policy and electronic commerce. Finally, the chapter considers the configuration of U.S. foreign economic policymaking itself and the role that competition policy perspectives can play in that process.

### Global Competition Initiative

Many competition issues are not trade issues but are nevertheless broadly international.

Such issues include harmonization of procedural or substantive features of merger notification and review and protocols to protect confidential information exchanged in the course of enforcement measures, among others. In the Advisory Committee's view, the United States and other nations should continue to use -- but not be limited to -- existing international organizations and venues. Indeed, the Advisory Committee recommends that the United States explore the scope for collaborations among interested governments and international organizations to create a new venue where government officials, as well as private firms, nongovernmental organizations (NGOs), and others can exchange ideas and work toward common solutions of competition law and policy problems. The Advisory Committee calls this the "Global Competition Initiative."

1. A Global Competition Initiative should be inclusive and foster dialogue directed toward greater convergence of competition law and analysis, common understandings, and common culture. Such a gathering also could serve as an information center, offer technical expertise to transition economies, and perhaps offer mediation and other dispute resolution capabilities. Areas for constructive dialogue might include further discussions among competition agencies to:

- Multilateralize and deepen positive comity;
- Agree upon the consensus disciplines identified in Chapter 2 regarding best practices for merger control laws and develop consensus principles akin to the recent OECD recommendation on hard-core cartels; consider and develop disciplines to define actions of governments; for example in areas with negative spillover potential such as export cartels, which require broader international cooperation and consultation;
- Consider and review the scope of governmental exemptions and immunities that insulate markets from competition around the world (as discussed in Chapter 5);
- Consider approaches to multinational merger control that aim to rationalize systems for antitrust merger notification and review (as discussed in Chapter 3);
- Consider frontier subjects that are quintessentially global such as e-commerce, which will create new challenges for policymakers around the world;
- Undertake collaborative analysis of issues such as global cartels (discussed in Chapter 4) and market blocking private and government restraints (discussed in Chapter 5); and
- Possibly undertake some dispute mediation and even technical assistance services.

2. A Global Competition Initiative does not require a new international bureaucracy or substantial funding. The Group of Seven (G-7) summit is an attractive model, in that it demonstrates that countries can create mechanisms to exchange views and attempt to develop consensus on economic issues without an investment in a secretariat or permanent staff. This proposed initiative would benefit from support from international organizations such as the WTO, OECD, the World Bank, and UNCTAD.

**International Mediation of Competition Disputes**

The Advisory Committee recognizes that existing multilateral organizations are not equipped to handle some competition conflicts between nations. The only options currently available in those conflicts are domestic litigation against a sovereign state, brinkmanship, or diplomatic negotiation. Consequently, some consideration and experimentation with approaches is needed to provide alternative options for resolving these conflicts. One possible approach is to create a mediation mechanism in which neutral but expert parties can help the parties reach a settlement and where no party to a dispute enjoys any home-court advantage.

1. The Advisory Committee recommends that the U.S. government and other interested governments and international organizations consider developing a new mediation mechanism as well as some general principles to govern how international disputes, at least sovereign competition policy disputes, might be evaluated under such a mechanism. This mechanism could be developed under the auspices of the proposed Global Competition Initiative or elsewhere.

2. The members of the mediation panel would be drawn from a roster of internationally respected antitrust and competition experts. An examination of a competition policy conflict by an expert panel will face many challenges. However, in some circumstances it could prove useful to clarify the competition policy characteristics of the problem at hand.

**Electronic Commerce and Competition Policy**

In thinking about the global challenges to competition policy in the next century, the Advisory Committee identified e-commerce and the application of competition policy to high technology industries as important frontier issues. Accordingly, in Chapter 6 the Report considers some of the competition policy dimensions raised by e-commerce.

**The Role of the Department of Justice in U.S. Foreign Economic Policy**

For a variety of reasons, the Antitrust Division of the Department of Justice has not traditionally played a central role in deliberations on U.S. foreign economic policy nor seen its role as broadly international in nature. Globalization is changing this reality if not the existing structures. The Report considers whether and how the role of the Antitrust Division should be included in U.S. Government discussions concerning foreign economic policy.

1. The Advisory Committee believes that the law enforcement dimensions of antitrust must remain outside of the deliberative interagency process. Some members are concerned that the participation of antitrust officials in senior interagency deliberations broader than antitrust enforcement runs the risk of politicizing antitrust decisionmaking; others are more of the view that it is important to have such participation in all domestic and foreign policy deliberations that implicate competition policy.

2. One potentially constructive step would be to ensure that the Antitrust Division, working in close consultation with the Federal Trade Commission, is the lead negotiator on any international discussions on competition policy, be they multilateral, bilateral, or regional. This approach has parallels in other international negotiations, such as those involving financial services and securities.

**Expanding U.S. Technical Assistance in Competition Law and Policy**

The Advisory Committee has considered additional affirmative steps the United States might undertake to expand technical assistance to overseas competition agencies. Technical assistance programs may provide the United States with a voice to support the adoption of sound competition principles and promote the rule of law, especially by transition economies. Further, in light of the proliferation of new antitrust authorities, technical assistance can be used to convey practical experience and advice to emerging antitrust regimes, as well as guidance on the formulation of domestic competition policies that make sense in the globalized economy. U.S. support of new competition policy regimes also creates an opportunity for the United States to share its perspective. This can be important as a means of influencing the legal environment in which U.S. exporters and businesses operate.

U.S. government support for technical assistance programs to support competition policy regimes around the world has been a small but important component of its enforcement cooperation work over the past decade. U.S. antitrust authorities have provided technical assistance under programs characterized by modest funding, geographical limitations, and varying duration or scope. The Advisory Committee advocates application of a broader view of U.S. priorities in this regard, and recommends the following:

1. The United States and indeed the world community should devote more technical assistance to the development of competition policy structures abroad.

2. Support to transition and developing antitrust regimes should be included among U.S. funding priorities, and the U.S. government should more vigorously support a variety of ways of offering such support.

3. The United States should create and seek opportunities for deepening consultation and cooperation with other countries and organizations providing technical assistance, including those major jurisdictions that are engaged in providing

structured technical assistance, and multilateral or international organizations such as the OECD, the World Bank, the International Monetary Fund, and the WTO.

# Recent Developments in EC and UK Competition Law

## 1.10.00 – 28.2.02

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## ARTICLE 81

*1. Horizontal agreements*

### COMMISSION DECISIONS

*FETTCSA* OJ [2000] L 268/1, [2000] 5 CMLR 1011

Commission decision imposing fines totalling just under EUR 7 million in the maritime transport sector for an agreement not to discount from published tariffs. The Commission rejected the argument that FETTCSA was a 'technical agreement' permitted under Regulation 4056/86. The agreement was regarded as a 'serious' rather than a 'very serious' infringement for the purpose of the Commission's *Guidelines on fines*.

*Soda Ash* Commission Press Release IP/00/1449, 13 December 2000

The Commission has readopted the *Soda Ash* decisions under Article 81 and Article 82

*Graphite Electrodes* Commission Press Release IP/01/1010, 18 July 2001

Commission decision imposing fines of EUR 218.8 million for fixing the price and sharing the market for graphite electrodes

*SAS/Maersk Air* Commission Press Release IP/01/1009, 18 July 2001, OJ [2001] L 265/15

Commission decision imposing fines totalling EUR 52.5 million for a market-sharing agreement in the air transport sector

*Sodium Gluconate* Commission Press Release IP/01/1355, 2 October 2001

Commission decision imposing fines totalling EUR 57.53 million for price-fixing and market sharing

*Vitamins* Commission Press Release IP/01/1625, 21 November 2001

Commission decision imposing fines totalling EUR 855 million for price-fixing and market-sharing

*Citric Acid* Commission Press Release IP/01/1743, 5 December 2001

Commission decision imposing fines totalling EUR 135.22 million for price-fixing and market-sharing

*Belgian Brewers* Commission Press Release IP/01/1739, 5 December 2001

Commission decision imposing fines of EUR 91 million for price-fixing and market-sharing

*Luxembourg Brewers* Commission Press Release IP/01/1740, 5 December 2001

Commission decision imposing fines totalling EUR 448,000 for market-sharing

*German Banks* IP/01/1796, 11 December 2001

Commission decision imposing fines totalling EUR 100.8 million for price fixing

*Zinc Phosphate* IP/01/1797, 11 December 2001

Commission decision imposing fines of EUR 11.95 million for price-fixing and market-sharing

*Carbonless Paper* Commission Press Release IP/01/1892, 20 December 2001

Commission decision imposing fines of EUR 313.7 million for price-fixing and market-sharing

*UEFA's broadcasting regulations* OJ [2001] L 171/12

Commission decision of 19 April 2001 clearing UEFA's broadcasting regulations

*Covisint* Commission Press Release IP/01/1155, 31 July 2001

Commission comfort letter clearing the Covisint 'B2B'

*Eutilia/Endorsia* Commission Press Release IP/01/1775, 10 December 2001

Further comfort letters for B2B electronic-marketplaces

*ECO-Emballages* Commission Press Release IP/01/850, 15 June 2001, OJ [2001] L 233/37

Commission approval of a system of selective collection and recovery of household packaging waste

*DSD* OJ [2001] L 319/1

Similar approval to *ECO-Emballages*

*Identrus* OJ [2001] L 249/12

Negative clearance given to agreements establishing Certification Authorities of trusted e-commerce transactions

*CECED* Commission Press Release IP/01/1659

Article 81(3) comfort letters sent in relation to agreements to reduce energy consumption of dishwashers and water heaters

*Visa International* OJ [2001] L 293/24

Negative clearance given to the Visa International rules

**COURT OF FIRST INSTANCE JUDGMENTS**

Cases T-197/97 and 198/97 *Weyl Beef Products BV v Commission* judgment of 31 January 2001

The CFI dismissed an action for annulment of a Commission decision rejecting a complaint

Case T-144/99 *Institute of Professional Representatives before the European Patent Office v Commission* judgment of 28 March 2001

The CFI partially annulled the Commission's decision in *EPI Code of Conduct*

Case T-16/98 *Wirtschaftsvereinigung Stahl v Commission* [2001] 5 CMLR 310

The CFI annulled the Commission's decision, OJ [1998] L 1/10, [1998] 4 CMLR 950, which found that a system of information exchange infringed Article 65 ECSC

Cases T-202/98 etc *Tate & Lyle v Commission* judgment of 12 July 2001

The CFI substantially upheld the Commission's decision *British Sugar etc*, although the fine on Tate & Lyle was reduced

Case T-112/99 *Métropole v Commission* judgment of 18 September 2001

The CFI rejected the application by a party to a joint venture that aspects of the Commission's decision should be annulled

**EUROPEAN COURT OF JUSTICE JUDGMENTS**

Cases C-248/98 P etc *Cartonboard* judgment of 16 November 2000

The ECJ reduced 3 fines and referred 2 cases back to the CFI

Case C-35/99 *Arduino*, Case C-309/99 *Wouters* and Case C-221/99 *Conte*

The Advocate General gave Opinions in these cases on 10 and 12 July 2001, dealing with various aspects of the application of Article 81 to the provision of professional services. Judgment was given in *Conte* on 29 November 2001.

Case C-218/00 *Cisal di Battistello Venanzio & C. Sas v INAIL* judgment of 22 January 2002

Judgment that INAIL, entrusted by law with management of a scheme providing insurance against accidents at work not an undertaking for the purposes of the competition rules

*2. Vertical agreements*

**COMMISSION DECISIONS**

*Spring* OJ [2000] L 195/49

Commission decision clearing the standard form tenancy agreements of the Inntrepreneur Pub Company

*Nathan-Bricolux* OJ [2001] L 54/1

Commission decision imposing a fine of EUR 60,000 for restrictions on passive sales and impairing the freedom of distributors to determine their prices and commercial resale conditions

*Opel Nederland BV* OJ [2001] L 59/1, [2001] 4 CMLR 1441

Commission decision imposing a fine on Opel of EUR 43 million for export bans; on appeal Case T-368/00 *General Motors BV v Commission* (judgment pending)

*JC Bamford Group* Commission Press Release IP/01/1526, 21 December 2000

Commission decision imposing a fine of EUR 39.6 million for restrictions on sales outside allotted territories and associated practices; on appeal Case T-67/01 *JCB Service v Commission* (judgment pending)

*VW* Commission Press Release IP/01/760, 30 May 2001, OJ [2001] L 262/14

Commission decision imposing a fine of EUR 30.96 for resale price maintenance in Germany

**Note on cars generally:** the Commission's Report on the Evaluation of Regulation 1475/95 (COM)2000)743 final, 15.11.00) and its 2000 *Report on Competition Policy* points 104-121

*Glaxo Wellcome* Commission Press Release IP/01/661, 8 May 2001, OJ [2001] L 302/1

Commission decision refusing individual exemption to the dual pricing policy of Glaxo Wellcome according to the destination of its pharmaceutical products

*Yves St Laurent* Commission Press Release IP/01/713, 17 May 2001

Commission approval of the Yves St Laurent selective distribution system

*German books ('Sammelrevers')* Commission Press Release IP/01/1035, 19 July 2001

The Commission has issued a statement of objections in relation to the operation of this rpm system in so far as it affects inter-state trade

**COURT OF FIRST INSTANCE JUDGMENTS**

Case T-41/96 *Bayer v Commission* judgment of 26 October 2000

Judgment annulling the Commission's finding of an agreement in *Bayer AG/Adalat* OJ [1996] L 201/1; this case has been appealed by the Commission to the ECJ

Case T-25/99 *Roberts v Commission* judgment of 5 July 2001

The CFI rejected an appeal against the Commission's clearance of the Greene King tenancy agreements

**EUROPEAN COURT OF JUSTICE JUDGMENTS**

Case C-214/99 *Neste Markkinointi Oy v Yötuuli* judgment of 7 December 2000

Judgment applying the *Delimitis* case to exclusive purchasing agreements in the petrol-station sector in Finland; one-year exclusive purchasing agreements found not to contribute to the foreclosure of the market

*3. Legislation*

Guidelines on the applicability of Article 81 to horizontal co-operation (OJ [2001] C 3/2) and new regulations for research and development agreements and specialisation agreements, Regulation 2658/2000, OJ [2000] L 304/3 and Regulation 2659/2000, OJ [2000] L 304/7

New *de minimis* Notice OJ [2001] C 368/13

Regulation 1324/2001 OJ [2001] L 177/56

This extends the block exemption (Regulation 1617/93) on passenger tariffs and slot allocation at airports until 30 June 2002

Commission Evaluation Report on Regulation 240/96

## ARTICLE 82

### COMMISSION DECISIONS

*Soda Ash*: see above

*New Postal Services in Italy* OJ [2001] L 63/59

Commission decision under Article 86 in conjunction with Article 82 concluding that Italy had infringed the competition rules in relation to the provision of certain new postal services with a guaranteed day- or time-certain delivery

*Deutsche Post* OJ [2001] L 125/27, OJ [2001] L 125/27

Commission decision imposing a fine of EUR 24 million on Deutsche Post for loyalty rebates; also finding that it had been guilty of predatory pricing using the incremental cost standard rather than the *AKZO* test

*Duales System Deutschland* Commission Press Release IP/01/585, 20 April 2001, [2001] 5 CMLR 689

Commission decision finding that DSD had abused a dominant position in the way it exercised its trade mark in the market for organizing the collection and recycling of sales packaging in Germany

*Michelin* Commission Press Release IP/01/873, 20 June 2001

Commission decision imposing a fine of EUR 19.76 million for loyalty rebates

*Deutsche Post* Commission Press Release IP/01/1068, 25 July 2001, OJ [2001] L 331/40

Commission decision condemning Deutsche Post for intercepting, surcharging and delaying incoming international mail

*La Poste* Commission Press Release OJ [2002] L 61/32

Commission decision imposing a fine of EUR 2.5 million on the Belgian Post Office for pricing practices having a tying effect

*IMS Health* Commission Press Release OJ [2002] L 59/18

Commission interim measures decision requiring IMS to licence its '1860 brick structure', interim decision suspended pending appeal by President of CFI 26 October 2001

### COURT OF FIRST INSTANCE JUDGMENTS

Case T-128/98 *Aéroports de Paris v Commission* [2001] 4 CMLR 1376

Judgment dismissing the appeal against the Commission's decision that there had been an abuse of a dominant position in relation to ground-handling at Paris Airports

Case T-139/98 *AAMS v Commission* judgment of 22 November 2001

CFI judgment rejecting the appeal against the Commission's decision in *AAMS*

## EUROPEAN COURT OF JUSTICE JUDGMENTS

Case C-163/99 *Portuguese Republic v Commission* judgment of 29 March 2001

Judgment upholding the Commission's decision that Portugal had infringed Article 86 in conjunction with Article 82 in relation to the landing fees charged at Portuguese airports

Case C-340/99 *TNT Traco SpA v Poste Italiane* judgment of 17 May 2001

Judgment dealing with Articles 82 and 86 in relation to Italian legislation on express mail services

## LEGISLATION

Commission Notice on services of general economic interest, OJ [2001] C 17/4

## EUROPEAN COMMUNITY MERGER REGULATION

### PHASE II INVESTIGATIONS: POSITION AT 6 FEBRUARY 2002

| Case name and number | Cleared? | Cleared condition-ally? | Prohibited outright? |
|---|---|---|---|
| Case No IV/M1532<br>*BP Amoco/Arco*<br>OJ [2001] L 152/1 | | YES | |
| Case No IV/M.1578<br>*Sanitec/Sphinx*<br>OJ [2000] L 294/1, [2001] 4 CMLR 507 | | YES | |
| Case No IV/M.1601<br>*Allied-Signal/Honeywell*<br>OJ [2001] L 152/1 | | YES | |
| Case COMP/M.1628<br>*Totalfina/Elf Aquitaine*<br>Website, French | | YES | |
| Case No IV/M.1630<br>*Air Liquide/BOC* | | YES | |
| Case No COMP/M.1636<br>*MMS/DASA/Astrium* | | YES | |
| Case No IV/M.1641<br>*Linde/Aga*<br>Website, German | | YES | |
| Case No COMP/M.1646<br>*CGD/Partest/BCP/SairGroup/Portugália*<br>**NB: abandoned by the parties** | | | |
| Case No COMP/M.1663<br>*Alcan/Alusuisse*<br>Website, English | | YES | |
| Case No COMP/M.1671<br>*Dow Chemical/Union Carbide*<br>Website, English | | YES | |
| Case No COMP/M.1672<br>*Volvo/Scania*<br>Website, English | | | YES |
| Case No COMP/M.1673<br>*VEBA/VIAG*<br>Website, German | | YES | |
| Case No COMP/M.1693<br>*Alcoa/Reynolds*<br>Website, English | | YES | |

| Case name and number | Cleared? | Cleared condition-ally? | Prohibited outright? |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Case No COMP/M.1715<br>*Alcan/Pechiney*<br>**NB: abandoned by the parties** | | | |
| Case No COMP/M.1741<br>*MCI WorldCom/Sprint*<br>(on appeal, Case T-310/00 *WorldCom v Commission* (judgment pending)<br>Not yet published | | | YES |
| Case No COMP/JV.27<br>*Microsoft/Liberty Media/Telewest*<br>**NB: abandoned by the parties** | | | |
| Case No COMP/M.1806<br>*Astra Zeneca/Novartis*<br>Not yet published | | YES | |
| Case No COMP/M.1813<br>*Industri Kapital (Nordkem)/Dyno*<br>Website, English | | YES | |
| Case No COMP/M.1845<br>*AOL/Time Warner*<br>Website, English | | YES | |
| Case No COMP/M.1852<br>*TimeWarner/EMI*<br>**NB: abandoned by the parties** | | | |
| Case No COMP/M.1853<br>*EDF/ENBW*<br>Website, English | | YES | |
| Case No COMP/M.1879<br>*Boeing/Hughes*<br>Website, English | YES | | |
| Case No COMP/M.1882<br>*Pirelli/BICC*<br>Website, English | YES | | |
| Case No COMP/M.1915<br>*Post Office/TPG/SPPL*<br>Not yet published | | YES | |
| Case No COMP/M.1940<br>*Framatone/Siemens/Cogema/JV*<br>Website, English | YES | | |
| Case No COMP/M.1963<br>*Industri Kapital/Perstorp*<br>**NB: abandoned by the parties** | | | |
| Case No COMP/M.2033<br>*Metso/Svedala*<br>Not yet published | | YES | |

| **Case name and number** | **Cleared?** | **Cleared condition-ally?** | **Prohibited outright?** |
|---|---|---|---|
| Case No COMP/M.2060<br>*Bosch/Rexroth*<br>Website, German | | YES | |



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|---|---|---|---|
| Case No COMP/M.2097<br>*SCA/Metsä Tissue*<br>Website, English | | | YES |
| Case No COMP/M.2117<br>*Aker Maritime/Kværner*<br>**NB: abandoned by the parties** | | | |
| Case No COMP/M.2139<br>*Bombardier/Adtranz*<br>Website, English | | YES | |
| Case No COMP/M.2149<br>*T-Online International/TUI/C&N Touristic*<br>**NB: abandoned by the parties** | | | |
| Case No COMP/M.2187<br>*CVC/Lenzing* | | | YES |
| Case No COMP/M.2201<br>*MAN/Auwärter*<br>Website, German | YES | | |
| Case No COMP/M.2220<br>*General Electric/Honeywell*<br>Not yet published | | | YES |
| Case No COMP/JV.55<br>*Hutchison RCPM/ECT*<br>Not yet published | | YES | |
| Case No COMP/M.2283<br>*Schneider/Legrand* | | | YES |
| Case No COMP/M.2314<br>*BASF/Pantochim/Eurodial*<br>Not yet published | YES | | |
| Case No COMP/M.2322<br>*CRH/Addtek*<br>**NB: abandoned by the parties** | | | |
| Case No COMP/M.2333<br>*De Beers/LVMH*<br>Not yet published | YES | | |
| Case No COMP/M.2363<br>*BHP/Caemi*<br>**NB: abandoned by the parties** | | | |
| Case No COMP/M.2380<br>*FöreningsSparbanken/SEB*<br>**NB: abandoned by the parties** | | | |
| **Case name and number** | **Cleared?** | **Cleared condition-ally?** | **Prohibited outright?** |
| Case No COMP/M.2389<br>*Shell/DEA* (and an Article 9 reference to Ger | | YES | |
| Case No COMP/M.2416<br>*Tetra Laval/Sidel* | | | YES |
| Case No COMP/M.2420<br>*Mitsui/CVRD/Caemi* | | YES | |

| | | | |
|---|---|---|---|
| Case No COMP/M.2434<br>*Group Villar Mir/ENBW/ Hidroelétrica del Cantábrico* | | YES | |
| Case No COMP/ECSC.1351<br>*Usinor/Arbed/Aceralia* | | YES | |
| Case No COMP/M.2498<br>*UPM-Kymmene/Haindl* | YES | | |
| Case No COMP/M.2499<br>*Norske Skog/Parenco/Walsum* | YES | | |
| Case No COMP/M.2530<br>*Südzucker/Saint Louis* | | YES | |
| Case No COMP/M.2533<br>*BP/E.ON (and an Article 9 reference to Gern* | | YES | |
| Case No COMP/M.2495<br>*Haniel/Fels* | | | |
| Case No COMP/M.2547<br>*Bayer/Aventis Crop Science* | | | |
| Case No COMP/M.2568<br>*Haniel/Ytong* | | | |

**ARTICLE 9 REFERENCES**

| **Case name and Member State to which referred** | **Case number** | **Year** | **Total or partial referral?** |
|---|---|---|---|
| *Steetley/Tarmac*<br>UK | Case No IV/M.180 | 1992 | Partial |
| *McCormick/CPC/ Rabobank/Ostman*<br>Germany | Case No IV/M.330 | 1993 | Total |
| *Holdercim/Cedest*<br>France | Case No IV/M.460 | 1994 | Partial |
| *RWE/Thyssengas*<br>Germany | Case No IV/M.713 | 1996 | Total |
| *Gehe/Lloyds Chemist* | Case No IV/M/716 | 1996 | Total |
| *Bayernwerk/Isarwerke*<br>Germany | Case No IV/M.808 | 1996 | Total |
| *Rheinmetall/British Aerospace/Stn Atlas*<br>Germany | Case No IV/M.894 | 1997 | Partial |
| *Sehb/Viag/Pe-Bewag*<br>Germany | Case No IV/M.932 | 1997 | Total |
| *Promodes/Casino*<br>France | Case No IV/M.991 | 1997 | Partial |
| *Preussag/Hapag-Lloyd*<br>Germany | Case No IV/M.1001 | 1997 | Partial |
| *Preussag/Tui*<br>Germany | Case No IV/M.1019 | 1997 | Partial |

| | | | |
|---|---|---|---|
| *Compagnie Nationale De Navigation/Sogelfa* France | Case No IV/ M.1021 | 1997 | Partial |
| *Lafarge/Redland* France and the UK | Case No IV/M.1030 | 1997 | Partial (to France and the UK) |
| *Vendex/KBB* Netherlands | Case No IV/M.1060 | 1998 | Partial |
| *Promodes/S21/ Gruppo GS* Italy | Case No IV/M.1086 | 1998 | Partial |
| *Krauss-Maffe/ Wegmann* Germany | Case No IV/M.1153 | 1998 | Partial |
| *Alliance Unichem/ Unifarma* Italy | Case No IV/M.1220 | 1998 | Total |
| *Rabobank-Beeck/ Homann* Germany | Case No IV/M.1461 | 1999 | Total |
| *Total/Petrofina* France | Case No IV/M.1464 | 1999 | Partial |
| *CSME/MDPA/SCPA* France | Case No IV/M.1522 | 1999 | Total |
| *Heineken/Cruzcampo* Spain | Case No IV/M.1555 | 1999 | Total |
| *Totalfina/Elf Aquitaine* France | Case No IV/M.1628 | 1999 | Partial |
| *Carrefour/Promodes* France and Spain | Case COMP/M.1684 | 2000 | Partial |
| *Anglo American/ Tarmac* United Kingdom | Case COMP/M.1779 | 2000 | Total |
| *Hanson/Pioneer* United Kingdom | Case COMP/M.1827 | 2000 | Total |
| *Interbrew/Bass* UK | Case COMP/M.2044 | 2000 | Partial |
| *C3D/Rhone/Go-Ahead G plc* UK | Case COMP/M.2154 | 2000 | Partial |
| *Enel/Wind/Infostrada* Italy | Case COMP/M.2216 | 2001 | Partial |
| *Metsäliitto/ OsuuskuntaVapo* Finland | Case COMP/M.2234 | 2001 | Partial |
| *Shell/DEA* Germany | Case COMP/M.2389 | 2001 | Partial (Phase II ECMR) |
| *Connex/Govia* UK | Case COMP/M.2446 | 2001 | Total |
| *BP/E.ON* Germany | Case COMP/M.2533 | 2001 | Partial (Phase II ECMR) |
| *Haniel/Fels* Netherlands | Case COMP/M.2495 | 2001 | Partial (Phase II ECMR) |

| | | | |
|---|---|---|---|
| *Haniel/Young* | Case COMP/M.2568 | 2001 | Partial |
| *SEB/Moulinex* France | Case COMP/M.2621 | 2002 | Partial |
| *Cargill/Cerestar* UK | Case COMP/M.2502 | 2002 | Partial |
| *Aker Maritime/ Kvaerner II* | Case COMP/M.2683 | 2002 | Partial |

**NB also Sulzer/Promatech: first ever Article 22(3) joint request by four Member States to the Commission (UK, Germany, Spain and Italy)**

## PROCEDURAL DECISIONS

*Mitsubishi Heavy Industries* OJ [2001] L 4/31

Commission decision imposing a fine of EUR 950,000 for supplying incomplete information and for failing to supply complete and correct information: note that Mitsubishi was not a notifying party

*Deutsche Post/trans-o-flex* OJ [2001] L 97/1

Commission decision imposing fines of EUR 100,000 on Deutsche Post for supplying incorrect and misleading information

## COURT OF FIRST INSTANCE

Case T-342/00 R *Petrolessence and Société de Gestion de Restauration Routière v Commission* judgment of 17 January 2001

Dismissal of application for interim relief by third party in relation to the TotalFina/Elf concentration

## LEGISLATION

*Notice on commitments* OJ [2001] C 68/3

*Notice on restrictions directly related and necessary to concentrations* OJ [2001] C 188/5

## PRACTICE AND PROCEDURE

### COURT OF FIRST INSTANCE JUDGMENTS

Case T-112/98 *Mannesmannröhren-Werke AG v Commission* judgment of 20 February 2001

Judgment dealing with the right to silence

Case T-206/99 *Métropole Télévision v Commission* judgment of 21 March 2001

Judgment annulling the decision of the Commission rejecting Métropole's complaint

### EUROPEAN COURT OF JUSTICE JUDGMENTS

Case C-344/98 *Masterfoods Ltd v HB Ice Cream Ltd* judgment of 14 December 2000

Judgment holding that a national court must not reach a conclusion which is contrary to a decision of the Commission

Case C-361/00 *Cho Yang Shipping v Commission* judgment of 15 December 2000

Judgment in which the ECJ dismissed an application for a suspension of the Commission's decision to impose a fine in the *TACA* decision

Cases C-339/98 P and C-450/98 P *IECC v Commission* [2001] 5 CMLR 238 and 291

Judgments upholding the CFI's judgment refusing to annul the Commission's rejection of complaints

Case C-453/99 *Courage Ltd v Crehan* judgment of 20 September 2001

This case considers whether a co-contractor can sue the other party where an agreement infringes Article 81(1): what if the parties are not in pari delicto?

### LEGISLATION

Commission decision of 23 May 2001 on the terms of reference of hearing officers in certain competition proceedings OJ [2001] L 162/21

Draft Regulation to replace Regulation 17/62 OJ [2000] C 365/1

Leniency Notice OJ [2002] C 45/3

## UK LAW

### OFT/OFTEL DECISIONS

*General Insurance Standards Council* 26 January 2001
Annulled on appeal, Cases 1002-1004/2/1/01, 17 September 2001

*Napp Pharmaceutical Holdings Limited* (fine of £3.21 million) 5 April 2001
Substantially upheld on appeal, Cases 1000 and 1001/1/1/01, 15 January 2002

*Swan Solutions Ltd/Avaya ECS Ltd* 6 April 2001

*DSG Retail Ltd ('Dixons')/Compaq Computer Ltd/Packard Bell NEC Ltd* 18 April 2001

*BT Surf Together and BT Talk & Surf Together pricing packages* 4 May 2001

*Consignia and Postal Preference Service Limited* 15 June 2001

*Aberdeen Journals* (fine of £1.3 million) 16 July 2001
On appeal, Case 1005/1/1/01

*ICL/Synstar* 24 July 2001

*LINK Interchange Network Ltd* 16 October 2001

*Memorandum of Understanding on the Supply of Oil Fuels in an Emergency* 25 October 2001

*XDSL Wholesale Products of BT* 24 January 2002

*Market sharing by Arriva plc and FirstGroup plc* 30 January 2002

*Notification by the Film Distributors' Association* 1 February 2002

### BLOCK EXEMPTION FOR TRAVEL CARDS

### JUDGMENTS IN CIVIL ACTIONS

*Claritas (UK) Ltd v The Post Office* 1 November 2000

*Synstar Computer Services (UK) Ltd v ICL* 30 March 2001

*Network Multimedia Televisions Ltd v Jobserve Ltd* 5 April 2001

*Hendry v World Professional Billiards and Snooker Association* 5 October 2001

### FURTHER GUIDANCE

*The Application of the Competition Act in the Water and Sewerage Sectors* (OFT 422)

*The Application of the Competition Act in the Energy Sector* (OFT 428)

*The Application of the Competition Act to Railway Services* (OFT 430)

*The Application to the Northern Ireland Energy Sectors* (OFT 437)

Public Sector Bodies and the Competition Act 1998

(draft) *Intellectual Property Rights* (OFT 418)

(draft) *Services of General Economic Interest* (OFT 421)

## FURTHER REFORM OF UK COMPETITION LAW

*Productivity and Enterprise: A World Class Competition Regime (Cm 5233, 2001)*

## COMPETITION COMMISSION REPORTS – 2000/2001

### Monopoly investigations

| *Title* | Command number | Date published | Finding of detriments to the public interest? |
|---|---|---|---|
| *The supply of impulse ice-cream* | Cm 4510 | 28.01.00 | Yes |
| *New cars* | Cm 4660 | 10.04.00 | Yes |
| *Supermarkets* | Cm 4842 | 10.10.00 | Yes |
| *Supply of fresh processed milk to middle-ground retailers in Scotland* | Cm 5002 | 22.12.00 | Yes, but not by a two thirds majority, so no remedies |

### Merger investigations

| 2000/2001 | Command number | Date published | Finding of detriments to the public interest? |
|---|---|---|---|
| *Alanod Aluminium-Veredlung GmbH & Co and Metalloxyd Ano-Coil Ltd* | Cm 4545 | 19.01.00 | Yes<br><br>**Note: undertaking as to price control** |
| *CHC Helicopter Corporation and Helicopter Services Group ASA* | Cm 4556 | 28.01.00 | No |
| *NTL Incorporated and Cable & Wireless Communications plc* | Cm 4666 | 22.03.00 | No |
| *Vivendi SA & British Sky Broadcasting Group plc* | Cm 4691 | 18.04.00 | No |
| *Carlton Communications plc/United News &* | Cm 4781 | 14.07.00 | Yes, in the case of Carlton/United News & |

| | | | |
|---|---|---|---|
| *Media/Granada Group* | | | Media; no, in the cases of Carlton/Granada and Granada/United News & Media **Note: divestiture required** |
| *Air Canada/Canadian Airlines* | Cm 4838 | 31.8.00 | No |
| *Sylvan International Ltd/Locker Group plc* | Cm 4883 | 2.11.00 | Yes **Note: outright prohibition** |
| *BUPA/Community Hospitals Group* | Cm 5003 | 7.12.00 | Yes **Note: outright prohibition** |
| *BUPA/Salomon International LLC/Community Hospitals Group* | Cm 5003 | 7.12.00 | Yes **Note: divestiture required** |
| *Nutreco Holding BV/Norsk Hydro ASA* | Cm 5004 | 22.12.00 | Yes **Note: outright prohibition** |
| *Interbrew/Bass* | Cm 5014 | 3.1.01 | Yes **Note: outright prohibition and divestiture required; final outcome to be decided following judicial review** |
| *Icopal Holding A/S/ and Icopal a/s* | Cm 5089 | 10.4.01 | No |
| *BASF AG/Takeda Chemical Industries Ltd* | Cm 5209 | 4.7.01 | No |
| *SCR-Sibelco SA/Fife Silica Sands Ltd* | Cm 5139 | 4.7.01 | Yes **Note: divestiture required** |
| *Reed Elsevier/Harcourt General* | Cm 5186 | 5.7.01 | No |
| *Lloyds TSB/Abbey National* | Cm 5208 | 10.7.01 | Yes **Note: outright prohibition** |
| *Octagon Motorsports,British Racing Drivers Club* | Cm 5252 | 6.9.01 | No |
| *Duralay International Holdings/Gates Consumer & Industrials* | | | No |
| *Eastmand Kodak Company/ColourCard Ltd* | | | No |

# REPORT ON THE NATURE AND IMPACT OF HARD CORE CARTELS AND SANCTIONS AGAINST CARTELS UNDER NATIONAL COMPETITION LAWS

## Executive Summary

This Report by the OECD Competition Committee continues the programme begun in 1998 with the Recommendation of the OECD Council on hard core cartels. That Recommendation and a subsequent progress report by the Committee note that hard core cartels impose significant harm upon consumers world-wide, and they call for enhanced sanctions against cartel participants to serve as a deterrent to that conduct. This Report examines in greater detail (1) the nature and impact of cartels, (2) the sanctions against cartels that are available under national competition laws and that are imposed by national competition agencies and (3) the optimal use of sanctions for achieving the deterrence of cartel activity. The following general points are made in the Report:

1. *The worldwide economic harm from cartels is clearly very substantial, although it is difficult to quantify it accurately. Conservatively, it exceeds many billions of U.S. dollars per year.*

   Cartels harm consumers and have pernicious effects on economic efficiency. A successful cartel raises price above the competitive level and reduces output. Consumers choose either not to pay the higher price for some or all of the cartelised product that they desire, thus forgoing the product, or they pay the cartel price and thereby unknowingly transfer wealth to the cartel operators. Further, a cartel shelters its members from full exposure to market forces, reducing pressures on them to control costs and to innovate. All of these effects adversely affect efficiency in a market economy.

   It is not easy to quantify these effects, however. It would require comparison of the actual market situation under the cartel to that which would exist in a hypothetical competitive market. Competition officials usually do not undertake to make such a calculation, both because it is difficult to do and because their laws usually do not require it. When an estimate of harm is necessary, however, most officials employ a proxy, which is the unlawful gain accruing to the cartel members from their activity. In its simplest form, this estimation is the product of the cartel "mark-up" above the competitive price and the commerce affected (in units) by the cartel agreement. Even this calculation can be difficult, as it requires an assessment both of the amount of "affected commerce" and of what the "competitive" price would have been absent the agreement.

   The OECD's Competition Committee conducted a survey of cartel cases conducted by its Members between 1996 and 2000, in an attempt to learn more about the harm from cartels. The responding countries described a total of 119 cases, but in many of these it was not possible to estimate harm. Still, the amount of commerce affected by just 16 large cartel cases reported in the OECD survey exceeded USD 55 billion world-wide. The survey showed that the cartel mark-up can vary significantly across cases, but in some it can be very large, as much as 50% or more. Thus, it is clear that the magnitude of harm from cartels is many billions of dollars annually.

2. *Cartel operators can go to great lengths to keep their agreements secret, showing that they fully realise that their conduct is harmful and unlawful. In some cases, they are explicit in their contempt for the competitive process.*

The results of the OECD survey provided examples of the lengths to which cartel conspirators have gone to hide their actions. Conspirators in one case, faced with a document demand from the competition authority, loaded two automobiles with bid files and took them to the country, where it took a full day to burn them in "four huge bonfires." In another case, the conspirators carefully controlled the creation and retention of incriminating documents by, among other things, conducting internal audits to verify that such documents no longer existed. When it was felt necessary to keep certain spreadsheets showing allocations of business among the conspirators, the files were copied onto computer disks and hidden in the eaves of one employee's grandmother's house. In another case, internal documents from one of the defendants revealed an unofficial motto of the company: "Our competitors are our friends, our customers are the enemy."

3. *The principal purpose of sanctions in cartel cases is deterrence. Ideally, sanctions should take away the prospect of gain from cartel activity. Because not all cartels are uncovered and punished, many experts contend that effective deterrence requires imposing a fine against organisations participating in a cartel that is a multiple of the estimated gain on those cartels that are uncovered. Further, sanctions against individuals can provide important, additional deterrence.*

It is widely agreed that an effective sanction against a cartel should take into account not only the amount of gain realised by the cartel but also the probability that any given cartel will be detected and prosecuted. Because not all cartels are detected, the financial sanction against one that is detected should exceed the gain actually realised by the cartel. Some believe that as few as one in six or seven cartels are detected and prosecuted, implying a multiple of at least six. A multiple of three is more commonly cited, however. Determining the gain, as noted above, can be difficult. Some experts recommend employing a proxy when the gain cannot be calculated, such as a percentage of total turnover of the participants.

Whether or not it is possible to calculate accurately an optimal financial sanction against enterprises, in practice it is difficult to implement it. Sanctions against natural persons, placing them at risk individually for their conduct, provide an overall enhancement to deterrence. While, as noted below, relatively few countries currently impose any kind of sanction against individuals for cartel conduct, some are considering the enhancement of such sanctions.

4. *Strong sanctions against enterprises and individuals increase the effectiveness of leniency programs in uncovering cartels and provide incentives to cartel participants to co-operate with a cartel investigation.*

Cartel sanctions also provide an incentive for cartel participants to defect from the secret agreement and provide information to the investigators. The threat of very large fines against companies for cartel conduct provides incentives for firms to defect from the cartel and benefit from leniency. Similarly, the threat of strong sanctions against individuals provides added incentives for those individuals to "blow the whistle" on cartel conduct and to offer co-operation to government investigators in exchange for reduction or elimination of the punishment.

5. *The competition laws of most countries provide for the imposition of large fines against organisations for cartel conduct. In some cases, however, the maximum fines found in these laws may not be sufficiently large to accommodate multiples of the gain to the cartel, as recommended by many experts. In some countries, natural persons can also be fined, and in fewer countries they can be sentenced to imprisonment. The recovery of money damages by victims of a cartel is*

*another component of financial sanctions against cartels. A minority of OECD countries permit the recovery of such damages.*

The maximum fines found in the competition laws of most countries are expressed either in absolute terms or as a percentage of the annual turnover of the respondent company. Without more experience in assessing the unlawful gain realised by cartels, it is difficult to know whether these maximums are sufficiently large to accommodate the desired multiples of that gain. One benchmark in this regard might be the new law in New Zealand, which recently completed an in-depth study of optimal sanctions in cartel cases. The maximum fine provided in that law is the greater of three times the unlawful gain, NZD 10 million (the equivalent of approximately EUR 4.8 million) or 10% of the total turnover of the enterprise. In most countries whose laws contain absolute maximum fines the maximum is below the equivalent of NZD 10 million. Several of these countries have as an alternative maximum, however, 10% of total turnover of the respondent, which is consistent with the New Zealand standard.

In several OECD countries, but less than half, natural persons can be fined for cartel conduct, often for very large sums. The laws of nine OECD countries provide for imprisonment of natural persons. Fourteen countries permit the recovery of money damages by cartel victims.

6. *Some countries are now imposing very large fines on enterprises for cartel conduct, but more countries are still not doing so. Few countries are aggressively sanctioning natural persons. There is a noticeable and welcome trend toward stronger sanctions, however. Several countries are revising their laws and practices with a view toward increasing sanctions on cartels and their members.*

The OECD survey showed that ten countries had imposed organisational fines in excess of the equivalent of USD 1 million within the survey period of 1996-2000. In three countries the largest fines were in excess of USD 100 million. In two the largest fines were between USD 10 million and 100 million and in the remainder the largest were between 1 and 10 million. Within the survey period these large fines increased in number and severity in the later years. In the remaining countries, however, no fines exceeded USD 1 million and in some the fines were small or nonexistent.

Only four countries had imposed fines on natural persons. In three of the four the largest fines exceeded the equivalent of USD 100,000. Only two countries, Canada and the United States, had imposed sentences of imprisonment on natural persons, and the U.S. was by far the leader in this regard. It imposed 28 such sentences in 1999 and 18 in 2000. The average length of those sentences was approximately 8 months in 1999 and 10 months in 2000. While the possibility for the recovery of money damages by cartel victims exists in several countries, in only the United States is the practice common.

Several countries have just completed or are in the process of reviewing their laws and policies relating to cartels, with a view toward increasing their enforcement efforts in this area. Those countries include Brazil, Canada, Denmark, France, Israel, the Netherlands, New Zealand, Norway, Sweden, Switzerland and the United Kingdom.

7. *Available data indicate that sanctions actually imposed have not reached the optimal level for deterrence.*

The OECD survey permitted comparison of financial sanctions with the cartel gain in a relatively few cases. The fines, expressed as a percentage of the gain, varied widely, from 3% to 189%. In only four cases, two from the United States, one from Canada and one from Germany, were the fines more than 100% of the estimated gain, and in no case was the fine as high as two or three times the gain, as recommended by some experts. Thus, it must be concluded that, while there is a distinct, if uneven trend toward more rigorous sanctions in cartel cases, available data indicate that larger sanctions are required to achieve effective deterrence.

## I. Introduction

1. The 1998 Recommendation of the OECD Council Concerning Effective Action Against Hard Core Cartels ("Cartel Recommendation") noted in its Preamble that ". . . hard core cartels are the most egregious violations of competition law and . . . they injure consumers in many countries by raising prices and restricting supply, thus making goods and services completely unavailable to some purchasers and unnecessarily expensive for others." The Preamble notes further that hard core cartels ". . . create market power, waste, and inefficiency in countries whose markets would otherwise be competitive." The Recommendation calls on OECD Members to provide for " . . . effective sanctions, of a kind and at a level adequate to deter firms and individuals from participating in such cartels."

2. The 2000 Cartel Report noted that an important step in enhancing anti-cartel enforcement is "overcoming the knowledge gap concerning the harm done by hard core cartels."[1] Improving public knowledge about the nature of this conduct and the harm that it causes would bolster popular support for more effective action against it. The Report also called for further work on sanctions against cartels, recognising that the principal purpose of such sanctions is deterrence.[2]

3. This report is a follow-on to that earlier work. It discusses the types of harm that can result from cartel activity and notes issues relating to quantifying that harm. It describes some recent cartel cases in Member countries in which some approximation of the level of harm was estimated, and illustrates the nature of cartels with examples of evidence from such cases. It reviews the laws of Member countries providing for sanctions against cartels and lists some sanctions that were applied in recent cases. Finally it discusses the subject of optimal sanctions and again considers some recent cases relating to that question.

## II. The nature and impact of cartels

4. Cartels are universally recognised as the most harmful of all types of anticompetitive conduct. Moreover, they offer no legitimate economic or social benefits that would justify the losses that they generate. Thus, they are condemned in all competition laws; in some countries they are classified as a crime. Sophisticated cartel operators know that their conduct is unlawful and so they conduct their business in secret, sometimes taking great pains to keep their agreements from the public and from law enforcement officials.

5. That the harm from cartels is large is undisputed. Quantifying it precisely, however, is difficult. Data collected through a recent OECD survey provide some additional information on the magnitude of cartels' harm. The OECD's study permits the following general, non-scientific but important conclusion: <u>The harm from cartels is even larger than has been previously thought, and conservatively exceeds the equivalent of billions of U.S. dollars per year.</u>

Issues of identification and calculation

6. It is helpful first to consider briefly the economic basis for the generally accepted conclusion that cartels cause great harm.

7. Cartels that successfully reduce output and raise price above the competitive level cause consumers, collectively, to purchase less of the cartelised product and to pay more for the quantity that they do purchase. There can be differing views about the real harm to society that results. Economists agree that there is a loss resulting from consumers' collective decision to purchase less of the product at the cartel price. A lower quantity of a product (or service) is produced and consumers are forced to substitute a less desirable product for that quantity that they can no longer afford to buy. There is another, usually larger loss to consumers resulting from their having to pay the higher cartel price for that quantity that they do purchase. Without more, however, economics could not conclude that society as a whole is worse off as a result of this "wealth transfer" from consumers to producers (the cartel operators).

8. Of course, economics is not the only means of determining cartel harm. There are social and equity issues that are relevant as well. It is difficult to be indifferent about the total effect of a cartel on consumers. They unwittingly pay a supra-competitive price that is the result of an agreement, usually secret, among producers who know, or should know, that their conduct is unlawful. Those circumstances plus the international consensus that an important purpose of competition laws is to protect consumers cause almost all competition experts to consider the wealth transfer effect as a cartel harm.

9. Cartels can have other harmful economic effects as well. In addition to the misallocation of resources described above, a cartel shelters its members from full exposure to market forces. The result could be reduced pressure to control costs and to innovate.[3] This harm to "productive" and "dynamic" efficiency is no less real than that to "allocative" efficiency described above, if even more difficult to measure.

10. Indeed, measuring any of the harms described above is difficult. The competition community tends to focus on the unlawful gain accruing to the cartel operators, because it is the easiest to calculate. There is another, equally important reason for concentrating on gain, however, which relates to sanctions. It is agreed that the purpose of sanctions in the cartel context is deterrence. As discussed further below, an optimal sanction should ensure that would-be cartel operators cannot expect to profit from such conduct, meaning that they would lose through sanctions whatever gains they might initially acquire. The optimal financial penalty, therefore, would take into account the gain from the unlawful conduct.

11. Calculating unlawful gain is also difficult, of course. In its simplest form it can be approximated by multiplying the increase in price resulting from the cartel agreement (the "overcharge") by the amount of turnover (in units) subject to the agreement.[4] Determining the hypothetical competitive price, or "reference price," that is used to determine the unlawful margin is itself difficult. One can either attempt to make a prediction of what the price would have been in the affected market, or use a "benchmark" price determined by examining one or more other markets comparable to the affected one where presumably there was no collusion.[5]

12. In sum, calculating the harm from cartels is difficult, and requires the use of various proxies and assumptions. There are several reasons why it should be done, however. The overarching one is the need to inform consumers and policymakers about the importance of implementing an aggressive program against this practice. It may also be necessary to calculate harm in order to provide redress to consumers who suffer from the effects of an unlawful agreement. An important additional reason, however, is that only by understanding the extent that cartels cause harm can governments apply appropriate sanctions against the practice, sanctions that provide an effective deterrent.

Estimates of actual harm

13. The Cartel Report noted recent prosecutions of international cartels in the United States, which disclosed that just ten such cartels had "affected over USD 10 billion in U.S. commerce," and "cost individuals and businesses many hundreds of millions of U.S. dollars annually in the U.S. alone." Taking into account the fact that these data represented the effects of only a few cartels in one economy (albeit the world's largest), and that other cartels presumably are never discovered or prosecuted, the report extrapolated from that information the conclusion that the effects of hard core cartels world-wide are of great magnitude. The Report relied upon estimates that on average, cartels produce overcharges amounting to 10% of the affected commerce and cause overall harm amounting to 20% of affected commerce.

14. This report builds on the base provided in the Cartel Report, but progress in this area is difficult, for at least two reasons. First, most competition laws do not require proof of a specific harm as an element in the prosecution of a hard core cartel. While most countries have not embraced a "per se" rule like that in effect in the United States, proof of a specific level of harm is usually not required to establish liability, and so competition agencies usually do not undertake to do it. Second, as discussed above, it is difficult to calculate harm. Thus, even where proof of harm may be useful in arriving at an appropriate sanction it may not be done.

15. In early 2001 Working Party No. 3 of the Competition Committee collected data from 15 Member countries on cartel cases that they had processed between 1996 and 2000. The Members provided information about a total of 119 cases. These cases do not represent nearly all of the cartel cases prosecuted by the responding countries (nor indeed, by all OECD countries) in that period, however. Issues of reporting burdens or confidentiality of information kept some countries from reporting on all of their cases. Thus, these 119 cases represented substantially less than half of the total number of cartel cases prosecuted by OECD countries in the relevant period, although they do include many of the larger ones.

16. In October 2001 the Competition Committee held its first "Global Forum on Competition." Delegations from eighteen non-Member countries[6] participated with Committee delegates in a two-day meeting on competition policy issues of interest to all participants. The invitees were asked to submit information about cartel cases that had been prosecuted in their countries in recent years. Twelve countries responded. Those responses were also employed in the preparation of this report. A summary of the responses is contained in Annex C.

17. The surveys provided some interesting information about the general characteristics of cartels that have come to the attention of competition agencies. By number, domestic cartels, or cartels that affect markets that are no larger than national boundaries and sometimes smaller, were predominant in the survey results. The participants in these cartels were usually local or domestic firms, though on occasion they were domestic subsidiaries or affiliates of foreign enterprises. Domestic cartels occurred in all economic sectors, but they were relatively more common in some sectors, including construction and construction materials (cement, concrete, asphalt), sales to government institutions, bulk food products, electrical equipment, and the services sector, including in particular local transportation services, the professions and health care. A single "profile" of markets that were subject to cartelisation did not emerge, but some characteristics did come up repeatedly, including high concentration (but not necessarily in some service markets), homogeneous products and, a factor that occurred in many cases, the existence of an industry trade association that provided the opportunity for conspirators to meet and agree. Some of these cartels had existed for many years, even decades, especially in countries that had not long been prosecuting cartels actively.

18. More recently, however, competition agencies have begun to uncover and prosecute large international cartels, whose participants are multinational companies headquartered in different countries. The number of reported international cartels was relatively small, which makes generalisation difficult, but these markets also tended to be highly concentrated, to involve homogeneous products and to have at the centre of the conspiracy an industry trade association. Several of the international conspiracies had devised complex price fixing schemes, which were augmented and made more transparent for their members by market allocation agreements, either in the form of quotas or territorial agreements. In some cases involving both domestic and international cartels the cartel operators had designed elaborate mechanisms to enforce the agreement and punish cheating.

19. In several of the reported cases evidence was developed showing that the cartel operators fully realised that their conduct was harmful and unlawful, causing them sometimes to go to great lengths to keep their agreement secret. Following are a few examples:

- Fire protection devices, Australia: Officials from one of the largest corporate defendants provided detailed evidence of deliberate destruction of incriminating documents after ACCC document demands were received. Two men, with the approval of their superior, loaded two automobiles with bid files and took them to the country, where it took a full day to burn them in "four huge bonfires."

- Driving schools, Denmark: One person remarked: " . . . [I]f we compete on prices at that level, a bit of mental calculation will show that each of us would give away 75.000 DKK each year to our customers instead of earning the money ourselves. That would be a stupid thing to do."

- Ready-mix concrete, Germany: The cartel kept detailed records, specifying in some cases the allocations of sales to the second decimal point. The system even specified who was to provide food and drink for the cartel meetings.

- Hotel association, Spain: the chairman of the hotel association wrote to his members: ". . . [W]e should make an important effort in order to obtain a price increase between two to four points over the inflation rate. . . ." At the same time the association was urging such an increase it represented to the Spanish government that it would not attempt to raise rates in order to help to control inflation.

- Lysine, U.S.: The now widely-viewed videotapes of cartel meetings contain several examples of overt, knowing conspiratorial activity, including some members joking at one meeting about inviting their customers and antitrust officials to sit with them. They also show an ADM executive exhorting his co-conspirators at one meeting to support the agreement, in which he says, "I wanna be closer to you than I am to my customer . . ." a sentiment that coincided with the oft-quoted unofficial motto at ADM, "Our competitors are our friends; our customers are the enemy."

- Vitamins, U.S.: The conspirators went to great lengths to keep track of and destroy incriminating documents, including conducting internal audits to verify that such documents no longer existed. When it was felt necessary to keep certain spreadsheets showing allocations of business among the conspirators, the files were copied onto computer disks and hidden in the eaves of one employee's grandmother's house.

20. The surveys also provided information about harm resulting from the reported cases. Annex A provides information about some of the larger cases in the surveys. The data relating to amount of affected

commerce and harm are not complete, for the reasons outlined above, but they do support some general conclusions. It was possible to estimate the amount of affected commerce in 16 of these large cases. Many of them involved affected commerce in the hundreds of millions or billions of national currency. The total for the 16 cases exceeded USD 55 billion. In some of the other reported cases it was not possible to provide a specific estimate of affected commerce, but the reporting agency noted that it amounted to "many billions" of national currency. Taking into account the many cartel cases, both known and unknown, in which specific amounts of affected commerce cannot be calculated, it seems clear that the total of such commerce amounts to many billions of dollars each year.

21. Annex A also provides estimates of harm, expressed in terms of percentages of affected commerce, that could be derived in 14 of the cases. These estimates range from a low of 3% to a high of 65%. Specifically, there were two cases below 5%, five between 5% and 15%, four between 20% and 30%, and three at 50%-65%. Real-world data on actual harm is sparse, however. One relevant document, the United States Sentencing Guidelines, employs certain assumptions about gain and loss in the cartel context:

> It is estimated that the average gain from price-fixing is 10 percent of the selling price. The loss from price-fixing exceeds the gain because, among other things, injury is inflicted upon consumers who are unable or for other reasons do not buy the product at the higher prices. Because the loss from price-fixing exceeds the gain, subsection (d)(1) provides that 20 percent of the volume of affected commerce is to be used in lieu of the pecuniary loss . . . [in calculating a base fine]. The purpose for specifying a percent of the volume of commerce is to avoid the time and expense that would be required for the court to determine the actual gain or loss. In cases in which the actual monopoly overcharge appears to be either substantially more or substantially less than 10 percent, this factor should be considered in setting the fine within the Guideline fine range.[7]

Empirical data supporting these percentages are sparse.[8] Interestingly, in the limited data (14 cases) from the survey, the median is between 15 and 20%. At the very least it seems clear that the gain from cartel agreements can vary significantly from case to case, and sometimes it can be very high. Moreover, since the actual loss to consumers includes more than just the gain transferred to the cartel, as discussed above, that loss – the total harm from cartels – is significant indeed.

22. In sum, it has been generally accepted for many years that cartels inflict substantial harm on consumers throughout the world. The experience of OECD countries in recent years, as they become more aggressive in finding and prosecuting cartels, has been to confirm that assumption. Indeed, recent cases against large, international cartels suggest that the dimensions of the problem are even larger than previously thought. It remains difficult to place a monetary value on the harm, but it is surely significant, amounting to billions of dollars annually.

## III. Sanctions available and applied in cartel cases

### Sanctions in Members' Competition Laws

23. Annex B contains thumbnail descriptions of the available sanctions for hard core cartels in the laws of Member countries.

*Fines against enterprises*

24. The laws of most Member countries provide for the possibility of large fines against enterprises found to have participated in a cartel. Maximum permissible fines may be expressed either as a specific monetary amount or as a percentage of some measure of turnover, or both. In the first category are Australia (AUD 10 million), Canada (CAD 10 million per count for conspiracies and discretionary for bid rigging) and Mexico (375,000 times the minimum general wage prevailing in the Federal District, currently the equivalent of about USD 1.5 million). In the second category, maximum fines expressed as a percentage of turnover, are France (10% of world-wide turnover), European Union (10% of previous year's global turnover), Hungary (10% of previous year's turnover), Italy (10% of previous year's turnover), Sweden (10% of annual revenue), and United Kingdom (10% of UK turnover for the duration of cartel, maximum three years).

25. Several countries have both types of maximums: Czech Republic (CSK 10 million or 10% of "net turnover" for previous year), Finland (EUR 672,752 or 10% of previous year's global turnover), Ireland (EUR 3,809,214 million or 10% of previous year's turnover), Japan (administrative surcharge of up to 6% of cumulative sales of products subject to the agreement, maximum three years, criminal fine of up to JPY 100 million), Korea (surcharge of 5% of turnover affected by cartel or KRW 1 billion, criminal fine of up to KRW 200 million), Netherlands (EUR 450,000 or 10% of turnover), Poland (the lesser of EUR 5 million or 10% of previous year's turnover) Slovak Republic (SKK 10 million or 10% of previous year's turnover), Spain (EUR 901,518 or 10% of previous year's turnover) and Turkey (TRL 200 million or 10% of previous years gross income). Two countries also provide alternatives, but instead of total turnover the maximum is stated in terms of unlawful gains: Germany (administrative fine of EUR 511,292 or three times additional profit from the cartel and United States (USD 10 million or twice the gain to the cartel or loss to the victims). A recent amendment to the New Zealand law provided for three alternatives: the greater of NZD 10 million, three times the illegal gain, or if the illegal gain is not known, 10% of the enterprise's annual turnover. Denmark and Norway provide for fines, but maximums are not stated. In Norway a court can also order confiscation of the cartel gains.

*Fines against natural persons*

26. Several countries, but less than half, provide for the imposition of fines on natural persons involved in cartel conduct: Australia (AUD 500,000), Canada (CAD 10 million per count for conspiracies and discretionary for bid rigging), France (EUR 1,524,490), Germany (administrative fine up to EUR 511,292 or three times the additional profit from the cartel realised by the natural person (and not the enterprise); criminal fines of up to EUR 1,840,651 for collusive tendering), Ireland (EUR 3,809,214), Japan (JPY 5 million), Korea (KRW 200 million), Mexico (7,500 times minimum general wage in Federal District), New Zealand (NZD 500,000), Norway (unspecified fines), Slovak Republic (unspecified fines), Spain (EUR 30,050), United States (USD 350,000 or twice the gain to the cartel or loss to the victims). In the majority of countries that impose fines on natural persons the violation is classified as a crime.

*Imprisonment of natural persons*

27. Fewer countries provide for the criminal sanction of imprisonment for natural persons: Canada (5 years per count), Germany (5 years for collusive tendering), Ireland (2 years), Japan (3 years), Korea (3 years), Mexico (sanction determined by the judicial authority), Norway (6 years), Slovak Republic (5 years), United States (3 years).

*Recovery of damages by victims*

28. In the following countries it is possible for victims of cartel activity to recover damages for their monetary loss, either in the course of the enforcement proceeding by the competition authority or separately in a civil action: Australia, Canada, Denmark, Finland, Germany, Ireland (including exemplary damages), Japan, New Zealand (including exemplary damages), Norway, Spain, Sweden, Switzerland, United Kingdom, United States (three times actual damages).

Sanctions actually applied in cartel cases

*Fines against enterprises*

29. Annex A provides data on sanctions imposed in several of the larger cases reported in the OECD survey on cartel cases. The monetary sanctions are also expressed as percentages of affected commerce and estimated harm, where those two factors could be calculated. The data show that in some countries large fines for cartel conduct, often in tens or hundreds of millions of national currency, are common. Ten countries have imposed fines in excess of the equivalent of USD 1 million. In three countries the largest fines were in excess of USD 100 million: the European Commission, Germany, and the United States; in two the largest were between USD 10 and 100 million: Canada and Korea; and the remainder were between USD 1 and 10 million: Australia, Finland, Japan, Norway and Spain. Other countries, of course, have not been so aggressive, but in several countries there are efforts underway to bring about substantially larger fines in cartel cases in the future, discussed further below.

30. Increases in fines in the United States have been particularly noteworthy in recent years. In the ten years prior to 1997 an annual average of USD 29 million in fines was collected. In 1997 USD 205 million was assessed, and in the four-year period 1997-2000 the total fines collected were USD 1.7 billion. This effort coincided with a new emphasis in the U.S. on prosecuting international cartels that harmed U.S. consumers. More than 90% of the 1.7 billion in fines collected in 1997-2000 was obtained in international cartel cases. Other countries reported similarly dramatic increases in fines in recent years, including Australia, Canada, the European Commission, Germany and Korea.

*Fines against natural persons*

31. Only four countries, Australia, Canada, Germany and the United States, reported in the survey that they had imposed fines on natural persons. All four were aggressive in targeting individuals for punishment, however. Canada, Germany and the United States each reported several fines that exceeded the equivalent of USD 100,000. Again, the U.S. has imposed some very large fines on natural persons in recent cases. In the graphite electrodes case, three individuals were fined in excess of USD 1 million, the largest of the three being 10 million. In a recent case involving bid rigging in sales of food to the New York City schools, one individual was fined 1 million and he and his company were required to pay 4.2 million in restitution.

*Imprisonment of natural persons*

32. Two countries, Canada and the U.S., reported sentencing individuals to terms of imprisonment. Canada reported three such sentences, the longest being for one year. Other individual defendants were required to perform community service for a specified period. The U.S. has been the most active in imposing imprisonment for cartel conduct. In fiscal year 1999, 28 individuals received such sentences; in

2000, 18. The average length of those terms of imprisonment was approximately 8 months in 1999 and 10 months in 2000. Again, in recent cases some longer terms have been imposed. In the lysine case three individuals were sentenced to terms of 36, 34 and 30 months, respectively. In the New York food bid rigging case noted above, the individual who was required to pay restitution of USD 4.2 million and fined 1 million was also sentenced to imprisonment for four years, the longest such penalty yet imposed in a cartel case.[9]

*Reviews of sanctions in other countries*

33. It is clear from the discussion above that countries are at different places in their treatment of cartels. There is substantial variation across countries in the number of prosecutions and in the sanctions applied to them. Several countries have just completed or are in the process of reviewing their laws and policies relating to cartels, however, with a view toward increasing their enforcement efforts in this area. These include Denmark (a new competition law in 1998), France (an amended competition law in 2001), Ireland (a new emphasis on cartels as the top enforcement priority), the Netherlands (a new competition law in 1998, new guidelines for the setting of fines in 2002 and ongoing work on a leniency programme), New Zealand (a recently completed study of optimal sanctions, discussed below, and amendments to the competition law in 2001), Norway (a recently completed study of optimal sanctions, discussed below), Sweden (a proposal to criminalise cartel conduct), Switzerland (a proposal for fines for substantive violations of the competition law) and the United Kingdom (a new competition law that took effect in 2000 and an aggressive anti-cartel programme). Among non-Member observer countries to the Competition Committee, Brazil and Israel have implemented new anti-cartel programmes recently.

Conclusion

34. The competition laws of OECD countries provide for a wide range of sanctions against cartel participants, and by their terms they permit the imposition of heavy penalties. There is a clear trend in several countries toward stronger sanctions in cartel cases, and other countries are reviewing their laws and policies to provide for enhanced sanctions against cartels. Whether even the recent, more severe penalties are sufficient to deter future cartels is an open question, however, which is discussed further below.

## IV. Optimal sanctions

35. The principal purpose of sanctions in cartel cases is deterrence. The decision to form or join a cartel is primarily a financial one – cartels can rapidly and substantially improve their participants' profitability.[10] An effective deterrent, therefore, is one that promises, on average, to take away the financial gains that otherwise would accrue to the cartel members. Sanctions have another, related purpose in the cartel context – that of providing an incentive for cartel participants to defect from the secret agreement and provide information to the investigators.[11] The "carrot and stick" approach to cartel investigation requires that the "stick" – the possible sanction – be sufficiently severe to give effect to the "carrot" – the opportunity to avoid the sanction by co-operating. Thus, for both deterrence and co-operation purposes the potential sanction must be substantial if it is to be effective.[12] The following discussion will focus on the deterrent value of sanctions, as sanctions that are severe enough to be an effective deterrent will also provide the necessary stimulus to co-operate.

Fines against enterprises

*In theory*

36. As noted above, both New Zealand and Norway have studied this subject recently, and both came to similar conclusions.[13] These studies agree with the generally accepted wisdom that an effective sanction takes into account both the expected gains from the cartel and the probability that the cartel will be detected and punished.

> Firms will tend to discount the expected costs of penalties or remedies by some factor that represents their view on the likelihood of detection and punishment. . . . As detection and punishment are not perfect, effective deterrence requires penalties (or remedies) to be greater than the expected benefit from the illegal activity to compensate for imperfect detection and prosecution.[14]

> The most important principle for levying fines is that expected loss from violating the law should exceed the gain.[15]

To what extent the financial punishment should exceed the gain is much less clear. If, for example, only one in three cartels is detected and punished, then the monetary penalties for those that are prosecuted should be at least three times the expected gains if there is to be effective deterrence. It would be quite difficult to estimate the probability of detection of cartels, however, which in any event probably varies from country to country. One study based on a sample of cases from the United States during the period 1961 to 1988 estimated the probability of detection and punishment as between 13% and 17%, or between one in six and one in seven.[16] The U.S. authorities have developed more effective investigation methods since 1988, of course, notably an enhanced leniency programme, which presumably have improved the detection rate in that country. The detection rate in some other countries, however, is probably lower than in the U.S.

37. In any case, determining the multiplier to be applied to the gain is not the only problem in applying this equation. Quantifying the gain is itself difficult, as discussed above. Both Norway and New Zealand confronted this issue in their studies of optimal sanctions. Norway focused on simplifying the methodology for calculating gain from the cartel conduct. In its simplest form the calculation can be: cartel price minus the competitive price, or "reference price," multiplied by the turnover (in units) affected by the cartel agreement. Norway proposes that the reference price be determined by "benchmarking," using data from related, presumably competitive, markets.

38. New Zealand would focus equally on measuring the illegal gain and exceeding it by some amount to take into account a probability of detection of less than one, but it recognises the difficulties with calculating the gain, and proposes that a "proxy" for gain be available where necessary. The New Zealand study examined some alternative forms of sentences employed in other countries, as described above, including those that: 1) have a specific maximum stated in national currency, 2) are stated in terms of percentage of annual turnover, 3) are stated in terms of multiples of illegal gain, or 4) employ a combination of these measures. The study proposed

> . . . that penalties be allowed to be imposed of up to three times the illegal gain, or 10% of annual turnover (i.e. the Swiss model).[17] The Swiss model is preferred as it has the advantage that it sends a signal to the courts that penalties should be punitive by using a multiple of the illegal gain. The model then acknowledges the difficulty of calculating illegal gain by providing a proxy – the percentage of turnover.[18]

In 2001 the law was amended according to this recommendation, combining three measures: the greater of NZD 10 million, three times the illegal gain or, if the gain is not known, 10% of the turnover of the body corporate.

39. In recent years some large, high-profile international cartels that affected many countries have been discovered and prosecuted. Designing effective sanctions against these agreements presents special issues. Theoretically, unless a multinational cartel participant is prosecuted and fined in most or all of the countries in which the cartel had effects, the cartel still might have been profitable after paying fines in only some of the countries affected. This problem can be addressed, of course, through enhanced international co-operation in investigating and prosecuting these agreements. Further, the laws of several countries permit, sometimes explicitly, fines to be assessed on the basis of world-wide turnover. Thus, the cumulative effect of fines in these countries could account for non-prosecution in other countries. Of course, there is also a possibility of double counting if foreign turnover is taken into account in more than one country. That concern may be more theoretical than real, however, especially since some national laws permit basing fines on only one year's turnover.[19]

*In practice*

40. There are two issues affecting the adequacy of fines as a deterrent: whether a country's competition law permits fines that are sufficiently large to achieve the desired effect; and whether, if the laws are adequate, the fines actually imposed by the competition agency (and courts, where applicable) are large enough.

41. Assuming that an optimal sentence is best expressed as a multiple of the unlawful gain, the laws of only three countries, Germany, New Zealand and the United States, are written in that fashion – three times the gain in Germany and New Zealand and in the United States two times the gain realised by the entire cartel (not just the defendant). Other countries employ either a specified maximum amount or a percentage of annual turnover, or a combination of the two. Whether these measures are sufficiently large in any given country is difficult to determine in the abstract. Presumably the harm from a cartel – and therefore the optimal sentence – will vary according to the size of an economy.

42. One benchmark might be the new law in New Zealand. That country's economy is relatively small, on the global scale, and it has recently completed an in-depth review of optimal sanctions against cartels. As noted above, its new law provides for organisational fines of the larger of three times the unlawful gain, NZD 10,000,000 or 10% of the total turnover of the enterprise. Ten million NZD is equivalent to approximately EUR 4.8 million. Fifteen countries listed in Appendix B other than New Zealand express maximum fines at least in part in absolute terms. In 11 of the 15, the maximum amount is less than New Zealand's. Most of these countries, however, provide alternative maximums in terms of percentages of the annual turnover of the offending organisation. Maximum fines under this standard are potentially much larger. For example, the European Commission has imposed some very large fines (see Appendix A) under its maximum of 10% of the offender's annual global turnover. In a few countries, however, the relevant turnover is defined more narrowly, such as turnover affected by the cartel, or turnover within the prosecuting country. These limits would result in much smaller maximum fines.[20]

43. In sum, if it is concluded that an optimal organisational fine is one that is at least three times the unlawful gain to the respondent, it is difficult to determine in the abstract if the maximum fines in the laws of most countries are sufficiently large, as most of the maximums are not expressed in terms of unlawful gain. It is likely that in some cases, however, existing laws would not permit the imposition of optimally large fines against organisations.

44. In any case, the limited data that are available indicate that countries are not yet assessing fines that approach optimal levels. Annex A summarises 38 of the 119 cases reported in the OECD survey. On balance these are the larger ones, in terms of affected commerce and size of sanctions. It was possible to express pecuniary sanctions as a percentage of affected commerce in only 10 of these cases because, as discussed above, available data did not permit making even rough estimates of this relationship in most cases. In these 10 cases there was substantial variation in sanctions as a percentage of harm, ranging from 3% to 189%. Interestingly, four were above 100%, two from the U.S., one from Canada and one from Germany, though none was as large as twice the gain, when the prevailing wisdom seems to be that the multiple should be at least two or three.

45. The U.S. has had the most experience with fines nominally expressed as a multiple of the unlawful gain. U.S. law, it will be recalled, provides that the maximum corporate fine for cartel conduct is the larger of USD 10 million or twice the gain to the entire cartel or loss to the victims from the conduct. As of September 2001 U.S. courts had imposed more than 30 fines larger than USD 10 million in cartel cases.[21] They had also imposed at least five fines upon individuals in excess of the statutory maximum of USD 350,000. These fines in excess of 10 million and 350,000 were assessed, at least implicitly, under the "twice the gain or loss" formula. In fact, however, none of them was based on a finding by a court of gain or loss; all were resolved by a plea agreement. There are strong incentives in the U.S. system for both the government and the defendant to avoid litigation on the gain or loss issue.[22] U.S. officials state that they do make estimates of gain or loss in the process of applying the statutory formula internally[23], but their calculations usually are not publicly disclosed and have not been tested in court.

Compensatory damages for victims

46. As noted above, the laws of several OECD countries, but fewer than half, provide for recovery of compensatory damages by cartel victims. Such damages are properly considered as a component of pecuniary sanctions to which cartel participants are exposed. While the possibility for recovery of damages exists in several countries, it is seldom invoked, however. Civil damage cases are not common in most countries, save again the U.S., which has its well-known treble damage liability in antitrust cases. A detailed analysis of the U.S. treble damage policy is beyond the scope of this report, and in any event there is disagreement both within and without that country about the utility of various aspects of it. It is without doubt an important component of the financial deterrent to cartel conduct under U.S. law, however.[24]

47. New Zealand studied the issue of strengthening incentives for private damage actions as a part of its review of sanctions.[25] The report stated:

> Private enforcement of the Commerce Act 1986 is a necessary corollary to public enforcement in achieving an optimal deterrence to would be offenders. However, the Act currently provides insufficient incentives for market participants to engage in private litigation under the Act.[26]

It concluded that merely providing for the recovery of compensatory damages would not provide sufficient incentives for private enforcement in the New Zealand system. The report considered both treble damages and exemplary (punitive) damages as additional incentives, and settled on the latter, concluding that they are likely to provide more accurate signals and to offer greater fairness.[27]

Sanctions against natural persons

*In Theory*

48. In theory it is possible to fashion a sufficient deterrent simply through financial sanctions against the enterprise, but there are practical difficulties with such a regime. As discussed above, sufficient information on which to calculate the penalty (including the amount of the cartel gain and the multiple to be applied to it to account for the probability of detection and punishment) is usually lacking. But further, the optimal fine may be too large for the enterprise to bear; if imposed it could cause it to exit the market, one adverse result of which, of course, would be to diminish competition. The result in most cases of this kind would be the imposition of a less than optimal fine. Thus, a case can be made for providing for additional sanctions against individuals who engage in cartel conduct.[28]

49. This was the conclusion in a recent report to Parliament by the United Kingdom Department of Trade and Industry.[29] The report concluded that it would not be feasible to impose optimal fines on organisations if one assumes that the proper multiple to be applied to the cartel gain to arrive at the optimal fine is as high as six. To address the problem the report recommended creating a new criminal offence for individuals who participate in hard core cartels. The crime would be punishable only by imprisonment ("custodial sentence"). The report recommended against individual fines as punishment, given the risk, apparently unavoidable, of the employer paying the fines for its employees.

50. New Zealand studied this issue in its review of appropriate sanctions. Current New Zealand law provides for civil fines of individuals of up to NZD 500,000 (approximately EUR 236,000) for cartel conduct. The report concluded that this level of fine was sufficiently large, but noted that the sanction had been little used. The report recommended certain options for increasing the imposition of fines against individuals, including signalling to the courts that there is a greater need to impose such penalties and forbidding an employer from indemnifying the individual for any such fines imposed.[30]

51. Sanctions against individuals have another beneficial effect. They provide an incentive for individuals to offer co-operation in cartel investigations, against the interest of their employer. Thus, individual sanctions can enhance the effectiveness of leniency and "whistleblower" programmes. There is an offsetting consideration relating to individual sanctions, however. In many countries, sanctioning individuals requires criminalisation of the conduct. In that context individuals have rights against self-incrimination, which makes it more difficult to obtain evidence from them unless they willingly co-operate. In this sense, criminalisation of cartel conduct for individuals makes voluntary co-operation more possible, because of the threat of personal sanctions, but also makes it more necessary, because a right against self-incrimination attaches.

*In practice*

52. As noted above, while the laws of as many as thirteen OECD countries provide for the imposition of fines against individuals and seven provide for imprisonment for cartel conduct, only four have actually fined individuals in recent years and in only two have sentences of imprisonment been imposed. Thus, few countries are currently employing this potentially important, additional sanction.

**Conclusions**

53. Accurate quantification of the harm from hard core cartels is not currently possible, for several reasons, but there is no doubt that it very large, amounting to the equivalent of many billions of U.S.

dollars annually. OECD countries are increasingly aware of the magnitude of the problem, and of the need to impose severe sanctions on cartel participants so as to deter such conduct. Sanctions in recent cases in some countries reflect this growing awareness. Fines against enterprises above the equivalent of USD 1 million are no longer uncommon in some countries. Sanctions against individuals have also dramatically increased in a few countries, where such sanctions are legally possible. Still other countries have recently undertaken a review of their sanctions policy, with a view toward increasing penalties for cartel conduct. The trend toward more rigorous sanctions in cartel cases is uneven – in some countries sanctions continue to be minimal – but it is unmistakable.

54. A related question has to do with what level of sanctions is sufficient to provide the necessary deterrent to would-be cartel operators. This question also is difficult to answer accurately. Without doubt the sanctions should be severe. Many experts hold the view that the gross amount of financial sanctions should be greater than the gain to the cartel, to account for the fact that not all cartels are discovered and punished. Multiples of two or three times the cartel gain are most often advanced for this purpose, but studies supporting larger multiples exist. Sanctions can be imposed in any of three ways: as fines or forfeitures upon the offending enterprises; as fines, and in a few countries, imprisonment, imposed on natural persons who participate in the cartel; and as compensatory and, possibly, punitive damages awarded to the victims of the cartel. Sanctions against natural persons and civil damages are currently employed in only a few countries, but these alternative methods can provide an important supplement to organisational fines.

55. In any case, while there is a noticeable trend toward more rigorous sanctions in cartel cases, available data indicate that sanctions against enterprises and natural persons have not yet reached the optimal level for deterrence.

## NOTES

1 *Id.* at 13.

2 *Id.* at 19-20.

3 Cartel operators desire to maximise profits, of course, which means that each firm has incentives to control costs even in the cartel environment, but the agreement lessens external pressures to do so.

4 This methodology does not take into account other relevant factors, such as changes in unit costs resulting from the cartel and possible lost "profits" resulting from a reduction in unit sales caused by the higher cartel price.

5 New Zealand and Norway have recently undertaken ambitious studies of sanctions under their competition laws. Both deal in greater detail than this paper with these issues of identifying and quantifying harm to consumers and gain to producers resulting from cartels. Both also contain excellent analyses of the topic of optimal sanctions, which is discussed below. "Review of the Penalties, Remedies and Court Processes under the Commerce Act," Office of the Minister for Enterprise and Commerce, New Zealand, 1998; "Sanctioning Pursuant to the Norwegian Competition Act," Norwegian Competition Authority, 2001.

6 Argentina, Bulgaria, Chile, China, Chinese Taipei, Egypt, Estonia, India, Indonesia, Kenya, Latvia, Romania, Slovenia, South Africa, Thailand, Ukraine, Venezuela and Zambia.

7 United States Sentencing Guidelines, §2R1.1 cmt. n. 3.

8 *See*, Klawiter, "After the Deluge: The Powerful Effect of Substantial Criminal Fines, Imprisonment and Other Penalties in the Age of International Cartels," Remarks before the George Washington Law Review Symposium, 2001, at 17.

9 The maximum sentence for a single violation is three years, but this person was also convicted of other crimes that were related to and arose out of his cartel conduct.

10 There are ancillary benefits to the cartel participants as well. Cartels offer the "quiet life," or perhaps more accurately a "less stressful life," to their members – a respite from the full rigours and uncertainties of a competitive marketplace.

11 See generally, Report on Leniency Programmes to Fight Hard Core Cartels, OECD Competition Committee, 2001.

12 Sanctions are not the only deterrent to cartel conduct, of course. The probability of detection is a related and important element. Detection can be enhanced in a variety of ways, including the provision of adequate investigation tools, an effective amnesty programme and, in the context of international cartels, effective international co-operation among national competition agencies.

13 See note 4 above.

14 New Zealand, "Overview Paper" at paras. 28-29.

15 Norway, Summary of the Committee's Report.

16 P.G. Bryant and E.W. Eckhard (1991): Price Fixing: The Probability of Getting Caught," *Review of Economics and Statistics 531.*

17 In fact, as noted above, Switzerland has no direct sanctions for cartel conduct at present. Those fines can be imposed for failure to adhere to a decision of the Competition Commission or a voluntary settlement. An amendment providing for direct sanctions has been proposed.

18 New Zealand, "Paper 2 – Reforming Penalties and Offences" para. 16.

19 The European Commission, for example, can impose a fine of up to 10% of an enterprise's world-wide turnover in the preceding business year. Regulation 17/62, Article 15(2). The United States Sentencing Guidelines require calculation of fines in antitrust cases on the basis of "affected commerce," the definition of which is not limited to turnover in the U.S. United States Sentencing Guidelines, §2R1.1(d)(1). The U.S. Department of Justice takes the position that it can consider foreign turnover in its fine calculations. *See,* Spratling, "Are the Recent Titanic Fines in Antitrust Cases Just the Tip of the Iceberg?," remarks before the Twelfth Annual National Institute on White Collar Crime (1998), available at http://www.usdoj.gov/atr/public/speeches/1583.htm.

20 One writer has concluded that even a maximum of 10% of total turnover is likely not to be large enough in many cases. Assuming a gain to the cartel of 5% of the selling price (low, by most estimates), a duration of the cartel of five years and a 16% probability of detection, the optimal fine would be approximately 150% of the annual selling price of the cartelised product. In this hypothetical, only in the case in which the turnover of the cartelised product amounts to less than one fifteenth of the enterprise's total turnover would 10% of total turnover be sufficiently large. Wouter P.J. Wils, "Does the effective enforcement of Articles 81 and 82 EC require not only fines on undertakings but also individual penalties, in particular imprisonment?", at 11-14, presented to Sixth EC Competition Law and Policy Workshop at the European University Institute (Florence, 1-2 June 2001), available at http://www.iue.it/RSC/competition2001(papers).html and forthcoming in C.D. Ehlermann (ed.), European Competition Law Annual 2001 : Effective Private Enforcement of EC Antitrust Law (Hart Publishing 2002) and in W.P.J. Wils, The Optimal Enforcement of EC Antitrust Law : Essays in Law and Economics (Kluwer Law International 2002).

21 For data on these fines through March 2001, see, Griffin, "Status Report: Criminal Fines, International Cartel Enforcement, Corporate Leniency Program," remarks before the American Bar Association Section of Antitrust Law, 49th Annual Spring Meeting, March 28, 2001, available at http://www.usdoj.gov/atr/public/speeches/8063.htm.

22 See, Klawiter, note 7.

23 See, Spratling, "The Trend Towards Higher Corporate Fines: It's a Whole New Ball Game," remarks before the Eleventh Annual National Institute on White Collar Crime, New Orleans, Louisiana, March 7,1997.

24 Damage recoveries in private litigation resulting from the vitamins cartel, for example, have amounted to approximately USD 1 billion, and some aspects of the litigation are continuing. Private recoveries in the lysine litigation amounted to USD 45 million. There continues to be debate, however, about whether such recoveries are, on the one hand, still too small to provide an adequate deterrent, or on the other, excessively punitive. *Compare*, Adams, Colón and Busman, "License to Steal – The Benefits of Cartel Activity Still Outweigh the Costs," presented at the American Bar Association Section of Antitrust Law 49th Annual Spring Meeting, March 29, 2001, *with* Denger and Arp, "Does our Multifaceted Enforcement System Promote Sound Competition Policy?" Antitrust Magazine, summer 2001, 41-46.

25 New Zealand, "Paper 3- Reforming Remedies."

26 *Id.* at para. 1.

27 The 2001 amendments to the competition law added the remedy of exemplary damages in private cases.

28 See Wils, *supra.*

29 Department of Trade and Industry, "A World Class Competition Regime," July 2001, 37-45.

30 The 2001 amendments to the competition law left the maximum fine for individuals unchanged but provided that a court must impose a fine on an individual adjudged to have engaged in a cartel unless there are good reasons not to.

*Annex A*

**SELECTED CARTEL CASES**

**AFFECTED COMMERCE, ESTIMATED HARM AND SANCTIONS APPLIED**

(Monetary amounts stated in local currency – euros in eurozone countries)

| Country | Case | Affected Commerce | Estimated Harm | Sanctions (including damages to private parties, where applicable) | Fines as % of Affected Com-merce | Fines as % of Estimated Harm |
|---|---|---|---|---|---|---|
| Australia | Distribution Transformers | 320,505,000 | NA | 1.5 million (case continuing) | NA | NA |
| Australia | Power transformers | 40 million | NA | 5.5 million (case continuing) | NA | NA |
| Australia | Vitamins | NA | NA | 26 million | NA | NA |
| Australia | Frozen foods, Tasmania | NA | 10 – 12% price increase | 1.245 million | NA | NA |
| Australia | Installation of fire protection devices | More than 500 million | 5-15% price increase | 15.386 million | 3% | 31% |
| Canada | Snow removal | 16 million | Up to 20% | 4.048 million | 25% | 127% |
| Canada | Lysine | NA | NA | 3.573 million | NA | NA |
| Canada | Citric acid | NA | NA | 11.5 million | NA | NA |
| Canada | Sorbates | NA | NA | 25.3 million | NA | NA |
| Canada | Vitamins | 706.35 million | NA | 91.395million (case continuing) | 13% | NA |
| Denmark | Electric wiring services | NA (many billions over "several decades") | 20-30% | (Case continuing) | NA | NA |
| European Commission | Graphite electrodes | More than 2 billion | Up to 50% | 218.8 million | 11% | 22% |
| European Commission | Lysine | NA | NA | 110 million | NA | NA |
| European Commission | British sugar | NA | NA | 50.2 million | NA | NA |
| European Commission | Pre-insulated pipe | More than 2 billion | NA | 92.210 million | 5% | |
| European Commission | Vitamins | NA | NA | 855.22 million | NA | NA |
| Finland | Purchases of raw wood | NA | NA | 30 million | NA | NA |

| Country | Case | Affected Commerce | Estimated Harm | Sanctions (including damages to private parties, where applicable) | Fines as % of Affected Com-merce | Fines as % of Estimated Harm |
|---|---|---|---|---|---|---|
| Germany | Ready-mix concrete | 1,406 million (OECD estimate) | 112 million (8% of affected commerce) | 153 million | 12% | 136% |
| Germany | Road markings | More than 358 million (OECD estimate) | "Hundreds of millions" (more than 14% of affected commerce – OECD estimate) | 13.1 million | 3% | NA |
| Germany | Power cables | Many billions | Up to 50% | 127.6 million | NA | NA |
| Japan | Ductile iron pipe | NA | NA | 230 million | NA | NA |
| Korea | Military fuel | USD 548.3 million | NA | USD 14.6 million | 3% | NA |
| Mexico | Lysine | NA | NA | 1.699 million | NA | NA |
| Norway | Hydro-electric power equipment | 1.6 billion | 140 million (9% of affected commerce) | 75 million | 5% | 54% |
| Slovak Republic | Flour | NA | 200-300/ton | 2.24 million | NA | NA |
| Slovak Republic | Beer | 4 billion | NA | .1 million | Less than 1% | NA |
| Spain | Hotel association | 6 billion | 180 million (3% of affected commerce) | 6,600 | Less than 1% | Less than 1% |
| Spain | Sugar | 1.1 billion | 25.2 million (2% of affected commerce) | 8.7 million | Less than 1% | 35% |
| Switzerland | German language books | Many billions | NA | Fines not currently possible; amendment proposed | NA | NA |
| Switzerland | Drug distribution, industry-wide | NA | NA | Id. | NA | NA |

| Country | Case | Affected Commerce | Estimated Harm | Sanctions (including damages to private parties, where applicable) | Fines as % of Est. Com-merce | Fines as % of Estimated Harm |
|---|---|---|---|---|---|---|
| United States | Lysine | 1.4 billion world-wide | 78 million in U.S. | 147.48 million; imprisonment for three executives | NA | 189% |
| United States | Citric acid | 4.8 billion world-wide, 320 million U.S. | 100 million in U.S. (31% of affected commerce) | 141.89 million | 44% | 142% |
| United States | Graphite electrodes | 6 billion world-wide, 1.7 billion U.S. | As much as 65% | 410 million; imprisonment for two executives | 24% | NA |
| United States | Cairo wastewater construction | 300 million U.S. | 100 million (33% of affected commerce) | 87.7 million; | 29% | 88% |
| United States | Marine construction | 1 billion world-wide, 107 million U.S. | NA | 49.3 million; confinement for one executive | 46% | NA |
| United States | Sodium Gluconate | NA | NA | 32.95 million | NA | NA |
| United States | Sorbates | 2.2 billion world-wide, 1 billion U.S. | NA | 123.2 million | 12% | NA |
| United States | Vitamins | Up to 33 billion world-wide | NA | 1 billion in fines, 1 billion in damages; imprisonment for eight executives | NA | NA |

*Annex B*

## AVAILABLE SANCTIONS FOR HARD CORE CARTELS

| Country | Sanctions |
|---|---|
| **Australia** | • Pecuniary penalty (non-criminal) of AUD 10 million for corporations (AUD 750,000 for a secondary boycott offence) and AUD 500,000 for individuals, per offence.<br>• Injunctions.<br>• Damages (may only be sought through private action in a Court by a person who has suffered loss as a result of a contravention).<br>• Ancillary orders of various kinds in favour of persons who have suffered loss or damage because of the conduct (including specific performance and rescission and variation of contracts). |
| **Canada** | • Fine up to CAD 10 million per count, imprisonment for up to five years per count, or both. For "foreign directed conspiracies," fines in the discretion of a court. For bid rigging, fines in the discretion of a court, imprisonment of up to five years, or both.<br>• Damages |
| **Czech Republic** | • Fine up to CSK10million or up to 10 percent of the net turnover recorded over the last complete calendar year. |
| **Denmark** | • Fine, must be imposed by a Court, but the law does not provide for a maximum.<br>• Administrative order of annulment.<br>• Civil damages. |
| **European Union** | • Administrative fine imposed on enterprises only of up to 10 percent of previous year's global turnover. |
| **Finland** | • Penalty payment (competition infringement fine) of EUR 841 to EUR 672,752; the fine may be higher, but no more than 10 percent of the previous year's turnover.<br>• Agreements violating the law are void.<br>• Civil damages. |
| **France** | Pecuniary sanctions up to 10 percent of world-wide turnover.<br>• Criminal sanctions (individuals only): fines up to EUR 1, 524,490. |
| **Germany** | • Wilful or negligent violations: administrative fine up to EUR 511,292 or up to three times the additional profit obtained as a result of the violation.<br>• Collusive tendering: a crime, punishable by fines of up to EUR 1,840,651 or up to five years imprisonment, or both.<br>• Agreements violating the law are void.<br>• Civil damages. |
| **Hungary** | • Fine of up to 10 percent of undertaking's net turnover in previous year.<br>• Termination order; injunction. |
| **Ireland** | • Criminal conviction: fine of up to EUR 3,809,214 or 10 percent of previous year's turnover, whichever is greater (undertaking); same level of fine plus imprisonment for up to 2 years (individual).<br>• Civil declaratory and injunctive relief.<br>• Civil damages, including exemplary damages. |

| Country | Sanctions |
|---|---|
| **Italy** | • Fine, up to 10 percent of the turnover of each undertaking or entity during the prior financial year. |
| **Japan** | • Administrative surcharge upon entrepreneurs, up to 6 percent of the cumulative sales of the goods and services subject to the cartel for the duration of the agreement, except if the duration exceeds three years, the period for three years retroactive from the date on which the conduct ceased.<br>• Criminal fine up to JPY 100 million (entrepreneur);imprisonment up to three years or fine up to JPY 5million (persons).<br>• Damages may be sought through private action in a court by a person, a firm, or government agency that has suffered loss as a result of a contravention either under civil law or the Antimonopoly Act; under the AMA, a private suit may follow a decision by the JFTC finding a defendant to have violated the Act, and its decision becomes prima facie evidence of a violation in the private suit. |
| **Korea** | • Surcharge up to 5 percent of the turnover set forth in the Presidential Decree; where there is no revenue, up to KRW1billion.<br>• Criminal violation: imprisonment up to three years or fine up to KRW200million.<br>• Order to cease and desist, a public announcement of the violation by the enterprise, or any other necessary corrective measure. Failure to comply with the corrective measure is punishable by imprisonment up to two years or a fine up to KRW150million. |
| **Mexico** | Fine for enterprises up to 375,000 times the minimum general wage prevailing in the Federal District; for individuals, fine up to 7,500 times the minimum general wage prevailing in the Federal District.<br>• Criminal prosecution for conduct that violates the Criminal Code.<br>• Order the suspension, rectification or elimination of the practice. |
| **Netherlands** | • Administrative fine on enterprises not to exceed the higher of EUR 450,000 or 10% of the turnover of the undertaking or, if the infringement is committed by an association of undertakings, of the combined turnover of the undertakings that are members of the association, in the financial year preceding that in which the fine is imposed. |
| **New Zealand** | • Pecuniary penalties for bodies corporate of up to the greater of: NZD 10,00,000, three times the illegal gain or if the gain is not known, 10% of annual turnover; for individuals, up to NZD 500,000.<br>• Injunctions and remedial orders.<br>• Civil damages, including exemplary (punitive) damages. |
| **Norway** | • Criminal sanctions (for individuals): fines and imprisonment up to six years.<br>• Writ to relinquish cartel gains. Under the Criminal Code (Section 34) a Court can also order confiscation of the cartel gains.<br>• Injunctions. |

| Country | Sanctions |
|---|---|
| **Poland** | • Order to relinquish practices violating the law.<br>• Impose a fine equivalent to the amount of EUR 1,000 to 5,000,000 but not exceeding 10 % of the annual revenue of the undertaking in question in the year preceding the year of imposition of the fine; where there is no revenue (such as for trade associations), fine up to 50 times the average salary. |
| **Slovak Republic** | • Fine up to SKK 10 million or 10% of total turnover in previous year.<br>• Criminal fines and imprisonment up to five years. |
| **Spain** | • Fine up to EUR 901,518 (economic agents, companies, associations, unions or groups); can be increased up to 10 percent of total sales for the fiscal year preceding the Tribunal's decision.<br>• Coercive fines of between EUR 60 and 3,006 per day to require cessation of unlawful conduct or adherence to remedial orders.<br>• If the offending party is a legal entity, then an additional fine up to ESP 5 million imposed on the legal representative or the persons constituting the administrative bodies that participated in the agreement.<br>• Injunctions and remedial orders.<br>• Compensation of damages in a civil action. |
| **Sweden** | • Intentional or negligent infringement by an undertaking, fine up to 10 percent of the annual turnover of the undertaking.<br>• Injunctions and remedial orders.<br>• Remedies in civil law, including damages to private parties. |
| **Switzerland** | • Injunctions. Currently there are no fines directly for violating the competition law. Amendment providing such sanctions is under consideration.<br>• Administrative fines (for legal entities) of up to three times the illegal gain or up to 10 percent of the previous year's turnover realised in Switzerland for failure to comply with a decision of the Competition Commission or a voluntary agreement.<br>• Remedies in civil law: a) removal or cessation of the restriction; b) damages and reparations; c) remittance of illicitly earned profits. |
| **Turkey** | • Fines at least TRL 200million (undertakings and associations of undertakings) and up to 10 percent of the gross income in the prior fiscal year, as calculated by the Board (individuals or legal entities with the status of an enterprise and associations of undertakings and/or the members of those associations)<br>• In cases where the above fines are imposed on a legal entity (undertakings and associations of undertakings), a fine up to 10 percent of that fine is imposed on the individuals personally who are in the management organs of these legal entities. |
| **United Kingdom** | • Fines up to 10 percent of UK turnover (undertakings) for the duration of the infringement, up to a maximum of three years.<br>• Civil liability for damages. |
| **United States** | • Criminal violations: fines up to the larger of (a) USD10 million (corporations) and USD350,000 (others), or (b) twice the amount gained by the cartel from the violation or lost by the victims, and imprisonment up to three years.<br>• Private parties can make claims in court for injunctions, three times the damages suffered and reasonable attorney's fees.<br>• Restitution (generally where private damage case not available). |

*Annex C*

## SUMMARY OF SUBMISSIONS ON CARTEL ENFORCEMENT BY NON-MEMBER INVITEES TO THE OECD GLOBAL FORUM ON COMPETITION

### Bulgaria

Described three cases: price fixing in public transportation services in Sofia; price fixing in phone cards; market allocation in gasification services. The respondents were fined the equivalent of EUR 47,000, 9,000 and 25,500, respectively. Maximum fines for cartel conduct under Bulgarian law are EUR 150 million for organisations and EUR for individuals.

### China

Described three cases: bid rigging on tenders to operate a brickyard plant and two bid rigging cases on construction contracts. In one case the respondents were fined the equivalent of EUR 6,500. The maximum fine under the 1993 China Law for Countering Unfair Competition is the equivalent of EUR 26,000.

### Estonia

Described three cases: information exchange on prices among milk processors and wholesalers; price fixing in taxi services; price fixing in road transport. Fines equivalent to EUR 639 were imposed on each respondent in the taxi case. Maximum fines of to 5% of the net turnover of the offending party in the preceding year can be imposed for cartel conduct.

### Indonesia

Described one case, the first brought in Indonesia: bid rigging in the supply of pipe and pipe processing services. No fines were imposed. Fines of up to the equivalent of EUR 2.875 million can be imposed for civil violations. Fines of up to EUR 11.5 million and prison terms of up to six months can be imposed for criminal violations.

### Latvia

Described two cases: price fixing between a Latvian and a Russian airline on service between Riga and Moscow; agreement on contractual terms between providers of international courier post services. A fine of 0.7% of the annual turnover of the Latvian airline in the air transportation case was imposed in that case. No fines were imposed in the courier services case. A maximum fine of 10% of the respondent's total annual turnover can be imposed for cartel conduct.

### Peru

Described three cases: price fixing and information exchange in the sale of live chickens; bid rigging on construction of electricity transmission facilities; price fixing in taxi tours. Fines of the

equivalent of EUR 1,800 were imposed on each respondent in the bid rigging case and of EUR 900 on one respondent in the taxi tours case. Maximum fines for cartel conduct are the smaller of the equivalent of EUR 900,000 or 10% of the respondent's gross sales or income.

**Romania**

Described two cases: price fixing in bottled mineral water; market allocation in the distribution of pharmaceuticals. Unspecified fines were imposed in both cases. Maximum fines for cartel conduct are 10% of the respondent's annual turnover.

**Slovenia**

Described two cases: price fixing in the sale of electric energy; and market allocation in the production of cultural events. Maximum fines for cartel activity are the equivalent of EUR 135,000 for enterprises and EUR 13,500 for individuals.

**South Africa**

Described one case: fixing of contractual terms for the purchase of citrus fruits. The maximum fine for cartel conduct is 10% of the respondent's annual turnover.

**Chinese Taipei**

Described three cases: market allocation by a flour association in the purchase of grain; bid rigging on a contract for the purchase of mobile cranes; price fixing and market allocation in liquefied petroleum gas. The maximum penalty for cartel conduct is fines of up to the equivalent of EUR 3.1 million and imprisonment of up to three years.

**Thailand**

Maximum penalties of fines of up to the equivalent of EUR 144,000 and imprisonment of up to three years.

**Ukraine**

Described two cases: price fixing in the provision of services for electronic cash machines; market allocation in the sale of kaolin. Sanctions not specified.

**Zambia**

Described two cases: conspiracy between producer and purchaser of live poultry preventing entry of new sellers; price fixing in refined petroleum products. Maximum fines for cartel conduct of the equivalent of EUR 5,220, and for criminal violations, imprisonment for up to five years.

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# SEMINAR ON JUDICIAL ENFORCEMENT OF COMPETITION LAW

## Background Document

*The attached note was drafted by John W. Clark to serve as a background document for the Seminar on Judicial Enforcement of Competition Law to be held on 24 October 1996.*

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# SEMINAR ON JUDICIAL ENFORCEMENT OF COMPETITION LAW

## Background Document

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1. This Seminar on judicial enforcement of competition law is the first such OECD-wide meeting on this subject. It presents a unique opportunity for the exchange of ideas and experiences among judges and competition officials across many countries on this important subject of competition enforcement. The agenda is ambitious; it could occupy substantially more than one day. Nevertheless, the seminar promises to be a fruitful one. The following is an overview of some of the issues presented by each of the five topics scheduled for discussion during the day. Suggested questions for discussion are posed at the end of each section These are merely suggestions, however. Time may not permit exploration of all of the questions, and conversely, participants may wish to raise other issues relevant to each topic.

## 1. The Role of the Judiciary in the Implementation of Economic Policy

2. Judges and courts do not make policy directly, but they have an important role in its implementation. The judiciary is nowhere more significant than as the final arbiter in matters of commerce. Smoothly functioning markets require certainty that valid contracts are observed. Fair and effective judicial enforcement of contractual obligations provides that certainty. In addition, governments impose a myriad of other rules that govern and shape commerce, ranging from taxation and regulation of capital markets to safety and environmental regulations and labor standards. In most countries the courts enforce these rules, either in initial enforcement proceedings or as reviewers of administrative decisions. The task confronting judges in these situations may be exceptionally complex.

3. Almost all countries with advanced market economies have competition laws, and most transition and developing countries have such a law or are in the process of creating one. A competition law is an overarching set of rules that touches in some way almost all sectors in a market economy, including those in which there is a substantial amount of regulation. In most countries, these laws too are ultimately enforced by the courts.

4. National legal systems vary among countries, and so do mechanisms for enforcing competition laws. Judges who hear and decide competition cases may be generalists or specialists; they may be members of the national court system or of a specialised competition tribunal; they may take evidence and render decisions of fact and law in the first instance or they may hear appeals from administrative decisions, acting only on the record created in the lower tribunal; they may hear several antitrust cases in a year, or they may hear only one or a few in a period of several years.

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5. Nevertheless, there is much in common across countries in enforcement of competition laws. The laws themselves share common substantive provisions in many cases. The Committee on Competition Law and Policy ("CLP Committee"), of course, in its work on convergence has identified broad areas of agreement among Member countries on substantive competition policy. Most competition laws contain provisions prohibiting restrictive agreements, both horizontal and vertical, and most apply a stricter standard to traditional cartel conduct, such as price fixing and market allocation. Abusive conduct by dominant firms is prohibited, though there is not universal agreement on the forms of conduct that may be considered abusive. Finally, control of mergers is considered necessary to prevent the creation of market structures in which abuse of dominance and anticompetitive restrictive agreements would be substantially more likely.

6. Competition laws are written in general terms, however. Business conduct is ambiguous on its face, save perhaps the "naked" cartel arrangement, in the context of the rules governing competition. Enforcement officials and the judiciary are faced with the task of separating the competitively harmful conduct from the procompetitive, or merely benign. Such enquiries are therefore necessarily fact-intensive. There are differences among countries on the best way to undertake the difficult tasks of assembling and understanding complex factual material and applying general and ambiguous standards in evaluating it. The judiciary, whether specialised or general, may be more or less involved in the process.

7. In most countries, however, important competition cases are ultimately subject to judicial review, and thus the judiciary's role is an important one. As noted above, the courts do not make policy, nor in the matter of competition enforcement do they initiate cases. The broad, general standards that govern competition enforcement inevitably invest the enforcement authority with significant discretion in its prosecutorial decisions. In this regard, the competition authority has more such discretion than most government enforcement agencies, and the courts can exert important control over the exercise of this discretion. In common law countries, judicial decisions define and elaborate the legal standards that govern the competition agency's decisions. In all countries, success or failure in court shapes the enforcement decisions of the agency, and ultimately the country's competition policy itself.

> *What is the proper role of the judiciary in the implementation of national economic policy? How can the function of judicial review be employed most effectively to influence a country's competition policy? What are the limitations (institutional, procedural, national customs or traditions) that hinder effective enforcement of competition laws by the judiciary, and how can these limitations be overcome?*

## 2. The Role of Economics and Economists in Competition Cases

8. Competition policy is grounded in economics. Its purpose is to preserve an environment in which markets can function most effectively, according to generally accepted economic principles. Economics is not the only basis for competition policy in most countries, of course, but is likely to be the most significant. Economics is a science, if a relatively inexact one, that is not easily understood by non-economists. How can the lay competition enforcement community, in particular the judiciary, function effectively in such a technical environment?

9. In many countries, economics and practical experience in competition enforcement have combined over time to bring about analytical shortcuts, or presumptions, that obviate the need for sophisticated economic analysis in every case. Thus, both practical experience and economics teach that cartel conduct, without more, is harmful and should be proscribed. In most countries where such conduct is found, it is almost automatically enjoined and punished. It is usually unnecessary to examine in detail, or at all, the actual effects of the activity. (Identifying and analysing those situations in which restrictive

horizontal agreements may be combined with some efficiency-enhancing integration, however, poses a considerably more difficult challenge.)

10. Market structure, measured in terms of shares of output, capacity or sales held by market participants, is considered a predictor, though not sufficient by itself, of the competitive consequences of some business conduct. In some cases, the existence of high concentration may operate to create a presumption of illegality of certain conduct, including some mergers and exclusionary conduct by large firms. More recent economic thinking has cast doubt on the validity of some of these presumptions, however. More widely employed, on the other hand, are "negative" presumptions, or "safe harbours", based on market concentration. Mergers in markets in which pre and post-merger concentration are below certain specified levels may be considered lawful, without the need for further inquiry, because economics tells us that the likelihood of successful, harmful restrictive agreements or single-firm conduct is low or nonexistent where concentration is so low. A similar test may be applied to the definition of dominance. A firm cannot be considered dominant if its market share is below, say, 35 per cent. Concentration safe harbours may also be employed in analysis of restrictive non-cartel horizontal and vertical agreements.

11. Most issues that arise in competition analysis cannot be so readily resolved, however. Perhaps the single most important -- and vexing -- analytical issue is that of market definition. It is important because it cuts across all types of competition cases, save possibly cartel conduct. It is vexing because it is both fact-intensive and inexact. Economics provides a means of solving the problem -- identifying and measuring the degree of substitutability of products and locations of production or supply -- but the paradigm is almost impossible to use scientifically, such as by analysing transaction data relating to such substitutability, because the reliability and adequacy of such data are almost always subject to question, and also because most courts are not conversant with the rigorous statistical techniques that must be employed.

12. Courts and enforcement officials are usually more comfortable dealing with anecdotal evidence, including opinions of buyers and sellers, about aspects of substitutability in market definition inquiries. Such an approach has its own obvious weaknesses, however. A great deal of such evidence is required if it is to be credible, and such evidence can often be found supporting both sides of an issue.

13. Another area in which rigorous economics confronts practical competition analysis is in consideration of efficiencies. There is broad consensus that competitive markets result in the most efficient allocation of resources, which benefits consumers through greater output and lower prices. Efficiency considerations are important in competition analysis, therefore, but it seems that they are not often directly considered in competition cases. This is apparently so because efficiencies are so difficult to measure in specific cases, and balancing the efficiency gains against possible harm from anticompetitive conduct may be even more challenging for non-economists. (Of course, there may be other reasons why, in some countries, efficiencies are not usually an explicit factor in competition cases, including the existence of other public policy goals embodied in national competition policy.)

14. It appears that courts and competition authorities prefer to consider efficiencies indirectly, through, for example, the use of concentration safe harbours. The safe harbor may be constructed at least in part specifically to encompass many or most efficiency-enhancing transactions. In transactions that fall outside the safe harbor, efficiency gains can overcome demonstrated anticompetitive effects only in extraordinary circumstances. This approach permits certainty and ease of application, but it may be insufficiently sensitive to what is a central economic underpinning of competition policy.

15. Given that most judges of competition cases are not economists, there obviously can be a role for an expert economist as witness or advisor to the court in a competition case. First, for judges not conversant with basic economic principles the expert can provide the economic framework for evaluation



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of the case. Second, the expert can provide analysis of difficult factual issues in the case, especially those in which there is a significant amount of apparently conflicting evidence. Finally, the expert can provide opinion and analysis of the more ultimate and decisive issues in the case, including particularly an assessment of the likely competitive effects of the conduct in question. The procedures for obtaining such expert assistance may vary. In an adversarial system both sides to the case may provide their own experts in support of their position, and the court must evaluate the testimony of both. Alternatively, an expert or experts may be chosen to advise only the court. There are advantages and disadvantages to both methods.

> *Given the importance of economics in competition analysis, is it advisable to ask judges with little or no economic background to decide such cases? In any case, how can such non-specialist judges be informed of relevant economic analysis in specific cases? Given the specialised and technical aspects of economic policy, including particularly competition policy, are generalist or specialist judges better equipped to hear these cases, and if generalist judges are involved, how can they equip themselves for the task?. What legal inferences are permitted from economic analysis? Is it advisable to employ more or fewer of such "shortcuts" and if fewer, how can non-expert judges make accurate decisions? What is the value and role of expert witnesses and advisors in competition cases? Do the answers differ between the different categories of courts (ordinary versus specialised courts) and between countries? In particular, is there a difference between countries in which the principle of prohibition applies to the competition law, as opposed to those in which the abuse principle applies?*

## 3. Standards of Proof in Competition Cases

16. The ultimate substantive standards in competition cases are brief and general, such as "prevention, restriction or distortion of competition," or "substantially lessen competition." Moreover there are often several intermediate issues in competition cases, such as market definition or conditions of entry, any one of which may be determinative. These issues are both complex and fact-intensive. Courts must both evaluate the probative value of large amounts of often conflicting evidence and apply to that evidence accurate, but practical, legal standards that are not specifically prescribed in the competition statute.

17. Specific issues of this type are presented in every type of competition case. In cartel cases, for example, which are on the whole the most straightforward of competition cases, it is necessary nevertheless to prove that an agreement of a certain kind was reached. The evidence may permit, however, only an inference of agreement from certain conduct of the parties or from circumstantial evidence. Is evidence solely of "conscious parallelism" sufficient in this regard?

18. As noted above, market definition requires consideration of the substitutability of products and of sources of supply. Substitutability is usually a matter of degree, however. Some buyers (sellers when evaluating possible monopsony power) will more readily substitute between a set of products than others. Except in obvious situations the evidence on this issue will be contradictory and possibly indeterminative. In these situations courts may be tempted to adopt for purposes of competition analysis generally recognised industrial classifications that have been created for other purposes. Short of employing such external indices, which may not be sufficiently accurate for the purposes of competition analysis, there appear to be no good means of simplifying this most important step in the process.

19. In abuse of dominance cases, a critical first step is determining whether or not the subject firm is dominant. As noted above, a large market share is necessary for dominance, but it is not sufficient. Unless entry into the relevant market is also difficult, the large firm has no market power. But when is entry sufficiently "difficult," and how can such difficulty be measured? In one sense, the standard for measuring

difficulty of entry may be relatively arbitrary, for example, if it takes more than two years for successful entry it may be considered difficult. In other ways, the entry analysis is not susceptible to generalisation. A high absolute cost of entry, for example, may not signal real difficulty if all or most of the costs are not sunk, or if they are small relative to the size of the industry. The entry issue has come to be one of the most technical in competition analysis. Courts are faced with a real challenge in articulating a practical and accurate standard for this issue.

20. Mergers may be the most difficult type of case for courts and competition authorities, if only because merger cases involve all of the most complex analytical issues, including market definition, analysis of entry conditions and evaluation of competitive effects. The effects issue is especially challenging because it is prospective; it requires a prediction of future effects of present conduct. In all types of cases, however, again possibly saving only cartel cases, analysis of the competitive effects of the subject conduct is required. Moreover, competition laws impose a vague standard of substantiality. Most laws either by their terms or as a result of interpretation and practice, proscribe not all anticompetitive conduct but only that which is "substantially", or "significantly" anticompetitive. Courts and competition authorities are left to articulate that standard in a more concrete fashion. They may or may not resort to relatively "bright line" tests, for example, a presumption of unlawfulness of mergers resulting in a certain degree of market concentration.

21. In the analysis of competitive effects courts are likely to turn to evidence, if it exists, of the parties' purpose in employing the subject conduct. Evidence of intent to bring about an anticompetitive result, as well as a procompetitive one, is relevant in this regard. Probative evidence of the former, however, may not often be found, particularly if the parties are well counselled about how to avoid creating such evidence. In the absence of such a clear signal about the expected effects of the conduct in question, courts face a more difficult challenge in reaching an ultimate conclusion about the benefits or harm therefrom.

> *How do courts develop and employ the specific standards of proof that are required to implement the more general standards articulated in most competition laws? Such standards include the following: simplified burdens applicable to certain types of anticompetitive conduct, usually cartel conduct; substitutability of products or sources of supply in defining markets; assessment of entry conditions; necessity of proof of anticompetitive purposes or intent; magnitude of required anticompetititve effect, e.g. "significant" lessening of competition; proof of agreement - - tacit v. explicit agreements. What presumptions are employed in this regard, and are they sufficiently reliable?*

## 4. Judicial Review of Competition Cases

22. In most countries, courts become involved in competition cases only at the appellate level, reviewing decisions of administrative tribunals. They normally do not hear or evaluate evidence. They usually do not consider questions that are strictly factual in nature, except possibly to decide whether the record contains the necessary minimum factual basis for a conclusion by court or authority below. Thus, appellate judges on balance are not regularly or intimately involved in competition enforcement. They are likely to hear relatively few cases in comparison to the total number of enforcement actions instituted by the competition agency, and their role in the cases that they get is limited to the traditional function of appellate review of administrative actions, which in many countries affords a measure of discretion to the administrative authority. What is the real significance, therefore, of the judiciary in competition enforcement in most countries?



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23. The answer to this question is country-specific, of course, but the nature of competition cases affords the opportunity for substantial involvement by the courts at the appellate level. While appellate courts normally consider only questions of "law", as opposed to questions of "fact", that dichotomy may be blurred in competition cases. Is assessment of the competitive effect of the conduct in question, for example, an issue of fact or law? In any case, whether the tribunal below applied the correct method of analysis to the competitive effects analysis is likely to be reviewable at the appellate level, and as noted above, the proper articulation and application of relevant standards is critical in most competition cases.

24. If the tribunal below is a specialised one, whose members are experts in economics or competition policy, it may be afforded relatively more latitude in courts of appeals. It may be possible to overturn its decisions only upon a showing that it made a gross, or egregious error. These are matters that are specific to each country. The experience in countries where the judiciary is relatively more active in competition cases, however, suggests that generalist judges can exercise their appellate function capably in these cases, as in other types of cases involving complex commercial or scientific issues.

25. There are differences among countries as to the role of judicial precedent, which in turn could affect the manner and extent to which courts influence competition law and policy. In common law countries, of course, judicial precedent has a binding effect in appropriate circumstances. In this sense judges in common law countries "make" competition law much more than their counterparts in countries with a Roman law tradition. In the latter countries, the written law is likely to be more detailed, leaving relatively less room for judicial interpretation.

26. In common law countries judges are likely to have more flexibility to adjust competition law enforcement to changing economic and technological conditions, as well as, of course, to changing economic thought. Such flexibility can be useful in today's economic climate, in which markets are changing at an ever more rapid pace. On the other hand, the enforcement authority in all countries presumably retains such flexibility. In any case, the written competition law is relatively static in all countries, and thus accuracy and consistency of enforcement is important everywhere.

27. A separate question is whether applicable administrative or judicial procedures unduly limit the role of the courts in implementing competition policy. The competition agency may have broad authority to compromise or settle matters in dispute. These powers, coupled with possibly onerous expenses and delays associated with litigation, may make appeals of administrative decisions unpalatable to most parties. In some quarters there are calls for more active judicial supervision of decisions by competition authorities that do not result in litigation. On the other hand, a significant restriction of the competition agency's discretion to prosecute and compromise cases could severely impair its ability to enforce a law that, most agree, requires the intelligent exercise of such discretion.

> *What is the distinction between issues of fact and law in competition cases; for example, are market definition and assessment of competitive effects issues of fact or law? On what basis should an administrative decision be subject to reversal for an insufficient factual or legal foundation? What is the role of precedent in judicial enforcement of competition cases respectively in common law and Roman law systems? What are the advantages and disadvantages of both systems in terms of judicial enforceability, predictability and consistency in competition casesAre the courts getting "enough" competition cases, and if not, is the problem related to national administrative and judicial structures that control the manner in which such cases are resolved?*

## 5. Accommodation of Multiple Criteria in Competition Cases

28. As noted above, economics is in most countries the principal underpinning of competition laws, but other public policies may also find expression in the enforcement of these laws. There may be conflict between applicable policies in a given case, requiring courts to exercise a balancing function. It may be necessary somehow to weigh the perceived competitive harm from the conduct under scrutiny against other benefits to the public that are cognizable under the law.

29. Even when a strict economic analysis is employed, a balancing of conflicting interests is sometimes required. In particular, in a rule of reason analysis it may be necessary to balance expected efficiency gains from the relevant conduct against anticipated harm to competition that will also result. Economists have devised an elegant method for doing so in a quantitative manner. The cost savings resulting from efficiency gains are compared to the "dead-weight loss" caused by the expected anticompetitive price increase. This exercise is technical and relatively sterile, however, and there is disagreement among some economists and knowledgeable competition officials over the precise standard that should apply (e.g., "total surplus" vs. "total welfare"). In any case, as noted above, courts have not embraced the method to date and in general have preferred not to attempt directly such a balancing effort.

30. Other public policies also impinge upon competition policy to a greater or lesser extent in many countries. They include enhancement of employment (or reduction of unemployment), enhancement of competitiveness of national firms in international markets, promotion of regional integration, and protection of small firms against more powerful, larger ones. One or more of these objectives may conflict with the more narrow allocative efficiency goal in any given case, and the task may fall to the court to decide which is the more important in those circumstances.

31. There may also be conflict, real or perceived, between competition policy and other national laws. There is tension, if not conflict, between competition laws and those protecting intellectual property. The latter create property rights (considered by some to be "monopolies", but that is not always, or usually, the case) because it is necessary to provide adequate incentives for innovation. Courts may have to consider this underlying purpose of intellectual property laws when confronted with allegedly anticompetitive abuses of those rights. Similarly, while competition laws are said to "protect competition, not competitors" other laws may prohibit "unfair" competition. These two laws may conflict in some respects, particularly if public policy favors protection of certain classes of competitors, such as small and medium sized businesses, for reasons other than promotion of efficiency.

32. In every country there is pervasive regulation of some economic sectors, usually because they are characterised by elements of natural monopoly. Absent express exemption, competition laws may also apply to these industries, because parts of them can operate successfully in a competitive environment. Courts may be called upon in a given case to determine when competition should prevail over regulation, or vice versa. This exercise may include having to decide which of the public policies underlying the competition and regulatory regimes, respectively, are more important in the case at hand.

> *Given the broadly-worded competition laws in most countries, what are the legitimate goals of such laws, and how can courts identify and apply them? How can courts properly implement competition laws while taking into account other national laws such as intellectual property law or laws on unfair competition? When is it appropriate to permit anticompetitive conduct because of another overriding public interest, and how can courts balance such conflicting interests? In the absence of express legislative guidance, how can courts determine which public policy objectives are applicable to the case at hand?*

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United States Court of Appeals,
Third Circuit.

HIGHMARK, INCORPORATED,
v.
UPMC HEALTH PLAN, INCORPORATED,
Appellant.

**No. 01-1377.**

Argued Oct. 17, 2001.
Dec. 21, 2001.

Before: ALITO, BARRY, and ROSENN, Circuit Judges.

**OPINION OF THE COURT**

ROSENN, Circuit Judge.

This appeal has its genesis in the intense commercial rivalry between two insurers licensed in Pennsylvania to underwrite health insurance plans. This rivalry erupted in advertisements that appeared in the *Pittsburgh Post- Gazette* in February 2001. We had occasion almost a decade ago to observe the "dynamic role" commercial advertising plays in the financial and industrial activities of our society. *Castrol Inc. v. Pennzoil Co.*, 987 F.2d 939, 940- 41 (3d Cir.1993). Whether the McCarran-Ferguson Act (the McCarran Act), 15 U.S.C. §§ 1011-1015, bars a false advertising claim by an insurer against another insurer under Section 43(a) of the Lanham Act, 15 U.S.C. § 1125(a)(1)(B), is an issue of first impression in this court.

Alleging that UPMC Health Plan, Inc. (UPMC), one of the foregoing insurers, published full-page advertisements (the UPMC ad or the Ad) in the *Pittsburgh Post-Gazette* in February 2001 containing deceptive misstatements in comparing insurance plans offered by UPMC and Highmark, Inc. (Highmark), the other insurer, Highmark, promptly sought injunctive relief and damages in the United States District Court for the Western District of Pennsylvania. The bases for its action are that the UPMC ad contained false statements and deceptive advertising in violation of Section 43(a) of the Lanham Act, state common law claims of commercial disparagement, and intentional interference with contractual relations.

UPMC moved to dismiss the action for lack of subject matter jurisdiction, contending that neither its Ad, nor the services mentioned therein, substantially affect interstate commerce as required under Section 43(a) of the Lanham Act. UPMC later asserted that plaintiff's Lanham Act claims also were proscribed by the McCarran Act and the Pennsylvania Unfair Insurance Practices Act (UIPA), 40 PA. STAT. ANN. §§ 1171.1-.15 (1999). After a two-day hearing, the District Court denied the motion to dismiss and granted Highmark's motion for a preliminary injunction. In granting the injunction, the District Court found that UPMC's ad contained nine separate literally false statements. The Court also found that UPMC's advertising had a tendency to deceive the intended readers. The Court's order required UPMC to cease and desist further dissemination of its Ad and any other false and deceptive advertisements or marketing materials containing a claim specifically found by the District Court to be false and misleading. UPMC timely appealed to this Court. We affirm.

I.

As a licensed insurer, UPMC offers two health insurance plans marketed solely to employers and subscribers in Western Pennsylvania, the Enhanced Access Point of Service plan and the Enhanced Access HMO plan. Highmark, also a licensed insurer, offers three health insurance plans under its CommunityBlue umbrella, including its CommunityBlue Direct plan. The CommunityBlue Direct plan is also marketed solely to employers and subscribers in Western Pennsylvania. Both UPMC plans and Highmark's CommunityBlue Direct plan are network-based plans. As such, they utilize the services of hospitals and physicians under contract with the plan to provide health care to subscribers. UPMC's plans and Highmark's plan make their services available outside of their respective networks, but at a greater cost to the subscriber, through deductibles and co- payments.

The County of Allegheny chose the UPMC health plans and the Highmark CommunityBlue Direct plan as the exclusive health insurance plans offered to the County's non-union employees during the open enrollment period beginning on February 1, 2001. On February I and February 4, 2001, UPMC published full- page advertisements in the *Pittsburgh Post-Gazette* comparing various features of UPMC's

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and Highmark's plans. The top of the Ad states "A message to the employers of Allegheny County," and asks "If you were diagnosed with a serious illness tomorrow, which health plan would you rather have?" The District Court found nine statements in the Ad (including seven statements comparing UPMC and Highmark health care plans) were false and misleading.

The District Court reviewed the prerequisites for a preliminary injunction. Based on its findings of fact, it concluded that Highmark had established that it was likely to succeed on the merits and that it would suffer irreparable injury if injunctive relief were denied. The Court also balanced the hardship to the parties and considered the public interest. On balance, it reasoned that the injunction would prevent UPMC "from gaining an unfair advantage in its competition with Highmark" and that the public interest would best be served by a cessation of the Ad and the publication of a corrective advertisement. It thereupon granted the application for the injunction.

II.

On appeal, UPMC raises two significant legal issues. First, it claims the Ad does not substantially affect interstate commerce, and thus there is no Lanham Act jurisdiction. It also claims that the McCarran Act bars the application of the Lanham Act, because to do so would invalidate, impair, or supersede Pennsylvania's Unfair Insurance Practices Act.

First, we address the jurisdictional issues with respect to Highmark's Lanham Act claim. This is essentially a legal issue and our standard of review is plenary. *United States Sec. & Exch. Comm'n v. Infinity Group Co.*, 212 F.3d 180, 186 n. 6 (3d Cir.2000).

UPMC argues that the Lanham Act's interstate commerce requirement is not met because it directed its Ad to employees of Allegheny County, Pennsylvania, and the advertised health plans are sold only in Pennsylvania. Thus, it maintains that there is no substantial effect on interstate commerce. The District Court rejected this argument, holding that the Ad does indeed substantially affect interstate commerce. [The Court concluded that the Ad did have sufficient effects on interstate commerce to justify legislative jurisdiction under the Lanham Act, which provides for civil liability for any person who "uses in commerce" any false or misleading description or representation of fact which in commercial advertising misrepresents the nature, characteristics, or qualities of any person's services or commercial activities. 15 U.S.C. § 1125(a)(1)(B). It also found that the McCarran Act and Pennsylvania's UIPA did not bar application of the Lanham Act.]

III.

Notwithstanding subject matter jurisdiction in the federal District Court, [FN3] [omitted] UPMC contends that the District Court erred in granting the preliminary injunction. We use a three-part standard to review the District Court's decision. The ultimate decision to grant the preliminary injunction is reviewed for abuse of discretion; the District Court's findings of fact are reviewed for clear error; and the District Court's conclusions of law receive plenary review. *Warner-Lambert Co. v. Breathasure, Inc.*, 204 F.3d 87, 89 n. 1 (3d Cir.2000).

A.

Four factors are considered in determining whether to grant a preliminary injunction: (1) whether the movant has a reasonable probability of success on the merits; (2) whether the movant will be irreparably harmed by denying the injunction; (3) whether there will be greater harm to the nonmoving party if the injunction is granted; and (4) whether granting the injunction is in the public interest. *ACLU v. Reno*, 217 F.3d 162, 172 (3d Cir.2000). Although it is not clear from its brief, UPMC seems to challenge only the District Court's finding that Highmark has a reasonable probability of succeeding on the merits. Accordingly, that is the only finding we will address.

The District Court found that Highmark has a reasonable probability of succeeding on the merits. To establish its Lanham Act claim, Highmark must show: (1) the defendant made false or misleading statements about the plaintiff's product; (2) there is actual deception or a tendency to deceive a substantial portion of the intended audience; (3) the deception is material in that it is likely to influence purchasing decisions; (4) the advertised goods traveled in interstate commerce; and (5) there is a likelihood of injury to the plaintiff, e.g., declining sales and loss of good will. *Breathasure*, 204 F.3d at 91-92.

There are two ways to prove a false advertising claim under the Lanham Act. Either the advertisement must be literally false, or it must be literally true but misleading to the consumer. *Castrol Inc. v. Pennzoil Co.*, 987 F.2d 939, 943 (3d Cir.1993). If an advertisement is literally false, the plaintiff does not have to prove actual consumer deception. *Id.* If, on the other hand, an advertisement is literally true but misleading, the plaintiff must prove actual deception by a preponderance of the evidence. *Id.* If a claim is literally true, a plaintiff "

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'cannot obtain relief by arguing how consumers could react; it must show how consumers actually do react.' " *Id.* (quoting *Sandoz Pharm. Corp. v. Richardson-Vicks, Inc.*, 902 F.2d 222, 228-29 (3d Cir.1990)).

The District Court found nine separate claims made in the UPMC ad false and, in the alternative, misleading:
(1) Reference to the Highmark plan as "CommunityBlue." The District Court found that "CommunityBlue" is in fact a service mark for three of Highmark's network plans, which includes "CommunityBlue Direct," the plan actually being offered to Allegheny County employees.
(2) Highmark provides service only in 10 hospitals in Allegheny County, as compared to 18 hospitals offered by UPMC. The Court found that Highmark actually offers the services of 16 hospitals, when rehabilitation and psychiatric facilities are included. [FN4]

FN4. UPMC included rehabilitation and psychiatric facilities in determining the number of hospitals it offers.

(3) Highmark may send members to out-of-state hospitals for some types of care available in Allegheny County. The Court found that Highmark does not send subscribers to out-of-state hospitals for care available in Allegheny County.
(4) Doctors must obtain approval from Highmark before ordering some tests, admitting members to the hospital, and making other key medical decisions. The Court found that Highmark does not make medical decisions for its subscribers.
(5) UPMC does not limit self-referrals to its network specialists. The Court found that the $25 co-payment required by UPMC for such self- referrals is in fact a limitation. Further, the Court found that this representation implied that Highmark limits self-referrals; the Court found that Highmark did not.

The remaining four of the nine claims in the UPMC Ad that the District Court found false and misleading centered around the Ad's use of the word "access." The Ad claims that CommunityBlue Direct offers no access to specialty care at several named facilities, no access to several "world-renowned physicians," and no access to any services at Magee-Womens Hospital. The Ad also claims that CommunityBlue offers access to "only certain services" at Children's Hospital.

The District Court ruled that "access" has a plain meaning, applicable in this case. *The Merriam-Webster Dictionary* defines "access" as the "capacity to enter or approach." THE MERRIAM WEBSTER DICTIONARY 23 (5th ed.1997). The District Court's explanation on its face seems appropriate, as the Ad was addressed to the public and not the industry. The District Court, using this plain meaning, determined that most of the Ad's claims relating to access were false and misleading because CommunityBlue Direct subscribers do indeed have access to the disputed facilities and world-renowned doctors, but at a lower level of benefits (that is, with additional out-of-pocket costs). UPMC argues that the Court should not have defined "access" according to its plain meaning, but rather should have looked to objective industry standards to construe the term.

According to UPMC, the objective industry standard definition of "access" is "access without additional cost to the subscriber." Under this definition, UPMC claims, its Ad is both literally true and not misleading. There is not enough evidence to determine whether UPMC in fact offers the objective industry standard definition. [FN5] There are decisions that support UPMC's contention that industry standards are relevant in determining whether the use of the term "access" was literally false. *See, e.g.*, *Castrol*, 799 F.Supp. at 436 ("In order to determine whether a claim is literally false, courts have looked to objective industry standards rather than subjective standards of the party making the comparison."); *Tire Kingdom, Inc. v. Morgan Tire & Auto, Inc.*, 915 F.Supp. 360, 365-66 (S.D.Fla.1996) ("In making a threshold determination concerning the falsity of a challenged advertisement under the Lanham Act, examining the industry standard is appropriate."); *American Rockwool, Inc. v. Owens-Corning Fiberglas Corp.*, 640 F.Supp. 1411, 1443 (E.D.N.C.1986) ("In the view of the court, [objective industry standards] must be used in order to find a violation of the Lanham Act."). However, as there are several other claims in the Ad that support the District Court's granting the preliminary injunction, we need not decide this issue today.

FN5. In arguing for its definition, UPMC points only to a previous advertisement by Highmark that similarly used the term "access." More evidence is needed to prove its definition is the objective industry standard. For instance, in addition to competitors' advertisements, the defendant in *Illinois Bell Telephone Co. v. MCI Telecommunications Corp.* produced employee testimony and definitions used by expert sources in the industry. 1996 WL 717466, *4 (N.D.Ill.1996). In *Castrol Inc. v. Pennzoil Co.*, the District Court heard expert testimony to help it determine the industry standard. 799 F.Supp. 424, 437 (D.N.J.1992). One advertisement is not sufficient proof of an industry standard. However, we note that

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the burden of proving the objective industry standard definition rests on the plaintiff and not on the defendant. *Id.* at 436.

We now review the facts considered by the District Court in determining that Highmark has a reasonable probability of success on the merits. We see no need to discuss each of the claims presented by Highmark, and limit ourselves to the most obviously deceptive.

The UPMC ad asserts that CommunityBlue Direct "[m]ay send members to out-of- state hospitals for some types of care available" in Western Pennsylvania. UPMC does not even argue that it has evidence that this takes place; instead, it argues that Highmark has the means and motive to direct patients to out-of- state hospitals. Means and motive are not sufficient to prove the statement true, and the District Court did not clearly err in finding this claim literally false.

The UPMC ad also asserts that UPMC does not "limit self-referrals to our network specialists." The District Court found that the $25 co-payment is indeed a limitation, and thus this claim is also literally false. This ruling likewise is not clearly erroneous.

Of most importance, the Ad asserts that CommunityBlue Direct provides "[a]ccess to only certain services at Children's Hospital." This claim is literally false, because Children's Hospital is actually part of the CommunityBlue Direct network. UPMC again argues that the claim is true, because Highmark has the "incentives and means to steer patients away from Children's Hospital." Without presenting evidence that Highmark is actually diverting patients from Children's Hospital, any incentives and means it may have to do so are irrelevant.

[19] This assertion pertaining to Children's Hospital is of paramount importance because it speaks directly to the materiality and likelihood of injury components of Highmark's Lanham Act claim. As Judge Roth has noted, "[c]onsumer survey evidence is extremely helpful in determining whether an allegedly false statement is material." *Castrol*, 987 F.2d at 954 (Roth, J., dissenting). Patricia Ann Liebman, the Chief Executive Officer of UPMC, testified that at informational meetings with the non-union employees of Allegheny County, the employees specifically asked questions about the Children's Hospital claim. Liebman also testified that Children's Hospital is an important institution for health plans offering services in Western Pennsylvania; a lack of access to the Hospital will influence the plan that employees with children will choose. In light of such testimony, the District Court did not err in finding the claim material or in finding that Highmark has a reasonable probability of succeeding on the merits. Accordingly, the District Court did not abuse its discretion in issuing the preliminary injunction. Moreover, on an application for preliminary injunction, the plaintiff need only prove a prima facie case, not a certainty that he or she will win. 11A *Charles Alan Wright, Arthur R. Miller & Mary Kay Kane*, Federal Practice and Procedure: Civil 2d § 2948.3.

B.

Before concluding, we turn to UPMC's argument that the District Court did not address--unclean hands. UPMC argues that Highmark should be barred from bringing its Lanham Act claim because of the equitable doctrine of unclean hands. In July 1999, Highmark ran an advertisement in the *Post- Gazette* claiming to be the only health care plan offering "access" to five local hospitals ranked among America's best. UPMC claims that Highmark, having used the term "access" the same way UPMC did in the Ad before us, should not be heard now to complain about the UPMC ad. We reject this argument.

The equitable doctrine of unclean hands applies when a party seeking relief has committed an unconscionable act immediately related to the equity the party seeks in respect to the litigation. *Keystone Driller Co. v. General Excavator Co.*, 290 U.S. 240, 245, 54 S.Ct. 146, 78 L.Ed. 293 (1933). The doctrine is applicable in actions seeking relief under the Lanham Act. *Ames Pub. Co. v. Walker-Davis Publ'n, Inc.*, 372 F.Supp. 1, 13 (E.D.Pa.1974). [The court concluded that the doctrine should not be applied here.]

IV. CONCLUSION

In summary, we conclude that the plaintiff offered sufficient evidence to prove that the challenged activities substantially affected interstate commerce. Highmark also established that the McCarran Act did not preclude relief under the Lanham Act for the deceptive and misleading representations in UPMC's February 2001 Ad. Finally, the District Court did not abuse its discretion in granting Highmark's application for a preliminary injunction. Costs taxed against the appellant, UPMC.

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56 F.3d 1448
64 USLW 2001, 1995-1 Trade Cases P 71,027
**(Cite as: 56 F.3d 1448, 312 U.S.App.D.C. 378)**

United States Court of Appeals,
District of Columbia Circuit.

UNITED STATES of America, Appellant,
v.
MICROSOFT CORPORATION.
UNITED STATES of America
v.
MICROSOFT CORPORATION, Appellant.

**Nos. 95-5037, 95-5039.**

Argued April 24, 1995.
Decided June 16, 1995.
Rehearing and Suggestion for Rehearing En Banc
Denied Aug. 17, 1995.

Before: EDWARDS, Chief Judge; SILBERMAN and BUCKLEY, Circuit Judges.

SILBERMAN, Circuit Judge:

Section 16(e) of the Antitrust Procedures and Penalties Act, known as the Tunney Act, requires the district court to determine whether entry of an antitrust consent decree is "in the public interest." 15 U.S.C. § 16(e) (1988). In this case, the district court refused to enter a proposed consent decree the Antitrust Division of the Department of Justice negotiated with Microsoft Corporation. We conclude that the proposed consent decree is in the public interest, and that the district court exceeded its authority in concluding to the contrary. We therefore reverse and remand with instructions to enter an order approving the decree.

**I.**

Microsoft dominates the world market for operating systems software that runs on IBM-compatible personal computers ("PCs"). Operating systems software controls the operation of the computer and manages the interaction between the computer's memory and attached devices such as keyboards, printers, display screens and disk drives. In 1990, the Federal Trade Commission began investigating Microsoft's acquisition and maintenance of monopoly power in that market. When faced with the decision whether to file a complaint against Microsoft, however, the Commission deadlocked 2-2, thus suspending the agency's investigation.

The Antitrust Division of the Department of Justice then initiated its own investigation of Microsoft (apparently a rather rare occurrence), using the FTC's extensive investigatory file as its starting point. The Department issued 21 Civil Investigative Demands to Microsoft and third parties, reviewed one million pages of documents, and conducted over 100 interviews. The Department also deposed 22 persons, including Microsoft Chairman Bill Gates.

In July 1994, the Department filed a civil complaint under the Sherman Act, 15 U.S.C. §§ 1 and 2 (1988), charging Microsoft with unlawfully maintaining a monopoly of operating systems for IBM-compatible PCs and unreasonably restraining trade of the same through certain anticompetitive marketing practices.

The key anticompetitive practice against which the complaint is aimed is Microsoft's use of contract terms requiring original equipment manufacturers ("OEMs") to pay Microsoft a royaltyfor each computer the OEM sells containing a particular microprocessor (in this case, an x86 class microprocessor), whether or not the OEM has included a Microsoft operating system with that computer. The practical effect of such "per processor licenses," it is alleged, is to deter OEMs from using competing operating systems during the life of their contracts with Microsoft. The complaint further charges that Microsoft has exacerbated the anticompetitive effect of the per processor licenses by executing long-term contracts with major OEMs, and by requiring minimum commitments and crediting unused balances to future contracts, thereby extending the contract term and creating an economic disincentive for an OEM to install a non-Microsoft operating system.

The other anticompetitive device alleged in the complaint is Microsoft's use of overly restrictive nondisclosure agreements with certain independent software vendors ("ISVs"). Those ISVs provide applications software to run "on top of" Microsoft's operating system, enabling the user to perform a variety of tasks, such as wordprocessing. Microsoft provides those ISVs with advance test versions of its newest operating system so that the ISVs can develop their software to be compatible with that operating system. The government alleged that Microsoft, as a corollary, has imposed nondisclosure agreements on

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some ISVs which would restrict their ability to work with competing operating systems companies and to develop competing products for an unreasonably long period of time.

The government did not allege and does not contend--and this is of crucial significance to this case--that Microsoft *obtained* its alleged monopoly position in violation of the antitrust laws. The government believes that Microsoft's initial acquisition of monopoly power in the operating systems market was the somewhat fortuitous result of IBM choosing for its PCs the operating system introduced by Microsoft ("MS-DOS"), which, with Microsoft's successful exploitation of that advantage, led Microsoft to obtain an installed base on millions of IBM, and IBM-compatible, PCs.

It is undisputed that the software market is characterized by "increasing returns," resulting in natural barriers to entry. Because the costs of producing software are almost exclusively in its design, marginal production costs are "virtually zero." Professor Arrow, the government's consultant and a Nobel-prize winning economist, described the importance of Microsoft's large installed base in an increasing returns market as follows:
A software product with a large installed base has several advantages relative to a new entrant. Consumers know that such a product is likely to be supported by the vendor with upgrades and service. Users of a product with a large installed base are more likely to find that their products are compatible with other products. They are more likely to be able successfully to exchange work products with their peers, because a large installed base makes it more likely that their peers will use the same product or compatible products. Installed base is particularly important to the economic success of an operating system software product. The value of the operating system is in its capability to run application software. The larger the installed base of a particular operating system, the more likely it is that independent software vendors will write programs that run on that operating system, and, in this circular fashion, the more valuable the operating system will be to consumers.

In a not uncommon technique, the Department of Justice filed a proposed consent decree along with its complaint, which embodied the Department's and Microsoft's settlement of the case. The consent decree, which essentially tracks the complaint and is effective for 78 months following its entry, prohibits Microsoft from entering into per processor licenses, licenses with a term exceeding one year (unless the customer opts to renew for another year), licenses containing a minimum commitment, and unduly restrictive nondisclosure agreements. To prevent Microsoft from using other exclusionary practices to achieve effects similar to those achieved by the practices challenged in the complaint, the proposed decree also prohibits certain other arrangements such as lump-sum pricing and variants of per processor licensing. The decree applies to Microsoft's most popular operating systems products (MS-DOS, Windows and Windows 95) and successor versions or operating systems marketed as replacement products. The decree does not, however, cover "Windows NT" products, which are designed for sophisticated "high end users" and which do not enjoy a substantial portion of the market for such products.

Pursuant to Section 16(b) of the Tunney Act, 15 U.S.C. § 16(b) (1988), the Department of Justice published the proposed decree in the Federal Register, accompanied by a competitive impact statement, and invited comment. *See* 59 Fed.Reg. 42,845 (1994). Only five comments were received during the statutory period, to which the government responded on October 31, 1994.

At the first substantive status conference on September 29, 1994, the district judge informed the parties that over the summer he had read a book about Microsoft--*Hard Drive* [FN1]--because he "thought it would be a good idea maybe to know as much about Microsoft as probably they're going to know about me." Much of the ensuing discussion focused on accusations against Microsoft contained in the book. The district judge asked whether the government's lawyers had read the book and whether they had investigated the allegations made by its authors. In particular, the judge focused on the allegation that Microsoft engages in "vaporware," which he described in differing terms but ultimately defined as "the public announcement of a computer product before it is ready for market for the sole purpose of causing consumers not to purchase a competitor's product that has been developed and is either currently available for sale or momentarily about to enter the market." *United States v. Microsoft Corp.*, 159 F.R.D. 318, 334 (D.D.C.1995) ("*Opinion*"). [FN2] (The judge insisted that even truthful product preannouncements would violate the securities laws, if not the antitrust laws.)

FN1. James Wallace & Jim Erickson, *Hard Drive: Bill Gates and the Making of the Microsoft Empire* (1992).

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FN2. Based on his reading of *Hard Drive,* the district judge initially described "vaporware" as "putting out announcements that are misleading or not true to freeze the competition." When the judge asked Microsoft whether it engaged in "vaporware" so defined, Microsoft stated that such charges are "entirely false." Microsoft did not deny that it preannounced products, but explained in its subsequent filings that such preannouncements do not violate the antitrust laws unless they are knowingly false or misleading when made. The judge rejected Microsoft's position, stating that Microsoft's lawyer "[n]ever told me that you have this funny little interpretation of vaporware."

According to the district judge, *Hard Drive* also claimed that Microsoft's own applications developers have unfair access to information about Microsoft's operating systems, giving them an undue advantage over competitors in developing applications software that is compatible with Microsoft's operating systems. The government did not include "vaporware" or unfair access charges in its complaint against Microsoft.

At a subsequent status hearing on November 2, 1994, the district judge again referred to *Hard Drive* and its "vaporware" allegations, noting that the book "does allege some very serious practices," and telling the government that he wanted to be satisfied that the allegations in the book were not true. The Department was instructed to inform interested persons that they had until December 5, 1994 to seek leave to participate in the court's hearing on the consent decree. Only I.D.E. Corporation, which had participated in the comment process, sought leave to participate in the hearing. But on January 10, 1995, (over a month late and over the objection of both the government and Microsoft), the law firm of Wilson, Sonsini, Goodrich & Rosati, on behalf of three computer industry companies ("Doe Companies"), filed a 96-page memorandum (plus a 215-page appendix) arguing that the proposed consent decree was inadequate because it would not result in increased competition in the operating systems market, nor prevent Microsoft from monopolizing the rest of the software industry. The Doe Companies claimed that because of the unusual "increasing returns" nature of Microsoft's market position, it would be extremely difficult to dislodge Microsoft from its dominant status and return the market to a state of equilibrium, or competition. Moreover, they claimed that Microsoft had the capacity to leverage its installed base in the operating systems market so as to dominate the related markets for applications and other software products. The Doe Companies also attached two documents purporting to show that Microsoft had engaged in "vaporware." [FN3] Wilson, Sonsini's brief was accompanied by a motion requesting that the district court permit the late filing, and also permit the purported computer industry companies to remain anonymous, asserting "fear" that they would be subject to unexplained retaliation from Microsoft. The district court, without a hearing on the need for or propriety of the Doe Companies' proceeding anonymously, granted the motion over the government's and Microsoft's objections.

FN3. In it submissions to the district court, Microsoft rebutted the claim that the documents evidenced "vaporware" activities. Microsoft also explained that it preannounces products because ISVs need such early notification to begin developing compatible applications software. The district court, however, did not refer to Microsoft's rebuttal in its opinion.

On January 18, 1995, the United States filed a motion for entry of the decree (later joined orally by Microsoft at the district court's January 20, 1995 hearing) and attached an affidavit from Professor Arrow. As noted, Professor Arrow agreed with *amici* that in an increasing returns market there is a possibility of monopolization, which may be inefficient; but, he claimed, this process is entirely natural. He specifically rejected the notion that the government should intervene where, as he believed was the case here, the market success of the dominant firm was not the result of anticompetitive practices. Professor Arrow concluded that only artificial barriers, such as the licensing practices addressed in the decree, should be regulated or prohibited.

The next day the district court issued an order identifying issues to be addressed at the hearing scheduled for the following day. The parties were requested to explain why, among other things, the consent decree did not contain provisions that would (1) bar Microsoft from engaging in "vaporware," (2) establish a wall between the development of operating systems software and the development of applications software at Microsoft, and (3) require disclosure of all instruction codes built into operating systems software designed to give Microsoft an advantage over competitors in the applications software market. *See Opinion,* 159 F.R.D. at 326-27 n. 15. The Computer & Communications Industry Association ("CCIA") filed a motion for leave to intervene, or alternatively, to participate as *amicus curiae.*

The district court allowed I.D.E. Corporation, CCIA and the Doe Companies to participate in the January 20, 1995 hearing. [FN4] All three urged disapproval

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of the decree. The district judge devoted substantial time to questioning counsel about "vaporware" and pressing the government for information regarding its investigation of "vaporware" allegations--information which the government declined to provide on the ground that the such allegations were unrelated to the violations charged in the complaint. [FN5]

FN4. The district court subsequently issued an order denying motions to intervene by I.D.E. Corporation and CCIA but authorizing them to participate under § 16(f)(3) of the Tunney Act, which allows the district court to "authorize full or limited participation in proceedings before the court by interested persons ... in any other manner and extent which serves the public interest as the court may deem appropriate." 15 U.S.C. § 16(f)(3) (1988).

FN5. After the hearing on the consent decree, several *ex parte* submissions were sent to the district judge. First, the Doe Companies submitted a supplement to their brief which contained a redacted exhibit. At the same time the district judge ruled on the motion to approve the consent decree, he granted Microsoft's motion to strike the supplement, but only to the extent that it referred to the redacted exhibit. Then, Apple Computer, Inc. sent to the district judge an *ex parte* letter (with five attached affidavits) accusing Microsoft of anticompetitive practices not related to those charged in the complaint. The judge ordered that Apple's letter and affidavits be filed, but stated that he did not consider them. *See Opinion,* 159 F.R.D. at 328-29. Finally, Andrew Schulman, a software industry commentator, sent the district judge an *ex parte* letter opposing the consent decree. In his letter, Schulman stated that he had asked his publisher to send to the judge a copy of *Unauthorized Windows 95,* Schulman's latest book. Microsoft states thatthe judge did not disclose his receipt of the Schulman letter or book and Microsoft did not become aware of the letter's existence until the Doe Companies attached it to their supplemental submission. Upon learning that the materials Schulman sent to chambers had "become an issue in this case," the judge ordered that a facsimile from Schulman be filed. (The order did not refer to Schulman's previous letter opposing the consent decree.) That facsimile indicates that the district judge had returned Schulman's unsolicited book (along with a copy of the district judge's opinion).

On February 14, 1995, the district court issued an order denying the government's motion to approve the consent decree. The judge stated that he could not find the proposed decree to be in the public interest for four reasons:

First, the Government has declined to provide the Court with the information it needs to make a proper public interest determination. Second, the scope of the decree is too narrow. Third, the parties have been unable and unwilling adequately to address certain anticompetitive practices, which Microsoft states it will continue to employ in the future and with respect to which the decree is silent. Thus, the decree does not constitute an effective antitrust remedy. Fourth, the Court is not satisfied that the enforcement and compliance mechanisms in the decree are satisfactory.

*Opinion,* 159 F.R.D. at 332.

The judge's understanding of the extent of additional information he "need[ed]" to make the public interest determination under the Tunney Act was quite considerable and was of a character that the government contended was not only outside the scope of the Tunney Act, but was also improper for a judge to seek. The court required at a "minimum":

(1) The broad contours of the investigation *i.e.,* the particular practices and conduct of the defendant that were under investigation along with the nature, scope and intensity of the inquiry;

(2) With respect to such particular practices and conduct, what were the conclusions reached by the Government;

(3) In the settlement discussions between the Government and defendant: (a) what were the areas that were discussed, and (b) what, if any, areas were bargained away and the reasons for their non-inclusion in the decree;

(4) With respect to the areas not discussed at the bargaining table or not bargained away, what are the plans for the Government to deal with them *i.e.,* is the investigation to continue, and, if so, at what intensity, or if the investigation is to be closed, then the Government must explain why it is in the public interest to do so.

*Opinion,* 159 F.R.D. at 332.

The judge's second objection, going to the *scope* of the decree, was predicated on his concern that it does not apply to all of Microsoft's operating systems. The decree, it will be recalled, explicitly excludes from its coverage "Windows NT." In an apparent reference to Microsoft's contention that its product preannouncements do not fit the definition of "vaporware" and do not constitute antitrust violations, the court further noted that "taking into account Microsoft's penchant for narrowly defining the antitrust laws, the Court fears there may be

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endless debate as to whether a new operating system is covered by the decree." *Id.* at 333.

As to the third point--the essence of the *amici* 's objection--the judge concluded that the decree does not provide an effective antitrust remedy because it does not "pry open" the market to competition, *i.e.*, remedy the monopolist position Microsoft has achieved through supposed illegal means. The judge was especially concerned that the decree does not address "a number of other anticompetitive practices that from time to time Microsoft has been accused of engaging in by others in the industry." *Id.* at 334. Among such practices were "vaporware," Microsoft's "use[ ] [of] its dominant position in operating systems to give it an undue advantage in developing applications software," and its manipulation of its operating systems to render competing applications software inoperable or more difficult for consumers to use. *Id.* at 334-35.

Finally, the court determined that the consent decree did not oblige Microsoft to adopt sufficient internal compliance mechanisms. Based on its perception that Microsoft had misled the court about whether it engaged in "vaporware," the district court concluded that Microsoft's current staff of "50 or so in- house lawyers, along with its outside retained counsel," were insufficient to monitor the decree adequately. *Id.* at 336.

The United States and Microsoft appeal from the order refusing to enter the decree, asking this court to remand with instructions to enter the decree. Microsoft appeals as well from the order allowing the anonymous participation of the Doe Companies (and CCIA's participation), and asks that the case be remanded to another district court judge because it contends that Judge Sporkin has demonstrated personal bias against the company.

Since both parties to the decree have appealed the district court's order, these consolidated cases present the rare situation in which there is no appellee. Accordingly, we have allowed the Doe Companies, CCIA and I.D.E. Corporation to continue in their roles as *amici*.

**II.**

Both the government and Microsoft contend that the district judge vastly exceeded his authority under the Tunney Act, and that as a matter of law they are entitled to the court's entry of the consent decree. Before considering their arguments, however, we are obliged to determine that we have jurisdiction to entertain this appeal. [The court concluded that it did have jurisdiction, for the following reason]: The decree at issue here does, as in *Carson*, call for an injunction: Microsoft would be permanently enjoined from using what the government contends are anticompetitive licensing contracts for its PC operating systems. "Indeed, prospective relief [is] at the very core of the disapproved settlement." *Id.* . . . . It matters not whether a district judge objects to the injunctive relief as too strong or not strong enough: in either case, the judge is refusing to grant the injunction except under conditions that the parties will not accept. Nor is there any doubt in this case that the district judge had reached a firm determination. His order and opinion make that quite clear.

*Amici* nevertheless contend that the government has not shown any "serious consequences" that justify the interlocutory appeal. The government, it is argued, is only concerned about its settlement statistics. We disagree. The district court's refusal to enter the decree puts the government to a difficult, perhaps Hobson's, choice. It must either drop its case against Microsoft entirely and allow Microsoft to continue to engage in practices which the government believes are anticompetitive; or, it is compelled to litigate and presumably proceed under a vastly expanded complaint that in effect asserts that Microsoft engaged in activities which the government does not believe are illegal (*i.e.*, achieving its dominant position in the first place), or seeks remedies which the government does not believe are justified by the evidence. Moreover, as the government points out, the consent decree is part of a negotiated settlement. A district judge's refusal to accept the decree--particularly upon the grounds advanced--cannot but have enormous practical consequences for the government's ability to negotiate future settlements. *Cf. Carson*, 450 U.S. at 88 n. 14, 101 S.Ct. at 998 n. 14 (order refusing to enter consent decree would undermine Title VII's strong preference for encouraging voluntary settlement of employment discrimination claims). The Tunney Act was not intended to create a disincentive to the use of the consent decree. *See, e.g.*, S.REP. NO. 298, 93d Cong., 1st Sess. 7 (1973) ("The [Senate Judiciary] Committee wishes to retain the consent judgment as a substantial antitrust enforcement tool."); H.REP. NO. 1463, 93 Cong., 2d Sess. 6 (1974) (expressing intent to preserve the policy of the antitrust laws to encourage settlement by consent decree), *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 6535, 6536-37. We conclude, therefore, that the government easily meets the *Carson* standard. We have jurisdiction over the appeal.

Microsoft has also appealed the judge's refusal to

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enter the consent decree. Actually, in this situation, it is doubtful if we would have jurisdiction unless both parties to the decree appealed. Certainly if the government accepted the district judge's view of the case and wished to proceed to trial, the propriety of the judge's order would be moot; and, if Microsoft was no longer willing to agree to the government's conditions, the issue would similarly be moot. [FN6] Therefore, both parties must be entitled to appeal the district judge's refusal to enter the decree. Microsoft in addition appeals one order that the government does not: the order allowing participation by the Doe Companies and CCIA. Microsoft asserts that the district court erred in permitting the Doe Companies to participate anonymously. . . . . However, in our view, it is unnecessary to decide whether Microsoft would have been entitled to appeal this order independently. Since we have concluded that we have jurisdiction over the basic appeal, the district judge's order permitting the *amici* to participate is not really interlocutory. It comes before us as part and parcel of the record in this case.

**III.**

Appellants contend that the district judge misinterpreted the Tunney Act-- indeed interpreted that statute so as to raise serious questions regarding its constitutionality--by basing his rejection of the decree on considerations which implicate the executive branch's prosecutorial discretion. The thrust of the judge's concerns were directed to his dissatisfaction with the framework of the complaint fashioned by the Department. He thought it much too modest to deal with the imperfections in the relevant market and their cause--at least as he perceived them. Appellants contend that the judge did not simply make the proper inquiry into whether the decree was appropriate to the complaint, but instead asked whether the complaint itself was adequate. By doing so, it is argued, the judge improperly intruded on the government's prosecutorial role. The judge's demand that he be informed of the contours of the investigation, the settlement discussions, and the government's future investigative plans, indicates that the judge impermissibly arrogated to himself the President's role "to take care that the laws be faithfully executed."

*Amici,* defending the judge's order, argue that it merely focused on whether the remedy provided in the decree was adequate to the allegations in the complaint. Appellants respond, however, that even to the extent that the judge's order is directed to the adequacy of the remedy to the allegations actually charged--which they insist is only a minor theme in the judge's opinion--the judge nevertheless exceeded his authority. Under our own precedent dealing with uncontested modifications of a consent decree, we have repeatedly said that a district judge must approve such modifications so long as the proposal falls "within the *reaches* of the public interest." *United States v. Western Elec. Co.,* 900 F.2d 283, 309 (D.C.Cir.1990) ("*Triennial Review Opinion* ") (emphasis in original) (quoting *United States v. Bechtel Corp.,* 648 F.2d 660, 666 (9th Cir.), *cert. denied,* 454 U.S. 1083, 102 S.Ct. 638, 70 L.Ed.2d 617 (1981), in turn quoting *United States v. Gillette Co.,* 406 F.Supp. 713, 716 (D.Mass.1975)).

At the heart of this case, then, is the proper scope of the district court's inquiry into the "public interest." Is the district judge entitled to seize hold of the matter--the investigation into the putative defendant's business practices--and decide for himself the appropriate combined response of the executive and judicial branches to those practices? With respect to the specific allegations in the government's complaint, may the court interpose its own views of the appropriate remedy over those the government seeks as a part of its overall settlement? To be sure, Congress, in passing the Tunney Act, intended to prevent "judicial rubber stamping" of the Justice Department's proposed consent decree. H.R.REP. NO. 1463, *supra,* at 8, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS at 6538. The Court was to "make an independent determination as to whether or not entry of a proposed consent decree [was] in the public interest." S.REP. NO. 298, *supra,* at 5. Yet, Congress did not purport to alter antitrust precedent applying the public interest in reviewing consent decrees. H.R.REP. NO. 1463, *supra,* at 11, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS at 6539. The difficulty with that stated purpose is that there was virtually no useful precedent--certainly none in which an appellate court had approved a trial court's rejection of a consent decree as outside the public interest. *Cf. Antitrust Procedures and Penalties Act: Hearings on S.782 and S.1088 Before the Subcomm. on Antitrust and Monopolies of the Senate Comm. on the Judiciary,* 93d Cong., 1st Sess. 92 (1973) ("Senate Hearings") (Statement of Thomas E. Kauper, Assistant Attorney General, Antitrust Division, Dept. of Justice) ("[E]xcept in cases where a previous judicial mandate is involved and the consent decree fails to comply with that mandate, or where there is a showing of bad faith or malfeasance, the courts have allowed a wide range of prosecutorial discretion.").

Although the statute does not give specific guidance, it does speak in rather broad terms. In determining whether the decree is in the public interest, the

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district court is authorized to "consider":
(1) the competitive impact of such judgment, including termination of alleged violations, provisions for enforcement and modification, duration or relief sought, anticipated effects of alternative remedies actually considered, and any other considerations bearing upon the adequacy of such judgment;
(2) the impact of entry of such judgment upon the public generally and individuals alleging specific injury from the violations set forth in the complaint including consideration of the public benefit, if any, to be derived from a determination of the issues at trial.

15 U.S.C. § 16(e) (1988).

The Ninth Circuit observed (in a case in which the *defendant* wished to withdraw from the decree) that that language "suggests that a court may, and perhaps should, look beyond the strict relationship between complaint and remedy in evaluating the public interest." *Bechtel Corp.*, 648 F.2d at 666. But it went on to determine that "we cannot agree that a district court should engage in an unrestricted evaluation of what relief would best serve the public." *Id.* [FN7]

FN7. The Ninth Circuit subsequently split as to whether that language did or did not authorize a district court to look behind and beyond the complaint to judge the public interest. *United States v. BNS, Inc.*, 858 F.2d 456 (9th Cir.1988). The majority thought a district judge could look to non-antitrust factors, but not to antitrust concerns in markets other than those alleged in the complaint. *Id.* at 462-63.

The most prominent post-Tunney Act consent decree, the AT & T consent decree, was modified by the district judge in several respects in accordance with his views of the public interest and, although both the government and AT & T acquiesced, non-parties to the decree were allowed to intervene for purposes of appealing the district judge's public interest determination. It does not appear that any of the appellants challenged the constitutionality of the Tunney Act, but Justice Rehnquist, speaking for Chief Justice Burger and Justice White, nevertheless published a dissent from the order affirming the district court's entry of the decree. *See Maryland v. United States*, 460 U.S. 1001, 103 S.Ct. 1240, 75 L.Ed.2d 472 (1983). The dissent expressed grave doubt as to the Act's constitutionality because without a judicial finding of illegality (a consent decree is, of course, a settlement), the statute does not supply a judicially manageable standard for review of the decree, *id.* at 1004, 103 S.Ct. at 1242, and the considerations that led the Department of Justice to settle are not amenable to judicial review, *id.* at 1005-06, 103 S.Ct. at 1243-44. *See also Heckler v. Chaney*, 470 U.S. 821, 831, 105 S.Ct. 1649, 1655-56, 84 L.Ed.2d 714 (1985). For instance, a settlement, particularly of a major case, will allow the Department of Justice to reallocate necessarily limited resources.

The government, cautioning us as to the constitutional difficulties that inhere in this statute, urges us to flatly reject the district judge's efforts to reach beyond the complaint to evaluate claims that the government did *not* make and to inquire as to why they were not made. We agree. Although the language of section 16(e) is not precise, we think the government is correct in contending that section 16(e)(1)'s reference to the alleged violations suggests that Congress did not mean for a district judge to construct his own hypothetical case and then evaluate the decree against that case. Moreover, in section 16(e)(2), the court is authorized to consider "the public benefit ... of the determination of the issues at trial." Putting aside the perplexing question of how the district judge could insure a trial if the government did not wish one, "the issues" referred to must be those formulated in the complaint. Congress surely did not contemplate that the district judge would, by reformulating the issues, effectively redraft the complaint himself. We therefore dismiss the claim that the last line in section 16(e)(1), the catchall clause allowing the district court to entertain "any other considerations bearing upon the adequacy of such judgment," authorizes the wide-ranging inquiry the district court wished to conduct in this case. That language recognizes, *inter alia*, that a consent decree might well do unexpected harm to persons other than those "alleging specific injury from the violations set forth in the complaint." 15 U.S.C. § 16(e)(2) (1988). And the district court might ponder those sort of concerns in determining whether to enter the judgment.

To be sure, the Act also authorizes the district judge to "take testimony of Government officials ... as the court may deem appropriate." 15 U.S.C. § 16(f)(1) (1988). We do not read this language, however, to authorize the district judge to seek the kind of information concerning the government's investigation and settlement negotiations that he wished to obtain here. Even when a court is explicitly authorized to review government action under the Administrative Procedure Act, "there must be a strong showing of bad faith or improper behavior" before the court may "inquir [e] into the

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mental processes of administrative decisionmakers." *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 420, 91 S.Ct. 814, 825, 28 L.Ed.2d 136 (1971). Here, the district court is not empowered to review the actions or behavior of the Department of Justice; the court is only authorized to review the decree itself. It is unnecessary to consider whether the district court might have broader authority to inquire into the Department's deliberations, even though not authorized to "review" the Department's action, if there were a credible showing of bad faith. *See* Senate Hearings, *supra*, at 92. There is no such claim here.

The district court was troubled that if its review were limited to the market and practices within that market against which the complaint was directed, the government could, by narrow drafting, artificially limit the court's review under the Tunney Act. *See Opinion*, 159 F.R.D. at 332. We think, with all due respect, that the district court put the cart before the horse. The court's authority to review the decree depends entirely on the government's exercising its prosecutorial discretion by bringing a case in the first place.

That brings us to *amici* 's contention that the district court was justified in rejecting the decree as providing inadequate remedies, even if the court was barred from reaching beyond the complaint to examine practices the government did not challenge. The district judge (and *amici* ) believed that the decree would not "effectively pry open to competition a market that has been closed by defendant['s] illegal restraints." *Opinion*, 159 F.R.D. at 333 (quoting *United States v. American Telephone & Telegraph Co.*, 552 F.Supp. 131, 150 (D.D.C.1982) (in turn quoting *International Salt Co. v. United States*, 332 U.S. 392, 401, 68 S.Ct. 12, 17, 92 L.Ed. 20 (1947)), *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001, 103 S.Ct. 1240, 75 L.Ed.2d 472 (1983)). The judge was especially concerned that Professor Arrow had not explained "how the decree remedies the monopolist position Microsoft has achieved through alleged illegal means *in an increasing returns market*. " *Id.* at 334 (emphasis in original). And he urged that the decree should address "a number of other anticompetitive practices that from time to time Microsoft has been accused of engaging in by others in the industry," such as "vaporware." *Id.*

[7] This argument, it seems to us, merely recasts the district court's order to make it appear less unorthodox. The complaint did not allege-- because the government did not believe it was true--that Microsoft's dominant market position resulted from illegal means. The district court and *amici* would have it be otherwise, but neither have the power to force the government to make that claim. And since the claim is not made, a remedy directed to that claim is hardly appropriate. Of course, such reasoning applies *a fortiori* to discrete practices such as "vaporware," that the government does not assert are antitrust violations and which bear no relationship to the practices against which the complaint is directed. Even where the government has proved antitrust violations at trial, the remedies must be of the "same type or class" as the violations, and the court is not at liberty to enjoin "all future violations of the antitrust laws, however unrelated to violations found by the court." *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100, 132-33, 89 S.Ct. 1562, 1581-82, 23 L.Ed.2d 129 (1969) (citations omitted).

If the essential dispute between *amici* and appellants were more narrowly cast as objections to the remedies sought, the district judge would still not be empowered to reject them merely because he believed other remedies were preferable. As we have said in the context of reviewing agreed upon modifications of a consent decree:

The court should also bear in mind the *flexibility* of the public interest inquiry: the court's function is not to determine whether the resulting array of rights and liabilities "is the one that will *best* serve society," but only to confirm that the resulting settlement is " 'within the *reaches* of the public interest.' "

*Triennial Review Opinion*, 900 F.2d at 309 (emphasis in original) (citing and quoting *Bechtel*, 648 F.2d at 666, in turn quoting *Gillette*, 406 F.Supp. at 716). Thus, a court should not reject an agreed-upon modification unless "it has exceptional confidence that adverse antitrust consequences will result--perhaps akin to the confidence that would justify a court in overturning the predictive judgments of an administrative agency." *United States v. Western Elec. Co.*, 993 F.2d 1572, 1577 (D.C.Cir.) ("*Triennial Review Remand Opinion* "), *cert. denied*, 510 U.S. 984, 114 S.Ct. 487, 126 L.Ed.2d 438 (1993).

The *Triennial Review* cases, dealing with the administration of the AT & T consent decree, involve a decree the oversight of which had been the business of a district judge for several years. In some respects, the parties' request for approval of a modification to a decree is akin to a request for entry of an initial proposed decree but, in other respects, it is different. In the latter situation, it seems to us that the district judge must be even more deferential than in the former. As Justice Rehnquist noted in *Maryland v. United States*, when a consent decree is

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brought to a district judge, because it is a settlement, there are no *findings* that the defendant has actually engaged in illegal practices. *See* 460 U.S. at 1004, 103 S.Ct. at 1242 (Rehnquist, J., dissenting). It is therefore inappropriate for the judge to measure the remedies in the decree as if they were fashioned after trial. Remedies which appear less than vigorous may well reflect an underlying weakness in the government's case, and for the district judge to assume that the allegations in the complaint have been formally made out is quite unwarranted. [FN8] We think the district judge's criticism of Microsoft for declining to admit that the practices charged in the complaint actually violated the antitrust laws was thus unjustified. *See Opinion*, 159 F.R.D. at 337; H.R.REP. NO. 1463, *supra*, at 6 ("Ordinarily, defendants do not admit to having violated the antitrust or other laws alleged as violated in complaints that are settled."), *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 6535, 6536-37. The important question is whether Microsoft will abide by the terms of the consent decree regardless of whether it is willing to admit wrongdoing.

FN8. On this point, we disagree with *Gillette*, 406 F.Supp. at 715- 16, in which the district court stated that "the decree is to be tested on the basis of the relief provided, on the assumption that the government would have won."

After a district judge has administered a consent decree for some period of time--as is true regarding the AT & T decree--it might be thought that he would gain at least some familiarity with the market involved, and therefore the lack of an initial trial is, at least marginally, less of an inhibition. But when the proposed decree comes to a district judge in the first instance as a settlement between the parties that may well reflect weaknesses in the government's case, the district judge must be even more deferential to the government's predictions as to the effect of the proposed remedies than he would be when a modification request is presented, as in the AT & T cases, long after entry.

Giving due respect to the Justice Department's perception of the market structure and its view of the nature of its case, we think the district judge was obliged to conclude that the remedies were not so inconsonant with the allegations charged as to fall outside of the "reaches of the public interest." The district court understandably questioned the government as to why the decree did not forbid Microsoft from using the alleged anticompetitive licensing practices with respect to all of Microsoft's operating systems (in particular, Windows NT products). But the government explained that Windows NT products do not have "a significant share of a relevant market at this time."

It might well be that the decree would be strengthened if Windows NT were explicitly covered (it could also be that this was a concession the government made in bargaining), but that is of no great moment. It is undisputed that Windows NT does not have a dominant market position, and Professor Arrow assured the court that the decree "appropriately addresses and remedies the anticompetitive effects of the practices challenged in the complaint." It is not for us (or the district court) to decide whether Professor Arrow is correct. "The quality of [his] presentation[ ] is enough ... to establish an ample factual foundation for the judgment call made by the Department of Justice and to make its conclusion reasonable." *Triennial Review Remand Opinion*, 993 F.2d at 1582. [FN9]

FN9. *Amicus* I.D.E. Corporation (which refers to itself as "IDEA") contends that the decree is inadequate because it does not require Microsoft to disgorge unused minimum commitment payments that IDEA made pursuant to its licensing agreement with Microsoft. In other words, IDEA asserts generally that the remedy should provide retroactive relief and that it should be tailored to meet IDEA's particular situation. While the district court may inquire into whether a decree will result in any positive injury to third parties, *see* 15 U.S.C. § 16(e)(2) (1988), in the absence of such injury, it should not reject an otherwise adequate remedy simply because a third party claims it could be better treated. The decree does not preclude IDEA from bringing its own private antitrust suit against Microsoft to gain the specific relief it seeks.

A district judge pondering a proposed consent decree understandably would and should pay special attention to the decree's clarity. The government may be entitled to rather broad discretion to settle with the defendant within the reaches of the public interest, but the district judge who must preside over the implementation of the decree is certainly entitled to insist on that degree of precision concerning the resolution of known issues as to make his task, in resolving subsequent disputes, reasonably manageable. We therefore think the district judge was on solid ground in, at least, inquiring as to the product lines covered in the decree. *Amici* suggest that in this respect the decree is ambiguous and that the district judge's refusal to accept it can be justified

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on this alternative ground. The decree provides that "successor versions of or replacement products marketed as replacements for the [covered products]" are covered by the decree. But, as noted, Windows NT is specifically excluded. What would happen, *amici* ask, if Windows NT were somehow to be made to serve as a replacement or successor to MS-DOS or Windows products covered by the decree? The government contends (and Microsoft does not dispute) that in such an unlikely event Windows NT would be covered as a successor to the covered products. We think that is the logical interpretation of the decree, and therefore perceive no continuing ambiguity. [FN10] In any event, the district judge's concern was not primarily ambiguous language, but was rather his perception that Microsoft had a "penchant for narrowly defining the antitrust laws," and that therefore "endless debate" might ensue "as to whether a new operating system is covered by the decree." *Opinion,* 159 F.R.D. at 333. This observation apparently stems from the "vaporware dispute" between Microsoft's counsel and the district judge, as well as from Microsoft's unwillingness to concede that the practices covered by the decree violated the antitrust laws. As we have already noted, the judge's conclusions about Microsoft's behavior past or future are, *on this record,* unwarranted.

FN10. *Amici* also contend without explanation that the decree contains a "loophole" by which a next-generation operating system can be taken outside the scope of the decree if Microsoft sells it "bundled" with an applications program. We perceive no interpretation of the decree's definition of covered products which would allow such a result.

Similarly, we would expect a district court to pay close attention to the compliance mechanisms in a consent decree. In this case, the lack of an adequate compliance mechanism was the final ground the district judge advanced for rejecting the decree. The district judge appeared to be concerned, however, with a great deal more than the decree. Although the court recognized that Microsoft employed "50 or so in-house lawyers, along with its outside retained counsel," all available to monitor compliance, he indicated that thecompany ought to be obliged to employ an internal compliance officer, such as a private inspector general. The judge, in accordance with his previously described views of Microsoft's business practices and positions taken in court, believed the decree should seek to fundamentally alter Microsoft's culture, perhaps even reduce its competitive zeal. Suffice it to say, those objectives exceed any legitimate concerns about actual compliance with the decree.

* * * * * *

When the government and a putative defendant present a proposed consent decree to a district court for review under the Tunney Act, the court can and should inquire, in the manner we have described, into the purpose, meaning, and efficacy of the decree. If the decree is ambiguous, or the district judge can foresee difficulties in implementation, we would expect the court to insist that these matters be attended to. And, certainly, if third parties contend that they would be positively injured by the decree, a district judge might well hesitate before assuming that the decree is appropriate. But, when the government is challenged for not bringing as extensive an action as it might, a district judge must be careful not to exceed his or her constitutional role. A decree, even entered as a pretrial settlement, is a judicial act, and therefore the district judge is not obliged to accept one that, on its face and even after government explanation, appears to make a mockery of judicial power. Short of that eventuality, the Tunney Act cannot be interpreted as an authorization for a district judge to assume the role of Attorney General.

Accordingly, the case is remanded with instructions to enter the proposed decree.

[After this, the Court appended a statement "per curiam" –by the full panel – ordering that the case should be assigned to a different district court judge on remand, because "t]he combined effect of the foregoing is to cause a reasonable observer to question whether Judge Sporkin "would have difficulty putting his previous views and findings aside" on remand. *United States v. Torkington,* 874 F.2d 1441, 1447 (11th Cir.1989)."]
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FRCP Rule 52
Federal Rules of Civil Procedure Rule 52

**UNITED STATES CODE ANNOTATED**
**FEDERAL RULES OF CIVIL PROCEDURE FOR THE UNITED STATES DISTRICT COURTS**
**VI. TRIALS**

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Amendments received to 3-25-02

Rule 52. Findings by the Court; Judgment on Partial Findings

**(a) Effect.** In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon, and judgment shall be entered pursuant to Rule 58; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court. It will be sufficient if the findings of fact and conclusions of law are stated orally and recorded in open court following the close of the evidence or appear in an opinion or memorandum of decision filed by the court. Findings of fact and conclusions of law are unnecessary on decisions of motions under Rule 12 or 56 or any other motion except as provided in subdivision (c) of this rule.

**(b) Amendment.** On a party's motion filed no later than 10 days after entry of judgment, the court may amend its findings--or make additional findings--and may amend the judgment accordingly. The motion may accompany a motion for a new trial under Rule 59. When findings of fact are made in actions tried without a jury, the sufficiency of the evidence supporting the findings may be later questioned whether or not in the district court the party raising the question objected to the findings, moved to amend them, or moved for partial findings.

**(c) Judgment on Partial Findings.** If during a trial without a jury a party has been fully heard on an issue and the court finds against the party on that issue, the court may enter judgment as a matter of law against that party with respect to a claim or defense that cannot under the controlling law be maintained or defeated without a favorable finding on that issue, or the court may decline to render any judgment until the close of all the evidence. Such a judgment shall be supported by findings of fact and conclusions of law as required by subdivision (a) of this rule.

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## Schedule 8
## APPEALS PART I GENERAL

*Interpretation*

1. In this Schedule-

"the chairman" means a person appointed as chairman of a tribunal in accordance with paragraph 27(2)(a) of Schedule 7;

"the President" means the President of the Competition Commission Appeal Tribunals appointed under paragraph 4 of Schedule 7;

"rules" means rules made by the Secretary of State under section 48;

"specified" means specified in rules;

"tribunal" means an appeal tribunal constituted in accordance with paragraph 27 of Schedule 7.

*General procedure*

2. - (1) An appeal to the Competition Commission must be made by sending a notice of appeal to the Commission within the specified period.

(2) The notice of appeal must set out the grounds of appeal in sufficient detail to indicate-

(a) under which provision of this Act the appeal is brought;

(b) to what extent (if any) the appellant contends that the decision against, or with respect to which, the appeal is brought was based on an error of fact or was wrong in law; and

(c) to what extent (if any) the appellant is appealing against the Director's exercise of his discretion in making the disputed decision.

(3) The tribunal may give an appellant leave to amend the grounds of appeal identified in the notice of appeal.

*Decisions of the tribunal*

3. - (1) The tribunal must determine the appeal on the merits by reference to the grounds of appeal set out in the notice of appeal.

(2) The tribunal may confirm or set aside the decision which is the subject of the appeal, or any part of it, and may-

(a) remit the matter to the Director,

(b) impose or revoke, or vary the amount of, a penalty,

(c) grant or cancel an individual exemption or vary any conditions or obligations imposed in relation to the exemption by the Director,

(d) give such directions, or take such other steps, as the Director could himself have given or taken, or

(e) make any other decision which the Director could himself have made.

(3) Any decision of the tribunal on an appeal has the same effect, and may be enforced in the same manner, as a decision of the Director.

(4) If the tribunal confirms the decision which is the subject of the appeal it may nevertheless set aside any finding of fact on which the decision was based.

4. - (1) A decision of the tribunal may be taken by a majority.

(2) The decision must-

(a) state whether it was unanimous or taken by a majority; and

(b) be recorded in a document which-

(i) contains a statement of the reasons for the decision; and

(ii) is signed and dated by the chairman of the tribunal.

(3) When the tribunal is preparing the document mentioned in sub-paragraph (2)(b), section 56 is to apply to the tribunal as it applies to the Director.

(4) The President must make such arrangements for the publication of the tribunal's decision as he considers appropriate.

## Appeals

*Appealable decisions.*

**46.** - (1) Any party to an agreement in respect of which the Director has made a decision may appeal to the Competition Commission against, or with respect to, the decision.

(2) Any person in respect of whose conduct the Director has made a decision may appeal to the Competition Commission against, or with respect to, the decision.

(3) In this section "decision" means a decision of the Director-

(a) as to whether the Chapter I prohibition has been infringed,

(b) as to whether the Chapter II prohibition has been infringed

,

(c) as to whether to grant an individual exemption,

(d) in respect of an individual exemption-

(i) as to whether to impose any condition or obligation under section 4(3)(a) or 5(1)(c),

(ii) where such a condition or obligation has been imposed, as to the condition or obligation,

(iii) as to the period fixed under section 4(3)(b), or

(iv) as to the date fixed under section 4(5),

(e) as to-

(i) whether to extend the period for which an individual exemption has effect, or

(ii) the period of any such extension,

(f) cancelling an exemption,

(g) as to the imposition of any penalty under section 36 or as to the amount of any such penalty,

(h) withdrawing or varying any of the decisions in paragraphs (a) to (f) following an application under section 47(1),

and includes a direction given under section 32, 33 or 35 and such other decision as may be prescribed.

(4) Except in the case of an appeal against the imposition, or the amount, of a penalty, the making of an appeal under this section does not suspend the effect of the decision to which the appeal relates.

(5) Part I of Schedule 8 makes further provision about appeals.

*Third party appeals.*

**47.** - (1) A person who does not fall within section 46(1) or (2) may apply to the Director asking him to withdraw or vary a decision ("the relevant decision") falling within paragraphs (a) to (f) of section 46(3) or such other decision as may be prescribed.

(2) The application must-

(a) be made in writing, within such period as the Director may specify in rules under section 51; and

(b) give the applicant's reasons for considering that the relevant decision should be withdrawn or (as the case may be) varied.

(3) If the Director decides-

(a) that the applicant does not have a sufficient interest in the relevant decision,

(b) that, in the case of an applicant claiming to represent persons who have such an interest, the applicant does not represent such persons, or

(c) that the persons represented by the applicant do not have such an interest,

he must notify the applicant of his decision.

(4) If the Director, having considered the application, decides that it does not show sufficient reason why he should withdraw or vary the relevant decision, he must notify the applicant of his decision.

(5) Otherwise, the Director must deal with the application in accordance with such procedure as may be specified in rules under section 51.

(6) The applicant may appeal to the Competition Commission against a decision of the Director notified under subsection (3) or (4).

(7) The making of an application does not suspend the effect of the relevant decision.

IN THE COMPETITION COMMISSION

APPEAL TRIBUNAL

Cases Nos. 1002/2/1/01(IR)
1003/2/1/01
1004/2/1/01

New Court
Carey Street
London WC2A 2JT

17 September 2001

Before:

SIR CHRISTOPHER BELLAMY (The President)
ANN KELLY
ADAM SCOTT

BETWEEN:

THE INSTITUTE OF INDEPENDENT INSURANCE BROKERS

Appellant

and

THE DIRECTOR GENERAL OF FAIR TRADING

Respondent

Supported by

THE GENERAL INSURANCE STANDARDS COUNCIL

Intervener

**and**

BETWEEN:

ASSOCIATION OF BRITISH TRAVEL AGENTS LIMITED

Appellant

and

THE DIRECTOR GENERAL OF FAIR TRADING

Respondent

Supported by

THE GENERAL INSURANCE STANDARDS COUNCIL

Intervener

Mr Nicholas Green QC and Mr James Flynn (instructed by Messrs Wilson Browne) appeared for the Institute of Independent Insurance Brokers

Mr Richard Fowler QC and Miss Kassie Smith (instructed by Messrs Nicholson Graham & Jones) appeared for the Association of British Travel Agents Limited

Mr Rupert Anderson and Mr Daniel Beard (instructed by the Director of Legal Services, Office of Fair Trading) appeared for the Director General of Fair Trading

Mr Aidan Robertson (instructed by Messrs CMS Cameron McKenna) appeared for the General Insurance Standards Council

JUDGMENT

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**Note:** For simplicity, this judgment will refer throughout to Articles 81 and 82 of the EC Treaty, whether in citations from judgments or otherwise, notwithstanding that the original citation referred to Articles 85 and 86 of the EC Treaty which were renumbered as Articles 81 and 82 by the Treaty of Amsterdam with effect from 1 May 1999.

## I INTRODUCTION

***The statutory framework***

1. The Competition Act 1998 ("the Act") came into force on 1 March 2000. This case concerns the application of section 2(1) of the Act which provides:

> "2. – (1) Subject to section 3, agreements between undertakings, decisions by associations of undertakings or concerted practices which–
>
> (a) may affect trade within the United Kingdom, and
>
> (b) have as their object or effect the prevention, restriction or distortion of competition within the United Kingdom,
>
> are prohibited unless they are exempt in accordance with the provisions of this Part."

That prohibition is known as "the Chapter I prohibition": see section 2(8).

2. Section 3 of the Act provides that the Chapter I prohibition does not apply to the various cases excluded pursuant to Schedules 1 to 4. Schedule 2 excludes, notably, the arrangements giving various bodies and organisations regulated under the Financial Services Act 1986. Schedule 3 excludes notably agreements made to comply with a legal requirement (paragraph 5), and agreements excluded by the Secretary of State on grounds of public policy (paragraph 7). Additional exclusions may be added by the Secretary of State acting under sections 3(2) and (3) of the Act. Schedule 4 of the Act excludes rules made by various professional bodies, although in a press release of 9 March 2001 the Government has stated its intention to seek the repeal of that Schedule.

3. Section 4 of the Act provides that the Director General of Fair Trading ("the Director") may grant an individual exemption from the Chapter I prohibition. Pursuant to section 9, the criteria for the grant of an individual exemption are that the agreement:

> "(a) contributes to–
>
> (i) improving production or distribution, or
>
> (ii) promoting technical or economic progress,
>
> while allowing consumers a fair share of the resulting benefit; but
>
> (b) does not–
>
> (i) impose on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives; or
>
> (ii) afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the products in question."

4. Under section 14 of the Act a party to an agreement may notify that agreement to the Director and apply to him for a decision as to whether the Chapter I prohibition has been infringed and, in the alternative, for the grant of an individual exemption.

5. These provisions are closely modelled on the corresponding provisions of Article 81 of the Treaty establishing the European Community ("the Treaty") and Council Regulation no. 17 OJ 1959-62, p. 87 as amended. So far as possible, the Act is to be interpreted and applied consistently with the principles of Community law: see section 60.

6. A party to an agreement in respect of which the Director has made a decision within the meaning of section 46(3) of the Act may appeal to this Tribunal against, or with respect to, that decision: sections 46(1) and 48(1).

7. Section 47 of the Act establishes a procedure for certain third party appeals. Where the Director has taken a decision as to whether the Chapter I prohibition has been infringed (see section 46(3)(a)), a person who is not a party to the relevant agreement but who demonstrates a "sufficient interest" may apply to the Director to withdraw or vary his decision. If the Director refuses that application, the third party may then appeal to this Tribunal under sections 47(6) and 48(1) of the Act. The appeals in the present case are both third party appeals brought under those provisions.

8. The powers of this Tribunal to determine appeals under sections 46 or 47 are set out in paragraph 3 of Schedule 8 of the Act, which provides:

> "3.–(1) The tribunal must determine the appeal on the merits by reference to the grounds of appeal set out in the notice of appeal.
>
> (2) The tribunal may confirm or set aside the decision which is the subject of the appeal, or any part of it, and may–
>
> (a) remit the matter to the Director,
>
> (b) impose or revoke, or vary the amount of, a penalty,
>
> (c) grant or cancel an individual exemption or vary any conditions or obligations imposed in relation to the exemption by the Director,
>
> (d) give such directions, or take such other steps, as the Director could himself have given or taken, or
>
> (e) make any other decision which the Director could himself have made.
>
> (3) Any decision of the tribunal on an appeal has the same effect, and may be enforced in the same manner, as a decision of the Director.
>
> (4) If the tribunal confirms the decision which is the subject of the appeal it may nevertheless set aside any finding of fact on which the decision was based."

9. The procedure governing appeals to this Tribunal is set out in the Competition Commission Appeal Tribunal Rules 2000, S.I. 2000 No. 261 ("the Tribunal Rules").

***The present appeals***

10. On 30 June 2000 the General Insurance Standards Council ("GISC") notified to the Director, in a voluminous notification under section 14 of the Act, the Rules of the General Insurance Standards Council ("the GISC Rules"). The GISC Rules are intended to establish a system of self-regulation governing the selling, advising or broking of general insurance carried on from a permanent place of business in the United Kingdom. Under the GISC Rules the term "general insurance" is defined by reference to the categories of business set out in Schedule 2 of the Insurance Companies Act 1982, namely insurance in respect of accident, sickness, land vehicles, railway rolling stock, aircraft, ships, goods in transit, fire and natural forces, damage to property, motor vehicle liability, aircraft liability, liability of ships, general liability, credit risk, suretyship, miscellaneous financial loss, legal expenses and assistance.

11. The Members of GISC comprise both insurers and intermediaries. Most United Kingdom insurers writing general business are Members of GISC. The intention of those promoting GISC is that the GISC Rules should apply to all intermediaries active in the supply of general insurance in the United Kingdom. Pursuant to Rule F42, the Members of GISC agree not to deal with intermediaries engaged in the selling, advising or broking of general insurance unless the intermediary concerned is a Member of GISC or the Appointed Agent or Sub-Agent of a Member of GISC.

12. From 26 July 2000 onwards the Institute of Independent Insurance Brokers ("the IIB") engaged in an extensive correspondence with the Director objecting to the GISC Rules and, in particular, to Rule F42.

13. The IIB is an association established in 1987. According to the IIB, it represents some 1,000 independent insurance broking firms in the United Kingdom, which is approximately half of all such firms. The members of the IIB service the needs of around 5 million private clients and 250,000 small and medium-sized commercial clients. The IIB strongly objects to its members being obliged to become Members of GISC by virtue of Rule F42 and seeks to establish its own system of self-regulation for independent broking intermediaries.

14. Similarly, by letters to the Director between 23 June 2000 and 4 December 2000, the Association of British Travel Agents Limited ("ABTA"), also drew the Director's attention to its opposition to the GISC Rules, in particular Rule F42.

15. ABTA is a well-known association in the travel industry which, among other functions, imposes regulatory requirements on its members, including bonding requirements to protect customers in the event of failure of an ABTA member. ABTA members include about 1,900 travel agents and 700 tour operators, and account for about 90% of package holidays sold in the United Kingdom. ABTA objects to Rule F42, and in particular to its members being compelled to join GISC in respect of the sale of travel insurance when they are already subject to regulation by ABTA, notably under Clause 1.7 of ABTA's Code of Conduct.

16. Having examined GISC's notification under section 14 of the Act, on 24 January 2001 the Director adopted Decision No. 98/1/2001 entitled "Notification by the General Insurance Standards Council" ("the GISC Decision"). In the GISC Decision the Director decided that the GISC Rules did not infringe the Chapter I prohibition.

17. On 22 February 2001 the IIB applied to the Director, pursuant to section 47(1) of the Act, to withdraw or vary the GISC Decision and substitute a finding that the GISC Rules infringed the Chapter I prohibition. On the same day the IIB asked the Director to adopt interim measures, pursuant to his powers under section 35 of the Act, on the basis that the viability of the IIB itself was being fatally undermined by the bringing into force of the GISC Rules.

18. On 23 February 2001 ABTA also made an application to the Director under section 47(1) of the Act to withdraw or vary the GISC Decision and to find an infringement of the Chapter I prohibition.

19. On 22 March 2001 the Director rejected the IIB's request for the adoption of interim measures in respect of the GISC Rules.

20. By two decisions dated 11 May 2001 addressed to the IIB ("the IIB Decision") and to ABTA ("the ABTA Decision"), respectively, the Director decided, pursuant to section 47(4) of the Act, that no sufficient reason had been shown for him to withdraw or vary the GISC Decision. In consequence he rejected the applications made by the IIB and ABTA under section 47(1) of the Act.

21. Pursuant to section 47(6) of the Act, the IIB appealed to this Tribunal against the IIB Decision by an appeal lodged on 11 June 2001. On the same day the IIB also lodged an application for interim relief, pursuant to Rule 32 of the Tribunal Rules. Pursuant to section 47(6) of the Act ABTA appealed to this Tribunal against the ABTA Decision by an appeal lodged on 15 June 2001.

22. At a case management conference held on 21 June 2001, GISC, a party intervening in these proceedings, agreed to write to its members, in terms satisfactory to the IIB, stating that Rule F42 was not yet in force and that, until its introduction under transitional rules on 1 September 2001, members of GISC were free to deal with non-Members. On that basis, the IIB did not pursue its application for interim relief. The implementation of Rule F42 is currently suspended pending the outcome of these proceedings.

23. Although these appeals are formally directed against the IIB and ABTA Decisions respectively, the substance of both appeals concerns the correctness, or otherwise, of the Director's finding, in the GISC Decision, that the GISC Rules fall outside section 2 of the Act. It is common ground that GISC is an "association of undertakings" and that the adoption of the GISC Rules constitutes a "decision by an association of undertakings" within the meaning of section 2(1). Similarly, it is common ground that the GISC Rules affect trade within the United Kingdom within the meaning of section 2(1)(a), and that none of the exclusions referred to in section 3 and Schedules 1 to 4 of the Act apply.

24. In the result, the main issue in these appeals is whether the GISC Rules, and in particular Rule F42, "have as their object or effect the prevention, restriction or distortion of competition within the United Kingdom" within the meaning of section 2(1)(b) of the Act.

## II FACTUAL BACKGROUND

### *The general insurance sector*

25. General insurance covers most kinds of non-life insurance. As regards consumers, the main kinds of general insurance are motor insurance, home insurance (buildings, contents, public liability etc), insurance for caravans, boats, animals and other property, travel insurance, medical and dental insurance, personal accident insurance, extended warranty insurance, legal expenses insurance and payment protection insurance of various kinds. In the commercial sector, general insurance includes marine, aviation, transport and property insurance, insurance against third party liability and pecuniary loss, and other miscellaneous risks. The evidence before us indicates only the broadest outline of the structure of the sector.

26. Figures contained in a Mintel Report annexed to GISC's intervention indicate that the total value of the market for general insurance in the United Kingdom in 1999 was approximately £27.2 billion, made up as follows:

| | £ '000 m |
|---|---|
| Property | 7.6 |
| Motor | 9.1 |
| Accident and health | 4.3 |
| Pecuniary loss | 3.5 |
| Liability | 2.7 |
| | 27.2 |

Within the pecuniary loss category, travel insurance accounted for £0.5 billion in 1999 and appears from the Mintel Report to be on a rising trend.

— *The insurers*

27. There are, we are told, over 100 companies actively underwriting general insurance business in the United Kingdom, leaving aside reinsurance companies, overseas companies and companies trading internationally in the London insurance market. In addition general insurance is underwritten by over 200 syndicates of Lloyd's underwriters. The carrying on of general insurance business as a principal is subject to prudential regulation under the Insurance Companies Act 1982. We understand that that regime will continue under the supervision of the Financial Services Authority ("FSA") in accordance with the Financial Services and Markets Act 2000 ("the FSMA") when that Act is fully in force: see Article 10 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ("the Regulated Activities Order").

28. It appears from figures submitted by the IIB and not contested that a number of leading companies (CGU/Norwich Union, Royal & Sun Alliance, AXA, Zurich, Cornhill and Direct Line) together account for around 60% of the general insurance sector, with rather larger market shares in sectors such as property and motor insurance. In the travel sector, it appears from the Mintel Report already cited that the largest underwriter is GE Financial Insurance (26%), followed by CGU/Norwich Union (15%), and AXA (14%) with the remainder of the market being accounted for by a number of other companies and Lloyd's underwriters.

29. For the purposes of the GISC Rules, general insurance activities also include reinsurance and retrocession, carried out, for example, by Lloyd's syndicates or specialised re-insurance companies. However, the reinsurance sector has not figured in the arguments of the parties. Similarly the activities of London market insurers and Lloyd's syndicates in the international London market for insurance and reinsurance appear to fall outside the scope of this case.

— *The selling, advising or broking of general insurance*

30. In the United Kingdom domestic market, insurance companies sell general insurance directly through their own direct sales operations (mainly over the telephone, on-line, through direct



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mail or direct response newspaper advertising), or through intermediaries. Direct selling by insurance companies, particularly to private consumers in sectors such as motor and household insurance, has expanded significantly since the establishment of Direct Line in the mid-1980s.

31. The main categories of intermediary have traditionally been (i) independent insurance brokers, including Lloyd's brokers, whose duty to the client is to give best advice and place the business with insurers on the most advantageous terms; (ii) single tied agents, who represent one insurance company; and (iii) multi-tied agents who under past practice have represented a number of insurance companies.

32. More recently, however, general insurance of various kinds has been increasingly sold by or through intermediaries who are not insurance specialists, but who offer insurance as a subsidiary part of their business or in connection with the sale of another product. Travel insurance, for example, is sold by travel agents, tour operators, supermarkets, banks, building societies, the Post Office and others, the policies being underwritten by insurance companies. Other insurance products are sold by banks, supermarkets and similar outlets. Many other concerns such as motor dealers, suppliers of computer equipment, household appliances and mobile phones, public utilities, furniture removers, suppliers of credit or store cards, and so on, offer various kinds of insurance as an ancillary part of their activities. As we understand it, these concerns will normally have arrangements with particular insurance companies either to introduce the business to them or to act as their agent in the sale of the product.

33. In a number of sectors intermediaries who offer insurance do not merely sell the insurance policies of insurance companies but devise their own insurance policies which they place with underwriters, as indicated in the evidence of Mr Howard, Chairman of the Association of Travel Insurance Intermediaries ("ATII"), filed on behalf of ABTA. According to Mr Kirsch, in evidence filed on behalf of the IIB, there is a "thriving intermediary market in insurance" where brokers set up special insurance schemes and themselves arrange underwriting for the policies in question. One particular example from the evidence of Mr Harris on behalf of the IIB appears to be that of Broker Direct Plc which apparently delivers motor insurance products to over 1,000 registered brokers under joint venture arrangements with Allianz Cornhill.

34. According to GISC's first consultation document published in 1998, brokers accounted for 50% of total premium income in the general insurance sector in the United Kingdom, other independent intermediaries (banks/building societies and others) accounted for 18% of premium income, and insurance company sales, directly and through company agents, accounted for 32%. GISC's notification to the Director indicates that, in 1998, 28% of sales of general insurance to

personal consumers were made through independent brokers, whereas in the commercial sector around 81% of sales were made through brokers. Some specialised types of insurance (e.g. title deed insurance) are sold through solicitors.

35. There are no firm statistics for the total number of insurance intermediaries in the United Kingdom. GISC originally estimated the number at 30,000 but we are told that GISC's latest estimate is around 15,000.

***The regulation of insurance intermediaries***

*— The historical position*

36. Until the developments associated with the introduction of the FSMA described below, the regulation of insurance intermediaries in the United Kingdom had three main aspects. First, the Insurance Brokers (Registration) Act 1977 ("the 1977 Act") established the Insurance Brokers Registration Council ("IBRC"). The IBRC regulated registered insurance brokers, and in particular established requirements regarding proper qualifications and training, the security of clients' money, adequate capital resources and other safeguards such as professional indemnity cover and a compensation fund. Under the 1977 Act, only intermediaries registered with the IBRC could use the title "insurance broker". Secondly, Lloyd's brokers, who were required by Lloyd's to be registered under the 1977 Act, were also subject to prudential regulation under the Lloyd's Act 1982. Thirdly, the Association of British Insurers ("ABI") established a voluntary General Insurance Business Code of Practice ("the ABI Code"). The ABI Code set out certain general principles regarding the sale of general insurance, and required non-registered independent intermediaries to carry professional indemnity cover. Under the ABI Code an intermediary could, subject to certain exemptions, be either the tied agent of one insurance company, or an agent of up to six companies (i.e. a multi-tied agent) or an independent intermediary. There were significant differences between the requirements of the ABI and those of the IBRC. The arrangements were regarded in some quarters as inadequate from the point of view of consumer protection and were notably the subject of a critical report published in 1997 by the National Consumer Council. A European Commission proposal for a Directive of the European Parliament and the Council on the regulation of insurance intermediaries in the European Union by means of a system of registration (COM (2000) 511 final) has not yet been adopted.

*— Reform of the regulation of financial services: the 1998 announcements*

37. In 1998 the Government announced its intention to undertake a wide ranging reform of the regulation of financial services. On 7 April 1998 the Economic Secretary to the Treasury (Helen Liddell MP) announced in Parliament that:

> "we propose to publish for consultation this summer draft legislation to reform the structure of financial services regulation. This will bring together regulation of investment business, deposit-taking and insurance business under a single regulator, the Financial Services Authority."

38. At the same time, the Government published a Treasury consultation paper – "Financial Services Regulatory Reform: Insurance Brokers and Other Intermediaries". The options considered in that paper were: not bringing the selling, arranging or advising on general insurance within the new regulatory regime, but taking powers to do so in the future; the establishment by the industry of "a clear standard of practice which will give customers an assurance of quality"; and the repeal of the 1977 Act. In that last connection the Treasury commented:

> "it would be open to the broker sector itself to establish a non-statutory successor body [to the IBRC] if it saw advantages in this. Such a body could operate a system, with all the necessary features – admission criteria, discipline and rules – for accrediting or recognising professional insurance brokers ... It might be appropriate for such a body to seek a Royal Charter and thereby to develop a form of chartered professional status for insurance brokers."

39. On 27 July 1998 the Economic Secretary to the Treasury (Helen Liddell MP) informed Parliament that the Government had decided to repeal the 1977 Act and to "look to the industry itself to put the desired standards on a soundly established footing from which they will command widespread support." A press release of the same date stated that "a majority [of those consulted] felt that the best way forward was offered by self-regulation by a body having support across the insurance industry, independent of insurers and intermediaries but taking their interests and those of their customers into account."

*— The reaction of the IIB to the 1998 announcements*

40. Following those announcements, in August 1998 the IIB called an extraordinary general meeting of its members which, we are told, was attended by over 500 brokers. That meeting agreed unanimously that the IIB should promote its own regulatory body to be a substitute for the IBRC. In the meantime, the IBRC itself had, following the Government's announcement, issued redundancy notices to its staff and began to wind up its affairs. In those circumstances the IIB suggested to the Treasury that it could provide the necessary infrastructure to enable regulation by the IBRC to continue to function until the effective repeal of the 1977 Act. The



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IIB was awarded a contract to do this and took on the necessary staff and premises. In this way the IBRC continued to regulate some 5,000 registered brokers until the eventual repeal of the 1977 Act which took place on 1 April 2001.

41. During that period the IIB itself worked on the principles and later the details of a set of rules known as IBRC Mk II which would form the basis for the continued regulation of IIB members by the IIB after the abolition of the IBRC. We are told that about 5,000 individual brokers applied to be registered on the IIB's "Institute Register of Insurance Brokers".

***The development and "empowerment" of GISC***

42. Meanwhile, in November 1998 the ABI, the Association of Insurance Intermediaries and Brokers, the British Insurance and Investment Brokers Association, the International Underwriters Association/London Insurance and Reinsurance Market Association, Lloyd's and The Lloyd's Insurance Brokers Committee published a first consultation document proposing the establishment of GISC as a single regulatory body for the sale of, and advice on, general insurance and reinsurance in the United Kingdom. According to GISC those sponsoring bodies together accounted for the vast majority of insurance placed and written in the United Kingdom.

43. It was recognised from the outset that GISC would not succeed unless there was some way in which all firms selling or giving advice on general insurance products could be brought within the GISC regime. The ABI consulted its members on this issue in September 1998 and concluded that "the only way to get organisations to submit to regulation by GISC would be for insurers to agree to deal only with distributors who are GISC members, and if they are direct writers, to be members themselves" (see GISC's notification to the Director, Form N, Schedule 10).

44. This aspect is referred to in paragraphs 3.7 to 3.10 of GISC's first consultation document of November 1998 which state, under the heading "Empowerment":

> "3.7. It has become apparent that there is only one way in which all firms who sell general insurance or give advice on general insurance products can be brought within the regulatory net. It is proposed that:
>
> - insurers which sell direct will be regulated by GISC;
> - insurers which assume responsibility for their agents will be regulated by GISC;
> - insurers will deal with brokers and intermediaries only if they are regulated by GISC; and

- insurers will only deal with agents for which they do not assume responsibility if the agents are regulated by GISC.

3.8 ABI members have already indicated preliminary agreement to these conditions, subject to seeing the details of the new regime. Everyone selling out of Lloyd's will be regulated either by Lloyd's or by GISC.

3.9 At first sight some may view this as insurers in some way 'capturing' the new regime or acting as regulators. This is not the case. The regulatory functions of setting the rules, monitoring of compliance, and taking disciplinary action against non-compliance will lie with GISC which will be independent of any particular sector of the industry.

3.10 It is true that empowerment of GISC will ultimately be achieved through insurers (for intermediary compliance) and trade associations (for insurer compliance). This is the only way in which such a regime can work. However, it is envisaged that GISC would only have recourse to insurers or trade associations as a very last resort, if it proved impossible to resolve compliance issues through any other route."

45. According to GISC, the response to its first consultation document was highly favourable. For example, a letter to GISC from Royal & Sun Alliance dated 3 February 1999, states:

> "As the largest non-life insurer in the UK, we fully support the establishment of a credible system of self-regulation, but strongly believe that this will only work if all interested parties agree to abide by "the rules". We are particularly concerned that significant sections of the market do not appear to have committed to the proposed regime. As an industry which is already subject to government scrutiny, we cannot afford to be divided on this issue and we all need to work hard to ensure that the system is upheld by all players. The consequences of failure will cost the industry dearly.
>
> ...
>
> We would only reiterate the point made in our covering letter regarding the absolute necessity of having the whole industry committed to the self-regulation process. Anything less than this position will mean that the industry has failed to obtain support for self-regulation and the reserve powers of the FSA/Treasury will be implemented. We firmly believe self-regulation represents the best way forward."

46. The Financial Services and Markets Bill was laid before Parliament on 17 June 1999. On 28 June 1999, Alan Milburn MP, Chief Secretary to the Treasury, said in Parliament:

> "Finally, on general insurance, my honourable friend will be aware that schedule 2 [of the FSMA Bill] provides for the regulation of a number of areas that are currently unregulated, including general insurance. We want to see whether the industry's own efforts through the new General Insurance Standards Council, can safeguard the public interest in the way that we want. We want to give that a fair wind and again, we shall monitor how well the industry puts its own house in order."

47. Similarly, on 1 July 1999, in a House of Commons Written Answer, the Economic Secretary to the Treasury (Patricia Hewitt MP) stated:



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> "I am pleased that the insurance industry, including general insurance intermediaries, has risen to the challenge outlined [by Helen Liddell MP]. A broad-based range of support has developed for the GISC, a new voluntary body to promote high standards of professional conduct among general insurance intermediaries.
>
> The GISC is committed to strengthening industry standards and developing the general insurance intermediaries' services to the public in all parts of the market. It plans to complement the statutory responsibilities of the FSA while stripping away unnecessary regulatory requirements on general insurance intermediaries. The GISC has gathered support with impressive speed. If it can fulfil its promise, it will provide valuable services to both general insurance intermediaries and their customers.
>
> There may in future be a case for statutory regulation of general insurance intermediaries. If so, the Financial Services and Markets Bill contains a provision which would enable the Treasury to specify regulated activity, and to give regulatory responsibility to the FSA. For the moment, I have no plans to specify advice on general insurance as a regulated activity."

48. On 20 October 1999 the ABI sent a circular to its members headed "Insurer Empowerment of the General Insurance Standards Council". In that circular the members of the ABI were asked to sign and return a form to the ABI confirming that, subject to being content with the final shape of GISC, the insurer in question would "undertake to join GISC if it sells direct, and to do business only through third party distributors that are also members of GISC."

49. On 25 October 1999 GISC issued its second consultation document setting out its proposals in more detail. According to GISC, the response to that document continued "to reflect overwhelming support for the concept of GISC as a single, independent, self-regulatory body for the insurance industry."

50. On 28 October 1999 the Economic Secretary to the Treasury (Melanie Johnson MP) stated at a Parliamentary Standing Committee on Delegated Legislation: that "the case for statutory regulation [of general insurance is] not proven ... I am pleased to say that progress in forming a General Insurance Standards Council has so far been very encouraging. I hope that all businesses that gain financially from the distribution of general insurance will respond positively to the challenge of self-discipline."

51. GISC was formally launched on 3 July 2000. On the occasion of the launch Stephen Timms MP, Financial Secretary to the Treasury, said:

> "In 1998, the Economic Secretary, Helen Liddell MP, challenged the industry to put in place arrangements that would offer a real alternative to statutory regulation of general insurance intermediaries. Has the industry risen to the challenge?
>
> ... I am both pleased and encouraged that the industry, in the broadest sense, has achieved so much in setting up the General Insurance Standards Council. No one

should doubt that the Government and the public want to see high standards of professional conduct among those who distribute general insurance products: from insurance companies and from insurance intermediaries..."

## III THE CONSTITUTION OF GISC AND THE GISC RULES

### *GISC*

52. GISC is a company limited by guarantee. The members of the company are at present the directors. GISC does not operate for profit but earns revenue from membership fees which are used to pay the costs of conducting regulation. GISC estimates that its future annual fee income will be of the order of £15 million when all United Kingdom intermediaries are members of GISC. Its current revenue from membership fees is about £6.5 million. GISC is not registered for VAT because, it says, it is not involved in the supply of goods or services.

53. At the date of these proceedings the Board of GISC was composed as follows. The brackets indicate each director's commercial background.

| **Director** | **Employer** | **(Background)** |
|---|---|---|
| Anthony Howland Jackson – Chairman | Formerly of Aon Group Ltd | (Lloyd's broker) |
| John Barton | Jardine Lloyd Thompson plc | (large independent broker) |
| Simon Bolam | E H Ranson & Co | (small independent broker) |
| The Rt Hon Baroness Dean of Thornton-le-Fylde | | (public interest member) |
| David Gittings | Lloyd's – Regulatory Division | (Lloyd's) |
| Anthony Latham | Royal & Sun Alliance Insurance plc | (insurer) |
| George Lowe | Formerly of Automobile Association Insurance Services Ltd | (large motor insurance intermediary) |
| Dr Oonagh McDonald CBE | | (public interest member) |
| Christopher McKee | Direct Line Insurance plc | (insurer selling direct) |
| John Miller | Anchor (UK) plc | (small intermediary) |
| Robert Newton | Formerly of CGU plc | (insurer) |
| Michael Pendle | Abbey National General Insurance | (large intermediary) |
| Michael Slack | Road Runner Group | (intermediary) |
| David Slade | Perkins Slade Ltd | (intermediary) |
| Previously – Stephen Wells who has now resigned as director | Formerly of National Westminster Insurance Services Ltd | (subsidiary of a bank) |
| Andrew Young | NFU Mutual | (insurer) |
| Christopher Woodburn – Chief Executive | GISC | |



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54. According to the material before us, the final constitution of GISC is not yet settled. In a third consultation document issued in December 2000 GISC proposed that: (a) GISC remain a company limited by guarantee; (b) there should be 16 directors, 10 elected, 5 independent, 1 Chief Executive; (c) regulated firms should become members of the company; (d) at least initially, there should be two categories of member, namely insurers and intermediaries; (e) members should be able to elect directors in their category; (f) there should be weighted voting rights; and (g) there should be a nominations committee to appoint the independent directors.

55. More specifically, in this consultation document the Board rejected for the time being the suggestion that a majority of the Board be independent directors, but proposed an increase in the number of independent directors from two to five. Of the ten elected directors, four would be elected by insurers and six by intermediaries.

56. As regards regulated firms becoming members of the company, the Board considered that the advantages of the regulated firms becoming members were:

> "accountability and transparency – the regulated businesses will have company law membership rights. The Board is therefore required to report to regulated businesses in their capacity as members of the company and regulated businesses can ultimately provide a check on the power of the Board.
>
> GISC is a self-regulating organisation and if regulated businesses are not members they will have no legal right to say how GISC is run;"

The Board concluded that:

> "the accountability and transparency provided by giving the regulated businesses a greater say in the running of the company will make GISC more attractive to potential members and, ultimately, enable it to meet its objectives more effectively."

57. As regards weighted voting rights, the Board considered:

> "that it is appropriate to acknowledge that a large business in the industry should, in principle, have a greater number of votes than a smaller business. This, of course, does not mean that the smaller businesses will have no influence. In practice, considerably more small businesses will be members of GISC and, together, they should be properly represented. The Board is therefore proposing that on balance 'weighted' voting would be appropriate, at least in the initial stages of GISC's development."

58. In relation to the election of directors, the Board considered that the advantages of members electing directors were:

> "5.4.1.1 the Board would be directly accountable to regulated businesses; and
>
> 5.4.1.2 an election process gives increased transparency;"

The Board concluded that the election of directors by the members:

> "gives the members a role in governance so they can satisfy themselves that an appropriate governance structure is in place (as proposed by the Cadbury Committee) and provides a formal and transparent procedure (in accordance with the Combined Code).

(We understand that the "Combined Code" is the document developed following recommendations of the Cadbury and other committees on corporate governance in public companies.)

59. The initial funding of GISC was approximately £2.1 million, of which intermediaries contributed just over 50%.

***The GISC Rules***

60. GISC's objective, as set out in Section A (paragraph 2) of the GISC Rules, is "to establish a single regulatory regime to monitor and enforce standards in all areas of General Insurance Activities". The various terms used in the Rules are defined in Section B. The requirements for membership are set out in Section F. The Rules themselves contain, notably, a code for private customers (Section C); a commercial code (Section D); practice requirements relating to e-commerce (Section E); membership practice requirements (Section G); rules relating to monitoring and investigation (Section H); and enforcement, disciplinary and appeal procedures (Sections I, J, and K). Details of the membership fees are at Appendix 2.

— *Definitions*

61. Under the GISC Rules as amended on 15 June 2000 and 24 October 2000, 'Regulated Activities' includes one or more of selling, advising or broking a 'General Insurance Product', that is to say one of the general insurance contracts listed in Schedule 2 to the Insurance Companies Act 1982. 'General Insurance Activities' means Regulated Activities carried on from a permanent place of business within the United Kingdom in connection with one or more General Insurance Products.

62. 'Insurer' means a person who writes a general insurance contract within the terms of Schedule 2 of the 1982 Act. 'Intermediary' means anyone who engages in General Insurance Activities who is not an Insurer, an Appointed Agent or Appointed Sub-Agent, an Introducer, a Service Provider or an Outsourcing Provider. An "Independent Intermediary" means an Intermediary who, in respect of any product type, offers or sells the products of more than one Insurer. A "product type" is defined as "any category of products which are competing or substitutable for one another".

63. An 'Appointed Agent' means a Non-Member who engages in General Insurance Activities on behalf of a Member pursuant to an Appointed Agent Agreement, and for whose General Insurance Activities the Member accepts responsibility. An 'Appointed Sub-Agent' is a Non-Member who engages in General Insurance Activities on behalf of an Appointed Agent or another Appointed Sub-Agent pursuant to an Appointed Sub-Agent Agreement and for whose activities the Member again accepts responsibility. An 'Introducer' introduces customers to members, Agents and Sub-Agents in return for fees or commission but does not advise or sell. We have not heard argument regarding Service Providers (e.g. actuaries, loss adjusters, salvage agents, vehicle repairers) and Outsourcing Providers (e.g. telephone call centres) who supply various ancillary services.

— *Membership*

64. Under Rule F1, Insurers and Intermediaries who engage in General Insurance Activities from a permanent place in the United Kingdom are able to apply for membership. Applicants not based in the United Kingdom may be considered for membership. Membership is determined by a Membership Committee, and is subject to appeal to a Membership Appeal Tribunal. The applicant must show that he is in a position to comply with the GISC Rules.

— *Rule F42*

65. For present purposes the most important Rule in the Membership Section is Rule F42 which provides:

> "Dealing with intermediaries
> Subject to any Rule waiver issued by GISC, Members shall not, and shall ensure that their Appointed Agents and Appointed Sub-Agents shall not, in the course of their General Insurance Activities, deal directly with any person in circumstances which would involve that person in engaging in General Insurance Activities as an Intermediary where that person is not a Member."

66. The effect of Rule F42 is that where an intermediary is not a Member of GISC, the insurer may deal with that intermediary only if he becomes an Agent or Sub-Agent of that insurer.

67. Rule F34 provides that "[w]here a Member decides to resign from Membership it must ensure that any General Insurance Activities which are outstanding are properly completed or responsibility for compliance with the Rules in respect of the resigning Member's Customers is accepted by another Member prior to resignation". Rule F37 provides that a Member remains subject to GISC's authority and jurisdiction for a period of two years from the date of termination or resignation of Membership.

68. Rule F14.18 provides that Members must agree to "state that they are Members of GISC in all advertising and communications with Customers and potential Customers in connection with General Insurance Activities and only use the GISC logo in accordance with instructions issued by GISC". We understand that the GISC logo has been registered by GISC as a service mark under the Trademarks Act 1994.

— *Agents and Sub-Agents*

69. Members may appoint Agents, who may in turn appoint Sub-Agents, who engage in general insurance activities on behalf of the Member and for whose conduct the member is responsible.

70. Rule F24 provides:

> "24. Insurers may not appoint an Independent Intermediary as an Appointed Agent or permit an Independent Intermediary to be appointed as their Appointed Sub-Agent for the purposes of offering or selling their General Insurance Products.
>
> An Independent Intermediary may only be appointed as an Appointed Agent or Appointed Sub-Agent of one Intermediary."

71. The effect of Rule F24, read with the definition of 'Independent Intermediary' is that an intermediary (for example a travel agent) cannot become an Agent of an insurer if he offers or sells the products of more than one insurer in respect of "the same product type". It follows that an intermediary such as a travel agent selling, for example, holiday cancellation insurance, must either become a Member of GISC or be tied to one insurer for holiday cancellation insurance.

— *The Codes*

72. The Private Customer Code is intended to ensure that general insurance customers are treated fairly and reasonably. The requirements cover such matters as explaining the service offered, matching the customer's requirements to the products and services offered, giving appropriate information, confirming the cover, observing service standards e.g. as to handling claims and issuing documentation, confidentiality, and handling complaints.

73. The Commercial Code contains similar requirements, based on a series of core principles, but is rather more broadly drawn. Failure to observe the Commercial Code is not apparently regarded as a breach of the GISC Rules as such.

74. The E-Commerce Code sets out requirements and advice regarding the offer of general insurance via the Internet, and in particular the information that must be supplied to the

Customer. The Member's website must display the GISC logo and a hyperlink to GISC's own site must be provided.

— *Membership Practice Requirements*

75. Section G contains the Membership Practice Requirements. Practice Requirement G1 covers the financial requirements which apply to intermediaries. The obligations cover areas such as segregation of insurance monies, holding and investing of insurance monies, investment principles, professional indemnity insurance, solvency and reporting and monitoring. Practice Requirement G1.18.2 disapplies the requirement for intermediaries to segregate clients' monies from their own monies where GISC is satisfied that "General Insurance Activities are secondary to the main business activity of the Intermediary". Practice Requirement G2 covers requirements concerning complaints handling. Practice Requirement G3 covers competence and training. Members must ensure that employees are properly trained and they must assess employees' competence on a regular basis. Employees should be adequately supervised and undertake continuing professional development.

76. Section H contains the rules regarding monitoring and investigation. GISC has appointed PricewaterhouseCoopers and Ernst & Young as monitors for an initial period of four years.

— *Enforcement and Discipline*

77. Where GISC considers that a GISC member may have breached one of the GISC Rules, it will refer the matter to an "Enforcement Committee". This Committee may impose on an infringing member a public reprimand; a fine; terms and conditions for continuing membership; suspension of membership; and expulsion and prohibition on re-application. The Enforcement Committee is selected from an "Enforcement Panel", the latter being appointed by the Board and consisting of public interest representatives, general insurance industry representatives, other individuals with sufficient experience of the general insurance industry, legally qualified individuals and Board members. The chairman or the deputy chairman of the Enforcement Panel (who must both be legally qualified and not a member of the Board) selects a minimum of four members from that panel to constitute an Enforcement Committee. The Enforcement Committee must include a minimum of a legally qualified chairman, two individuals with practical experience of the area of business relevant to the case and one public interest representative. If a GISC member does not agree with the decision of the Enforcement Committee, he has the right to have the case referred to a "Disciplinary Tribunal". A Disciplinary Tribunal is constituted from the Disciplinary Panel which is drawn from the same categories of persons as the Enforcement Panel but excluding Board members. There is a right

of appeal against any decision of a Disciplinary Tribunal to a "Disciplinary Appeal Tribunal". The Disciplinary Appeal Tribunal consists of a legally qualified chairman, one individual who has practical experience of the area of business relevant to the case and one public interest representative. Such an appeal only lies with permission and on a point of law or misinterpretation of the GISC Rules.

— *Fees*

78. Appendix 2, paragraph 7 of the GISC Rules sets out the membership fees payable by the GISC members. An intermediary must pay 0.1% of the amount due to it in relation to general insurance activities, net of all brokerage, fees, commissions and other income such as administration charges and overriders. An insurer must pay 0.025% of the gross premium income which it derives from general insurance activities, less any commission it pays to intermediaries or introducers. The minimum fee for membership of GISC is £200 per annum and the maximum annual fee is £100,000.

— *Exclusion of liability*

79. Rule A18 provides that "[i]n the absence of bad faith, GISC shall not be liable in damages for any loss, cost, damage or expense which arises from any act or omission of GISC in the discharge or purported discharge of GISC's powers or obligations under the Rules or in pursuance of its objective, whether arising from negligence, breach of contract or otherwise".

***The implementation of Rule F42***

80. It was envisaged from the outset that Rule F42 would be implemented in stages. The first step was taken by Lloyd's, who informed all Lloyd's Brokers by a circular of 31 May 2000 of an amendment to the Lloyd's Brokers Bye-law to the effect that:

> "A Lloyd's broker who is not a member of GISC by 3 July 2000 will not be permitted to place new or renewal business at Lloyd's until it becomes a member of the GISC. A Lloyd's broker who is not a member of the GISC by 1 September 2000 will be deregistered by Lloyd's."

81. By December 2000, according to GISC's third consultation document, GISC had about 800 members, including all Lloyd's brokers. According to GISC, it was envisaged that Members of GISC should not deal with intermediaries in breach of Rule F42 from 1 September 2001 with certain transitional arrangements applying until 1 January 2002. The evidence indicates, however, that at some stage members of GISC believed that 1 April 2001 was to be the starting date.

82. The following documents before the Tribunal indicate that considerable pressure has been placed on intermediaries to join GISC:

— A circular from AXA Insurance in October 2000 states that AXA Insurance "has joined GISC and is actively encouraging all distributors of general insurance products to do the same" and that "Right now, membership is voluntary and open to all brokers, intermediaries and direct sellers of general insurance. But in time – probably late 2001, early 2002 – when the Competition Authorities have given appropriate clearance, membership will become mandatory".

— A circular from PPP Healthcare, a subsidiary of AXA, in October 2000 refers to GISC as the "new regulator within the general insurance industry" and states that "we are now able to consider full terms for intermediaries currently holding Corporate only terms of business. This can be arranged provided you are, or once you become, a member of the GISC".

— A letter of 23 October 2000 from Groupama Insurances to an IIB member states that "the expected implementation of GISC Rule 42 in April 2001, will create a single, coherent regulatory system for the general insurance industry. This will in effect make membership mandatory for independent intermediaries and brokers (...) In simple terms, Groupama Insurances has taken the decision to trade only with full time insurance intermediaries registered as GSIC members and we are now establishing user friendly procedures to ensure compliance in this important area" (...) "With effect from April 2001, no organisation will be permitted to carry on general insurance business or offer advice without becoming a member. With this in mind, we believe that it is vital for you to apply for membership now so that you are ready and able to trade under the new regime".

— A letter of 7 February 2001 from Western Provident Association to its intermediaries states that "WPA will only recognise GISC member intermediaries from [1 April 2001], and all non registered agreements will be terminated (...) Therefore, if you are not presently registered with the GISC, I urge you to do so immediately to ensure your agreement with WPA is not affected in any way."

— A letter from PPP Healthcare of 1 March 2001 to an IIB member states that "it has been decided that as from 1 April 2001, membership of the GISC will be mandatory for all intermediaries wishing to set up Terms with PPP healthcare. Therefore, we recommend that you apply to them without delay. (...) If you respond and we are able to process your application by 16 March 2001, we will consider your request for Terms. (...) We regret that if we do not hear from you by 16 March 2001, we will have to lapse your application, unless you have registered with the GISC".

— A letter of 6 March 2001 from Iceni Motor Facilities to an IIB member states that "we will require written confirmation from yourselves of the name with which you appear on the GISC membership list in order that we can confirm your membership and continue to arrange the policy via your Company" (...) "...if we do not hear from you by 01/04/2001 we shall assume that you are not a member of the GISC and we will therefore deal direct with the client from that point".

— A circular of 4 May 2001 from Highway Insurance requests details of intermediaries' GISC membership number and date of application. It also states that "Highway Insurance will not be able to trade with any firm which is not a GISC member, or a GISC applicant, after [1 September 2001]. After 31 December 2001, we can only trade with GISC members".

— A letter of 7 July 2001 from Legal & General to an IIB member states that "as a member of GISC Legal & General will as from 1 September 2001 only be prepared to deal with GISC members or those that have applied for membership at that time".

— A letter of 12 July 2001 from Markel 702 (UK) Limited to an IIB member states that Markel has "taken a Management decision to deal only with those Agents who are existing GISC members or who will apply for membership prior to 1 September 2001". It goes on "I must advise you that we will be unable to issue any renewal documentation to you, provide quotations or accept any new business for risks renewing/incepting on or after 1 September 2001." (...) "Consequently you may wish to make alternative arrangements for your Clients after 1 September".

— A letter of 13 July 2001 from Zurich Insurance states that Zurich "strongly advise all our agents to join GISC in line with rule F42 (...) It is important that we establish your intentions regarding GISC, as this matter needs to be resolved before September (the deadline for applications to GISC)."

— A letter of 18 July 2001 from Alexander Forbes requests the "current status with regard to [the IIB member's] membership with GISC".

83. The Tribunal notes that a number of these letters were written after these proceedings had been commenced and after GISC had reminded its members, by a letter put on its website on 25 June 2001, that Rule F42 was not yet in force and that GISC Members were free to deal with non-Members until 1 September 2001. It was on the basis of that letter that the IIB decided not to pursue its claim for interim relief.

84. Following the fixing of the date for hearing of these appeals, the deadline of 1 September 2001 was postponed until 15 October 2001. Following the hearing on 20 and 23 July 2001, GISC confirmed to its members by letter of 27 July 2001 that the operation of Rule F42 will remain suspended pending the outcome of these proceedings, thus postponing both the 15 October and 31 December 2001 deadlines.

85. We were told that, as at 24 July 2001, more than 85 to 90% of United Kingdom insurance companies active in the general insurance sector were Members of GISC, although few Lloyd's syndicates had so far joined. As regards intermediaries, about 4,200 had been admitted to Membership, and another 1,500 applications were being processed. Since there are estimated to be over 15,000 intermediaries in the United Kingdom, that leaves about 9,000 to 10,000 intermediaries who are not yet Members of GISC. Of those, some 2,500 are ABTA members. On the evidence before us, about 1,000 broking firms are members of the IIB, a large number of which have, apparently, not so far joined GISC. As to the remainder, we were told by GISC on the second day of the hearing that "many firms may decide to go down the agency route and therefore they stop being a potential intermediary, they actually become an agent, and so the number of intermediaries may yet further decline".

86. As far as the IIB is concerned, the IIB applied to GISC for a waiver of Rule F42 by letter of 26 October 2000. That request was refused by GISC by letter of 21 November 2000. The IIB applied again to GISC for a waiver by letter of 20 February 2001 which request was refused by GISC by letter of 15 March 2001, mainly on the ground that such a waiver would undermine the principle of GISC as a sole regulator. It appears from a letter from ABTA to GISC of 7 March 2001, which records comments made by GISC during a working party on Rule F42, that GISC does not consider waivers in favour of organisations such as ABTA to be appropriate. GISC's letter to ABTA of 18 June 2001 indicates that GISC could see no justification "for compromising the fundamental principle that where there is customer choice regulatory responsibility should rest in one place..."

## IV THE PROCEDURE BEFORE THE DIRECTOR AND THE GISC DECISION

### *The submissions made to the Director*

87. Meanwhile, following the GISC notification on 30 June 2000, GISC, the IIB and ABTA all made submissions to the Director prior to the adoption of the GISC Decision on 24 January 2001. The Tribunal has no information as to the observations submitted to the Director by any other persons, notably in response to a public invitation to submit comments published by the Director in the Office of Fair Trading Weekly Gazette (Issue 35/2000, 21–27 October 2000).

88. A number of meetings and regular communication took place between representatives of GISC and the Director both before and after the notification. By letter of 3 March 2000, before the notification had formally been made, the Director asked GISC to ensure that all material information, including information on the extent to which membership of GISC was in practice required, was provided to him. In very brief outline, GISC's main arguments were as follows.

(i) GISC is instituted, with the blessing of the Government, to provide a harmonised set of standards for those engaging in general insurance activities from a permanent place of business in the UK. This system is well suited to the variety of different distribution channels that have developed over recent years including direct selling, internet sales and the growth in sales of financial services products by intermediaries such as supermarkets.

(ii) The Director's decision is sought on the basis that up to 100% of insurers and intermediaries who are eligible to join GISC will do so.

(iii) The overall aim of the GISC regime is pro-competitive and the analysis of the GISC Rules should be undertaken in that context: it will serve the public interest by delivering an appropriate level of customer protection whilst introducing a level-playing field for competition. It will tackle the inadequacies of the current regime, harmonise the system and remove unnecessary fetters on the operation of competition. Consistent market conditions will facilitate more open competition and contribute to greater opportunities for distribution of general insurance products.

(iv) It was established by the European Commission in the *London Futures* cases (*London Grain Futures Market* OJ 1987L19/22; *London Sugars Futures Market* OJ 1985 L369/25; *London Cocoa Terminal Market* OJ 1985 L369/28; *London Coffee Terminal Association* OJ 1985 L369/51) that systems of self-regulation do not fall within Article 81(1) provided that membership is open, clear and objective; and that the rules are proportionate to the aims of the association. The GISC regime fulfills all of these criteria. Moreover, in accordance with Case C-250/92 *Gøttrup-Klim v DLG* [1994] ECR I-5641, there are no provisions which are directly restrictive of competition: no group within the market will be able to use control of GISC to distort competition in its favour; the GISC Rules are necessary and proportionate to GISC's regulatory objectives; and small firms will benefit from the GISC regime.

89. The IIB made the following main points as regards the Chapter I prohibition. (The IIB also advanced arguments under the Chapter II prohibition imposed by section 18 of the Act (abuse of a dominant position) but those arguments have not been pursued before us.)

(i) The GISC Rules have as their object or effect the prevention, restriction or distortion of competition within Chapter I. By virtue of Rule F42 non-member intermediaries will be denied access to 80% of the insurers' market and the whole of the Lloyd's underwriting market. In addition, regulation of intermediaries by insurers is subject to material conflicts of interests, would result in the loss of independent advice, and lead to a general levelling down in standards of regulation. Since GISC seeks to regulate those intermediaries who have not previously been able or willing to satisfy the requirements of the IBRC, the GISC Rules will inevitably lead to lower standards of advice and a loss of protection for both consumers and businesses.

(ii) GISC cannot be granted an individual exemption under section 4 of the Act: (a) the restrictions are not indispensable, since other forms of regulation exist; and (b) the effect of the GISC Rules will be to eliminate competition in respect of independent insurance intermediary services. Brokers will not be able to continue to operate through their own regulatory regime unless they also join GISC. The burden on those brokers of two regulatory regimes will distort or prevent competition.

(iii) Should the Director fail to act, the result will be that brokers and intermediaries will be forced into GISC as a fait accompli and it will not be possible to reverse the position.

90. ABTA raised the following main points:

(i) The cost of GISC's regulation of the travel industry, which accounts for a tiny proportion of general insurance sales in the United Kingdom, is disproportionate: ABTA members' sale of insurance typically accounts for less than 2% of their total turnover. The costs of joining GISC will place a financial burden on the travel industry in excess of £2 million a year.

(ii) Travel agents will effectively be tied to one intermediary or insurer and will be unable to offer a range of travel products. This stifles competition and narrows consumer choice.

(iii) Rule F42 introduces a "closed shop" system which excludes ABTA members who do not join GISC from access to the insurance market. It reduces the ability of travel agents and tour operators to compete with mainstream insurers in the sale of travel insurance policies. ABTA should remain as the regulator for the travel industry, including travel insurance activities.

***The GISC Decision***

91. The GISC Decision first summarises the facts and the contents of GISC's notification. Paragraph 8 of the Decision makes it clear that GISC has requested a decision on the basis that it

will regulate the whole of the general insurance community in the United Kingdom, estimated at up to 16,000 eligible members: (see also paragraph 25 of the GISC Decision).

92. At paragraphs 24 and 25 of the GISC Decision, the Director found that GISC is an association of undertakings; that GISC's adoption of the Rules is a decision of an association of undertakings for the purposes of section 2 of the Act; that the Rules may also be characterised as an agreement or concerted practice between the members of GISC who are undertakings for the purposes of section 2 of the Act; and that the Rules affect trade within the United Kingdom within the meaning of section 2 of the Act.

93. As regards the issue whether the GISC Rules "have as their object or effect an appreciable prevention, restriction, or distortion of competition", paragraph 27 of the GISC Decision states that the Director has considered whether the Rules:

> "(i) impose or increase barriers preventing entry into or continued operation in the general insurance industry;
>
> (ii) reduce or distort competition between insurers, between intermediaries or between insurers and intermediaries; or
>
> (iii) result in the exchange of price or non-price information.

94. At paragraphs 29 to 32 of the GISC Decision the Director states:

> "29. The Director has decided that none of the Rules notified by GISC, by themselves or in combination with the other Rules, have as their object or effect an appreciable prevention, restriction or distortion of competition within the UK for the purposes of the Chapter I prohibition. The Rules are aimed at ensuring that members of GISC are competent to carry on general insurance activities and that there are safeguards in place to protect consumers. In order to achieve these necessary protections, the Rules impose standards which members must meet and procedures for enforcing them. To be effective, a self-regulatory framework of this nature will necessarily act as a control, to ensure competence and consumer protection, on the undertakings that operate in the relevant market. It does not follow from this that such a framework will, therefore, result in an appreciable prevention, restriction or distortion of competition. Indeed, in this case the Director is satisfied that the consumer benefits flowing from the Rules will not be undermined in this way. The Rules do not impose significant barriers to operating in the general insurance industry as the requirements and costs of compliance appear to be reasonable and will not result in an appreciable reduction or distortion in the overall level of competition. To be sure, the Rules impede businesses that lack competence or that operate in ways that jeopardise consumers. But that is not anti-competitive. Indeed, it may be positively pro-competitive as between the competent businesses that have proper safeguards in place to protect consumers.
>
> 30. The Director considers that the terms of membership and the membership application, enforcement and intervention procedures in GISC's Rules are transparent, non-discriminatory and based on objective standards. GISC's

membership fees do not operate as a barrier preventing entry into or continued operation in the general insurance industry for the purposes of section 2 of the Act. The Rules contain a clear description of the membership application, enforcement and intervention procedures that GISC will operate, under which GISC must provide reasons for its decisions and which include an appeals procedure.

31. The financial requirements in the Rules are transparent, non-discriminatory and based on objective standards. The exceptions to the financial requirements that are provided for in the Rules seek to make the application of the Rules proportionate to particular sectors and reflect the size and diversity of the general insurance community that GISC intends to regulate through its Rules.

32. The Director has not identified any provisions in the General Insurance Code for Private Customers or the Commercial Code which have as their object or effect an appreciable prevention, restriction or distortion of competition within the meaning of the Chapter I prohibition. In particular, the provisions in the Codes (and the Rules more generally) do not introduce artificial regulatory barriers in the number of insurers with whom an intermediary may do business or vice versa. The Director does not have any evidence to suggest that the Rules will result in the exchange of commercially sensitive information between those regulated by GISC which may raise concerns under the Chapter I prohibition."

95. The Director deals with Rule F42 at paragraphs 34 to 35 of the GISC Decision:

"34. Rule F42 is the means by which GISC will try to achieve its objectives and establishes a common regulatory framework for intermediaries, who will have to comply with GISC's Rules whether they choose to join GISC as full members or are regulated as appointed agents or appointed sub-agents via their relationships with members. Rule F42 does not require that all intermediaries become full members of GISC. The definition of intermediary in the Rules excludes, among others, appointed agents and appointed sub-agents. This section of the general insurance community is regulated through a principal member of GISC, with whom they have entered into an appointed agent or appointed sub-agent agreement. The principal will accept responsibility for their appointed agents' and appointed sub-agents' compliance with the Rules.

35. Rule F42 will prevent members of GISC and their appointed agents and appointed sub-agents from carrying on general insurance business with UK intermediaries who are not members of GISC. The Director does not have any indication that this Rule will result in significant numbers of intermediaries exiting from the market such that competition in the market will be reduced appreciably. Furthermore, it is open to members to enter into appointed agent and appointed sub-agent agreements to allow them to continue to do business with intermediaries who choose not to become GISC members. The Director has therefore concluded that Rule F42 will not give rise to an appreciable restriction or distortion of competition.

## V THE SECTION 47 DECISIONS

***The IIB's Section 47 Application***

96. In its section 47 Application dated 22 February 2001, which was supported by a number of witness statements by IIB members, the IIB submitted: that Rule F42 forces IIB Members to join GISC – at a high cost – and thus prevents them from submitting to regulation by other bodies, with a consequent restrictive effect on competition between providers of regulatory services; the 'exit test' applied by the Director at paragraph 35 of the GISC Decision was the wrong test in assessing whether competition was prevented, restricted or distorted by Rule F42; the GISC Rules would adversely affect the competitiveness of intermediaries, notably in impeding businesses that have higher regulatory standards than those required by GISC, in depriving such businesses of the possibility to differentiate themselves by virtue of higher regulatory standards, and in forcing certain independent intermediaries into 'agency' status to the advantage of GISC Member networks; the membership fees discriminated in favour of insurers; the relaxation of the requirement of segregation of clients' monies for firms where insurance was a secondary part of their activities gave such firms an unfair competitive advantage; and GISC's ability to grant waivers of Rule F42 was wholly subjective and not susceptible of appeal.

97. The IIB also made an application for interim relief also dated 22 February 2001 on the basis of infringements of both Chapter I and Chapter II. The IIB drew the Director's attention to the pressure being put on intermediaries to join GISC to which we have already referred (namely the circulars from AXA and PPP Healthcare in October 2000, the letter from Groupama Insurances of 23 October 2000 and the letter from Western Provident Association of 7 February 2001) and contended that the IIB was facing a drain of members that would make it impossible for the IIB to establish an alternative basis of regulation.

98. The IIB wrote to the Director reminding him of the gravity of the situation by letters of 5, 7, 14 and 19 March, 2001 again drawing attention to the pressure to join GISC being exerted on IIB Members by GISC members and referring to the letters from PPP Healthcare of 1 March 2001 and Iceni Motor Facilities of 6 March 2001. On 20 March 2001 the IIB informed the Director that they would have to make staff redundant and requested a definite response by 21 March 2001. The Director rejected the IIB's application for interim relief by letter of 21 March 2001.

99. The IIB continued to press the Director for a decision on the section 47 application, so as to enable the IIB to bring the matter before this Tribunal, by letters of 23 March, 26 March, and

12 April 2001. The Director replied on 18 April 2001 to the effect that 'no firm date' could be given.

100. On 30 April 2001 the IBRC was wound up pursuant to the repeal of the 1977 Act. According to the IIB, about 5,000 individual brokers had by then been registered on the Institute's register, but the IIB did not feel it could confidently proceed with IBRC Mk II without either a positive response from the Director or a successful appeal to this Tribunal. In a press release of 1 May 2001, Mr Paddick expressed his disappointment that the IIB had still not received a reply by the Director to the IIB's section 47 application of 22 February 2001, commenting that "such a ridiculous situation must either amount to competition law gone mad or being very wrongly applied".

101. On 3 May 2001 the IIB notified to the Director that, as a result of the absence of a decision under section 47, they had been obliged to make their entire regulatory division redundant and to put their premises on the market.

102. The Director rejected the section 47 application by the IIB Decision of 11 May 2001.

***The IIB Decision***

103. As regards the IIB's submission that the GISC Decision failed to analyse the impact of Rule F42 on competition between providers of supervisory and regulatory services, the Director found as follows at paragraph 17 to 18 of the IIB Decision:

> "... [The GISC Decision] did not address the question of whether the Rules could or were intended to affect competition within a market for supervisory and other regulatory services.
>
> As noted at paragraph 29 of the Decision, the Rules are aimed at ensuring that members of GISC are competent to carry on general insurance activities and that there are safeguards in place to protect consumers. The Director considers that regulation of this nature is not an economic activity but is implemented in the wider public interest. The function of GISC is to consider, prepare and implement rules which regulate the economic activities of undertakings in the general insurance sector. In light of European case law, this does not constitute an economic activity. Furthermore, GISC does not itself carry out general insurance activities. Consequently, the Director has no grounds for believing that, in carrying out its regulatory functions under the Rules, GISC competes economically with the IIB or any other trade association or supervisory body. On this basis, the Director is of the view that, for the purposes of the Act, GISC is not an undertaking in its own right."

104. As regards the IIB's submission that Rule F42 would drive out of business firms that do not join GISC and adversely affect the competitiveness of those who did join, the Director said at paragraphs 20 to 25 of the IIB Decision:

> "20. The Director concluded [in the GISC Decision] that a mandatory scheme of this nature would not infringe the Chapter I prohibition provided the agreement which establishes it does not, to an appreciable extent:
>
> — impose or increase barriers preventing entry into or continued operation in the general insurance industry; or
>
> — reduce or distort competition between insurers, between intermediaries or between insurers and intermediaries (for example, by resulting in the exchange of price or non-price information).
>
> 21. In the Decision, therefore, the Director considered whether the Rules would, individually or collectively, have any of these effects and was satisfied that they would not. He therefore concluded that Rule F42 will not give rise to an appreciable restriction or distortion of competition in the general insurance market.
>
> 22. The IIB has submitted that changing regulatory regimes may, in the future, impact on the ability of an intermediary who is a member of GISC to compete with other intermediaries, insurers and other industry players. GISC has introduced a new self-regulatory regime for the entirety of the general insurance community that it intends to regulate. In these circumstances, there is no reason to believe that intermediaries who fall within GISC's regulatory framework will, by virtue of this, be disadvantaged as compared with their competitors.
>
> 23. The IIB submits that the Director has failed to consider the impact on competition through the lowering of regulatory standards. Under Section 14(2) of the Act, the Director was asked to consider the application of the Chapter I prohibition to the Rules notified by the GISC. This required an objective analysis of the Rules to determine whether they had as their object or effect an appreciable prevention, restriction or distortion of competition within the UK. For these purposes, as set out in the Decision, the Director considered whether the Rules would impose or increase barriers to entry into or continued operation on the general insurance market; reduce or distort competition between markets participants; or otherwise prevent, restrict or distort competition, for example through the exchange of information. It was not necessary and would not have been appropriate for the Director to carry out a comparative analysis of the different types of regulation that may currently or in the future exist in the industry. The primary concern of the Director was to determine whether the GISC Rules themselves were objective, transparent and non-discriminatory and did not raise barriers to entry, a position that would stand regardless of the existence of alternative forms of regulation which may impose higher or lower requirements on those that they regulate.
>
> 24. As noted by the IIB, the Rules do not prohibit members of GISC from also being members of other trade associations or regulatory bodies. It is open to independent intermediaries and other segments of the market to seek to differentiate their services from others by setting up and promoting themselves as being subject to enhanced standards. The Director's Decision does not prevent this from occurring. The IIB has submitted that there are additional costs involved in belonging to a further trade association or

regulatory body in addition to GISC. This was not the basis on which the Director considered the application of the Chapter I prohibition to the Rules. In his analysis, the Director considered the Rules and concluded that they do not impose significant barriers to operating in the general insurance industry as the costs of compliance with GISC regulation appear to be reasonable.

25. The IIB has not produced any evidence to show that Rule F42 will work substantially to the business advantage of GISC member networks such that competition would be restricted or distorted to an appreciable extent."

105. As regards the granting by GISC of waivers of Rule F42, the Director said at paragraph 31:

> "31. The Director considered whether the terms of membership and the membership application, enforcement and intervention procedures in the Rules were transparent, non-discriminatory and objective and was satisfied that they were. As noted at paragraph 30 of the Decision, the membership application, enforcement and intervention procedures that GISC will operate are clearly described, require GISC to provide reasons for its decisions and include an appeals procedure. In the light of these points and of his overall assessment that Rules do not give rise to a barrier to entry and do not restrict or distort competition, the fact that GISC has the ability to waive Rule F42 does not alter the Director's assessment of the competitive effects of the Rules."

106. The Director also considered, and rejected for lack of evidence, the IIB's submissions on the questions of membership fees and segregation of monies under the GISC Rules (see paragraphs 26 to 30 of the IIB Decision).

***ABTA's Section 47 Application***

107. In its section 47 application dated 23 February 2001 ABTA submitted, notably, that Rule F42 is prima facie an appreciable restriction on competition since it places a restriction on the persons with whom an undertaking may deal and forms part of a large scale collective exclusive dealing arrangement covering practically the whole of an important economic sector. The Director's contrary view, at paragraph 35 of the GISC Decision, contains two errors: (i) the Director's 'exit' test represents only a part of the test for a material restriction on competition, and overlooks the fact that Rule F42 will in practice force ABTA members into membership of GISC, thus causing additional costs and affecting their competitiveness; (ii) the possibility that ABTA members could avoid becoming members of GISC by accepting appointments as Appointed Agents or Sub-Agents of GISC members overlooks Rule F24 which in effect precludes Appointed Agents or Sub-Agents from dealing with more than one insurer. That would severely limit the commercial freedom of ABTA members who customarily deal with several insurers. In addition, ABTA submitted that in paragraph 30 of the GISC Decision the Director had failed adequately to analyse the discriminatory effect of the GISC fees which

resulted in transactions through intermediaries being charged at a rate that was four times that charged for transactions through insurers selling direct.

***The ABTA Decision***

108. As regards Rule F42, the Director rejected ABTA's submissions at paragraphs 16 to 22 of the ABTA Decision:

> "16. When carrying out any analysis under the Chapter I prohibition of the Act, it is important to consider the overall effect of an agreement, taking account of the characteristics of the market on which it will operate, rather than just to consider individual provisions of the agreement in isolation. On this basis, the Director does not accept ABTA's submission that Rule F42 is prima facie a restriction of competition within the meaning of the Chapter I prohibition.
>
> 17. As noted at paragraph 25 of the Decision, GISC intends to regulate the whole of the general insurance community in the UK. Rule F42 is intended to achieve this since, once in force, it will bring into effect a form of compulsory regulation for intermediaries.
>
> 18. The Director concluded that a mandatory scheme of this nature would not infringe the Chapter I prohibition provided the agreement which establishes it does not, to an appreciable extent:
>
> — impose or increase barriers preventing entry into or continued operation in the general insurance industry; or
>
> — reduce or distort competition between insurers, between intermediaries or between insurers and intermediaries (for example, by resulting in the exchange of price or non-price information).
>
> 19. In the Decision, the Director considered, therefore, whether the Rules would, individually or collectively, have any of these effects and was satisfied that they would not. He therefore concluded that Rule F42 will not give rise to an appreciable restriction or distortion of competition in the general insurance market.
>
> 20. This conclusion took account of the fact that the Rules (including Rule F42) are intended to apply across the general insurance industry in the UK. Further in reaching that conclusion, the Director considered the membership fees of GISC and was satisfied that they would not operate as a barrier to entry or continued operation in the general insurance industry.
>
> 21. The Director noted at paragraph 35 of the Decision that the appointed agent and appointed sub-agent regime in the Rules provides one way in which intermediaries may avoid becoming full members of GISC. The Director recognises, however, that non-member intermediaries which enter into such arrangements remain subject to restrictions as to the member intermediaries and member insurers with which they can deal and that, given these restrictions, intermediaries may conclude that it will be more commercially advantageous to become full members of GISC. Nevertheless, given his conclusion that the Rules do not impose significant barriers to entering or operating in the general insurance market, this does not alter the Director's assessment set out in the Decision of the competitive effects of the Rules. For the same reason, the Director does not consider that the restrictions on those with which non-member agents may deal (and on the ability of

members to deal with non-member agents) are capable of constituting an appreciable restriction or distortion of competition in the relevant market.

22. The Director is not convinced that it will be so commercially unattractive to enter into agency and sub-agency agreements that intermediaries will be forced to exit the market. In any event, for the reasons set in paragraphs 16-21 above and in the Decision, the Director does not consider that Rule F42 will appreciably restrict competition between member insurers or distort competition between non-member agents and member intermediaries."

109. At paragraphs 23 to 25 of the ABTA Decision, the Director rejected ABTA's arguments regarding the GISC membership fees, on the basis that it was not demonstrated that the fee structure conferred any significant advantage on insurers. As regards the burden of regulatory costs, the Director considered (at paragraph 26) that these were not shown to be significant and that it was open to the members of GISC to belong to other trade associations or regulatory bodies. The Director added: "It would be open to other organisations, such as ABTA, to resolve any concerns they have about the costs to their members of regulation by, for example, reducing their own membership fees or ensuring that, when calculating their members' fees, they do not take into account revenue generated from their members' general insurance activities and on which their GISC membership fees are based."

110. We note that a detailed explanation of the basis for the calculation of the membership fees was provided to the Director by GISC on 17 May 2001, shortly after the adoption of the IIB and ABTA Decisions.

## VI THE PROCEDURE BEFORE THE TRIBUNAL

111. The applications in these appeals were lodged at the Registry on 11 and 15 June 2001 by the IIB and ABTA respectively. The IIB also submitted an application for interim relief pursuant to Rule 32 of the Tribunal Rules.

112. By documents lodged at the Registry on 13 and 18 June 2001, GISC submitted requests for permission to intervene in support of the Director in relation to the IIB and ABTA proceedings respectively, pursuant to Rule 14 of the Tribunal Rules.

113. At the case management conference held on 21 June 2001 the Tribunal (i) granted GISC permission to intervene in all three cases; (ii) ordered, by consent, that the Director disclose to the IIB and ABTA all correspondence between himself and GISC; and (iii) made no order on the IIB's request for interim relief: see paragraph 22 above.

114. The Director's Defence was served on 3 July 2001 and GISC's Statement of Intervention was served on 6 July 2001. No applications were made to lodge further pleadings. Oral argument was presented on 20 and 23 July 2001. Prior to the hearing the Tribunal drew the parties' attention to an article by Kay & Vickers entitled "*Regulatory Reform: an Appraisal*", in G Majone *Deregulation or Reregulation? Regulatory Reform in Europe and the United States* (1990) ("the Kay and Vickers article"). In that article, the authors discuss issues affecting competition and regulation, including competition between regulators.

115. The IIB requests the Tribunal:

— to set aside the IIB Decision;

— to withdraw the GISC Decision in so far as it concludes that Rule F42 does not prevent, restrict or distort competition;

— to rule on the eligibility of the GISC Rules for an individual exemption and the conditions to be attached to any such exemption, alternatively remit that issue to the Director with such directions and/or indications as the Tribunal may think fit; and

— to award the IIB its costs.

116. ABTA requests the Tribunal:

— to set aside the ABTA Decision and the GISC Decision;

— to declare that the GISC Rules and/or Rule F42 materially restrict or distort competition;

— to declare that the GISC fee structure is discriminatory and a restriction or distortion of competition; and

— to award ABTA its costs.

117. The Director requests the Tribunal:

— to dismiss both the IIB's and ABTA's appeals; and

— to order both the IIB and ABTA to pay their costs.

118. GISC requests the Tribunal:

— to dismiss both the IIB's and ABTA's appeals; and

— to order the IIB and ABTA to pay GISC's costs, in proportions to be determined.

119. The Tribunal determines, for the purposes of any procedural questions that may be relevant, that these proceedings are proceedings before a tribunal in England and Wales: see Rule 16 of the Tribunal Rules.

## VII ARGUMENTS OF THE PARTIES

### *The IIB*

120. In its Notice of Appeal, the IIB contends that the Director erred in law in concluding that Rule F42 of the GISC Rules does not constitute an appreciable restriction on competition within the meaning of section 2 of the Act, and did not give any adequate reasons for his conclusion. Furthermore, the Director erred in concluding that it was unnecessary and inappropriate to compare the GISC Rules with those of any other regulatory body. He further erred in concluding that insurance intermediaries could easily belong to both GISC and the IIB.

121. The IIB has no objection to GISC itself or the principle of regulation of the general insurance sector, but objects to GISC as the sole regulator. GISC is a private industry initiative. Its mandate as sole regulator is entirely self-assumed, and not required or sanctioned by statute or government policy. The strength and breadth of GISC's insurer membership is such that no intermediary can avoid doing business with the GISC insurer members. The effect of Rule F42 is that the members of the IIB will be forced to join GISC although they do not wish to do so.

122. In those circumstances Rule F42 self-evidently prevents, restricts or distorts competition: see the OFT's own publication *Trade Associations, Professions and Self-Regulating Bodies*, (OFT 408 at paragraph 6.3), an article by Dr Temple Lang (1984 Fordham Corporate Law Institute, p.605) and Commission decisions such as *Sarabex* (Eighth Report on Competition Policy), *Central Heating* 1972 OJ L264/22, *Rijwielhandel* 1978 OJ L20/18 and *IMA Rules* 1980 OJ L318/1. Moreover, the test applied by the Director to the effect that Rule F42 will not 'result in significant numbers of intermediaries exiting from the market' (GISC Decision, paragraphs 33 to 35) is inadequate, notably because it is based on the assumption that independent intermediaries *will* join GISC. But that puts the cart before the horse, because it is the market power of the insurers that compels intermediaries to join GISC in the first place.

123. Moreover, there is a restrictive effect on competition once intermediaries have joined GISC, since they are no longer able to differentiate themselves on the basis that they are subject to different or higher regulatory rules. According to the IIB, GISC's Rules represent a lowering of regulatory standards compared with those maintained by the IIB. The structure of GISC also

gives rise to an inherent conflict of interest where the insurers seek to regulate the distributors with whom they themselves are competing.

124. It is not correct to assert that intermediaries could be subject to regulation by both GISC and the IIB: the costs of dual regulation and differences between the two regulatory regimes rule this out. Since the GISC regime is both less strict and more expensive than the IIB's IBRC Mk II, the Director's assertion at paragraph 29 of the GISC Decision that the GISC Rules are "pro-competitive" is not sustainable. Similarly there is nothing to support the Director's conclusion that the costs of GISC "appear to be reasonable".

125. The Director's argument at paragraph 35 of the GISC Decision that intermediaries have the option of becoming an Agent or Sub-Agent of a GISC Member is a non point: this would simply prevent IIB members from continuing to be independent intermediaries. Moreover, GISC's powers to grant waivers of Rule F42 are not exercised in a transparent, objective and fair way, as evidenced by GISC's rejection of the IIB's request for a waiver, from which there is no appeal. The Director's analysis of waivers at paragraph 30 of the GISC Decision does not address that issue.

126. Furthermore, the GISC Decision fails to consider the impact on competition in the market for the provision of regulatory and trade association services, a market in which the IIB and GISC are in competition. Contrary to the Director's arguments in the IIB Decision the regulation carried on by GISC constitutes an economic activity: see Cases C-159/91 and C-160/91 *Poucet v Assurances Générales* [1993] ECR I-637 (paragraph 14), Joined Cases C-180/98 to C-184/98 *Pavlov* [2000] ECR I-6451, Case C-41/*90 Höfner v Macrotron* [1991] ECR I-1979, Case C-244/94 *Fédération Française des Sociétés d'Assurance* [1995] ECR I-4014, Case 118/85 *Commission v Italy* [1987] ECR 2599 (paragraph 7) and Case T-144/99 *Institute of Professional Representatives before the European Patent Office v Commission,* 28 March 2001 (paragraphs 64 and 65). The latter case also establishes that there is no "public interest" defence which takes an agreement outside Article 81(1). If the GISC Rules are justified in the public interest that is a conclusion the Director is only entitled to reach after a thorough investigation under section 4 of the Act.

127. In any event GISC is an association of undertakings and subject to competition law in its own right: see Joined Cases 209 to 215 and 218/78 *Heintz van Landewyck SARL v Commission* [1980] ECR 3125 (paragraph 88); Joined Cases T-25/95 et seq *Cimenteries CBR and Others v Commission* [2000] ECR II-491; and Joined Cases 96 to 102, 104,105, 108 & 110/82 *NAVEWA*

*v Commission* [1983] ECR 3369. The IIB also refers to the publication *Trade Associations, Professions and Self-Regulating Bodies* (OFT 408) paragraphs 7.1 and 7.2.

128. The IIB further argues (i) that the fee structure in the GISC Rules is discriminatory, since the fees for intermediaries are charged at four times the rate for insurers; and (ii) that the requirement to segregate client monies in favour of intermediaries whose general insurance activities are secondary to their main business activity is discriminatory.

129. In oral submissions, the IIB referred to the Kay & Vickers article where the authors argue that competition between regulators is to be encouraged. The IIB emphasised that the Director's exit test (paragraph 35 of the GISC Decision) was irrelevant: the relevant question is whether an independent intermediary can better differentiate himself by being outside of GISC but subject to IIB or other regulatory rules. In failing to compare the GISC Rules with other possibilities such as regulation by the IIB the Director conferred on GISC a de facto regulatory monopoly for no other reason than it was the first mover, with the insurers behind it. According to the IIB, the ability of an independent intermediary to present himself to a client as providing best advice unconnected to an insurer is the essence of his function, but the GISC system either excludes or significantly dilutes that possibility. Branding and differentiation of service is a critical element of competition in this sector. Moreover, GISC's refusal to grant the IIB a waiver demonstrates that GISC has no intention of exercising its waiver policy by reference to a test of consumer protection. According to the IIB, there is a major difference between an exclusive dealing rule which contains a waiver possibility and one such as Rule F42 which does not. At the least, GISC decisions on waivers should be based on objective grounds, proportionate, and subject to independent appeal.

130. The IIB's case is supported by two witness statements by Andrew Paddick, the Director General of the IIB, and several witness statements from IIB members.

***ABTA***

131. In its Notice of Appeal ABTA submits, first, that Rule F42 is a restriction on competition since it limits the persons with whom an undertaking will deal. A large scale collective exclusive dealing agreement is clearly an 'appreciable' restriction of competition. Moreover there is a real possibility that Rule F42 will in practice force into GISC membership those who would otherwise choose not to become members, and that the additional direct and indirect costs of membership will affect the competitiveness of ABTA members. In particular, GISC membership duplicates existing costs because ABTA members are already regulated on the sale

of travel insurance; such duplication may have the effect of weakening ABTA's position as a regulator and undermining the training it provides.

132. Secondly, ABTA draws attention to the combined effect of Rule F42 and Rule F24, which is that an insurer Member of GISC may not deal directly with a non-member agent where that non-member agent is an agent of a competing insurer. ABTA members customarily deal with several insurers and negotiate tailor-made policies e.g. for dangerous sports, multi-trip cover etc. Those provisions severely limit the freedom of member insurers to deal with non-member agents and significantly restrict competition between member insurers. In support of its submissions ABTA refers to the European Commission Notice (2001/C 3/02) *Guidelines on the applicability of Article 81 of the EC Treaty to horizontal cooperation agreements* (OJ C3/2, 06.01.2001), paragraphs 164 and 165.

133. It follows that neither the Director's approach (at paragraph 16 of the ABTA Decision) that Rule F42 is not an appreciable restriction when the "overall effect" of the agreement is taken into account, nor his alternative argument based on the 'umbrella option' (at paragraph 21 of the ABTA Decision) is tenable. The Director has made no proper analysis of the impact of Rule F42.

134. Thirdly, according to ABTA the method of membership fee calculation under the GISC Rules results in a fee for intermediaries that is four times the amount payable by insurers and confers a competitive advantage on insurer members who deal directly with consumers against those who deal through intermediaries. ABTA refers to the publication *Trade Associations, Professions, and Self-Regulating Bodies* (OFT 408) at paragraph 319 and *R v Customs & Excise ex parte Lunn Poly* [1999] 1 CMLR 1357. The Director's response to these points at paragraphs 24 to 26 of the ABTA Decision is theoretical and not based on any investigation.

135. In oral submissions, ABTA emphasised that the correct test is whether there is an appreciable effect on competition in the market under the GISC Rules as compared with the market without the GISC Rules: see the classic Article 81 test set out in Case 56/65 *Société Technique Minière v Maschinenbau Ulm* [1966] ECR 235. In fact Rule F42 gives rise to an exclusive dealing agreement which is a "hard-core" restriction in accordance with Case T-374/94 et seq *European Night Services v Commission* [1998] ECR II-3141. It plainly has an appreciable effect, particularly in the light of the fact that it is "hard-core".

136. The Director's approach ignores the effects on competition as it would have been in the *absence* of the agreement embracing the GISC Rules. The effects of the universal imposition of GISC's

Rules can only properly be considered by examining the cost benefits of alternative regulatory systems, which the Director has not done.

137. Moreover, the Director's submission that regulation in the public interest is not subject to the Chapter I prohibition is contrary to Community law as expressed in the Opinion of Advocate General Léger of 10 July 2001 in Case C-309/99 *Wouters v Algemene Raad van de Nederlandse Orde van Advocaten*. The issue of a single regulator versus multiple regulators is a competition issue which goes to the costs that are going to be imposed; the ability of those in the regulated market to differentiate themselves by reference to different standards; and the incentives that may be created for those in the regulated market to adopt courses of action in order to escape the new regime. This latter possibility is open to ABTA members by going offshore to obtain their insurance as Airtours, one of the largest tour operators, who currently use a Dublin insurer, have done.

138. Contrary to the submission advanced by GISC no pro-competitive purpose has been shown: first, there is no basis for concluding that a single regulator for all intermediaries and insurers is better than having sector specific or multiple regulators. Secondly, GISC cannot act as a single regulator because it is not capable of covering those who deal only with off-shore insurers or off-shore intermediaries.

139. Finally, the Director was wrong to dismiss the impact of the direct costs of the GISC system as being too small to have any significant effect. The cost of GISC regulation for ABTA members as a whole is at least £1.5 million, an appreciable amount in an industry that is working on very low margins – 1.15%. The indirect costs of dealing with two regulatory bodies instead of one cannot be offset by ABTA reducing its fees in relation to the regulation of insurance activities, because ABTA will in any event need to continue to monitor and regulate the financial position of its members in relation to all of their activities, including any 'offshore' activities.

140. ABTA's case is supported by the witness statements of Riccardo Nardi, Head of Legal Services, Stephen Howard, Chairman of ATII, which represents intermediaries selling over 80% of travel insurance sold to the general public in the United Kingdom; John Harding, Sales Director of an independent tour operator called Travelscene Limited; and Daniele Broccoli of Britaly Travel, a small independent travel agency.

***The Director***

141. In his Defence the Director submits that GISC was formed in response to the Government's desire to replace the previous fragmented system of statutory and non-statutory regulation with a

comprehensive system of regulation for the benefit of the public. Rule F42 is central to GISC's aim of creating a common regulatory regime to which all participants would be subject. Such a regime does not appreciably restrict competition, for the reasons given in the GISC, IIB and ABTA decisions.

142. According to the Director, the issue whether there should be one or several regulators is a matter of regulatory policy, not competition law. Contrary to the IIB's submissions, in carrying out its regulatory functions GISC is not engaged in an "economic activity" or any form of "trade" or business and is not, therefore, "an undertaking"; nor is GISC a trade association aiming to advance its members' interests but a regulatory body intended to protect the public; as such, the GISC Rules are a form of surrogate for state regulation: see Case C-118/85 *Commission v Italy* [1987] ECR 2599, at paragraph 7; the Commission Decision *Film purchases by German television stations* 1989 OJ L284/36, at paragraph 38; and (in the context of VAT law) the decision of the House of Lords in *Institute of Chartered Accountants v Customs & Excise* [1999] 1 WLR 701, at page 706. Furthermore, regulatory activities are not to be treated as the subject of EC competition law, irrespective of whether they are underpinned by statute or not: Case 123/83 *BNIC v Clair* [1985] ECR 391 at page 395 per Advocate General Slynn; Case C-364/92 *Eurocontrol* [1994] ECR I-43; Case C-153/93 *Germany v Delta Schiffahrts* [1994] ECR I-2517, at paragraph 14; and Advocate General Jacobs in Case C-475/99 *Ambulanz Glöckner* (17 May 2001).

143. As regards the effect on competition in the supply of insurance, as distinct from regulatory, services, the restriction created by Rule F42 is no more than a restriction on insurers and intermediaries not to operate outside the system of regulation. That in itself cannot create an appreciable effect on competition unless it either creates barriers to entry to the market or the terms of the regulation are discriminatory. There is no evidence that the GISC Rules create barriers to entry or will encourage exit from the industry.

144. In particular the membership costs of GISC are insufficient to constitute material barriers. Even those costs can be avoided by entering into appointed agency agreements.

145. Similarly membership of GISC does not amount to "double taxation", since the fees for GISC membership and fees for membership of trade associations such as ABTA/IIB are for different purposes. The latter are trade associations with a remit to promote the interests of their members whilst GISC is simply there to regulate them. Furthermore, should intermediaries wish to have imposed on them higher regulatory standards, they are not prohibited from doing so. The indirect costs of complying with the GISC Rules do not appear to be significant.

146. Since no competition issue arises, the availability or otherwise of a waiver of Rule F42 is not material to the competition assessment.

147. As regards the discrimination in membership fees alleged by the IIB and ABTA, the higher percentage of revenue which intermediaries pay as fees merely reflects the different manner in which they generate their income from the supply of insurance and the extent of a member's activity in the market. It is not established that such differences as there are have any appreciable effect on competition.

148. As regards IIB's objection to the derogation concerning the segregation of monies in favour of undertakings which have insurance as their secondary business, there is less need for such a segregation requirement where insurance is a secondary activity. There are major practical difficulties in segregating insurance monies in organisations where insurance is not the main business.

149. In oral submissions, the Director emphasised that GISC is not an undertaking, since its functions are purely regulatory: see the Opinion of the Advocate General in *Wouters*, paragraphs 135 to 144. The rationale behind the cases relied on by the Director is not the presence or absence of statutory backing but the fact that the activity in question is not commercial in nature. In any event, GISC cannot be regarded as a purely private initiative since there are statutory powers to intervene under the FSMA should GISC not prove to be an adequate regulator. In the light of the case law, it would not be open to the Tribunal to find that GISC is an undertaking in its own right without referring that point to the Court of Justice under Article 234 of the Treaty.

150. As regards the Kay & Vickers article, the issue is whether or not *as a matter of law* GISC is to be regarded as engaged in economic activity. The balance of jurisprudence is that it is not, so the concept of competition between regulators is outside the scope of the Chapter I prohibition. The Kay & Vickers article also recognises that one can have a situation where some regulatory authorities set higher standards, which is entirely consistent with the Director's case that other bodies are free to set higher standards.

151. Rule F42 is a restriction on conduct which does not have any significant competitive consequences. The Director is not obliged to undertake a cost benefit analysis of alternative regimes or to assess whether the GISC regime will result in higher or lower standards than are appropriate for the insurance industry. Those are consumer protection, not competition, issues.

152. In answer to certain procedural questions put to the Director by the Tribunal, the Director submitted that there is no duty of the Director to respond in a decision under section 14 to third party observations, provided the decision sets out the basis upon which it is made. As to whether there exists on the Director a duty to respond without undue delay to an application under section 47, the Director submitted that he is currently working to a guideline of two months for dealing with section 47 decisions.

***GISC***

153. In its Statement of Intervention in support of the Director, GISC reiterates that it is an independent, non-profit making organisation, funded entirely by membership fees, whose main purpose is to make sure that general insurance customers are treated fairly. The GISC Rules lay down the minimum standards of good practice which all GISC members must follow when they deal with consumers buying general insurance. A key element of this new system of self-regulation is Rule F42 which enables GISC to enforce its Rules contractually.

154. GISC was set up as a result of the Government's review of the statutory regime for the regulation of financial services in the UK and the decision to repeal the 1977 Act. If the Government were to conclude that self-regulation were inadequate, the FSA would take over the regulation of general insurance through section 22 of the FSMA.

155. GISC does not accept that it "represents" particular constituencies within the general insurance market: the composition of GISC was designed to be independent of any vested interest in the general insurance industry. There are two "public interest" directors on the GISC board and all directors have to act strictly in accordance with their fiduciary duties to the company. As such, GISC is not comparable with a trade association set up to promote the interests of its members, such as the IIB or ABTA.

156. GISC rejects the IIB's argument that Rule F42 excludes IIB from an alleged market for regulatory services on three grounds:

(i) Regulation is not an economic activity within the scope of Article 81(1) EC Treaty and the Chapter I prohibition, and GISC itself is not an undertaking: (illustrated by the fact that it is not registered for VAT). In addition to the cases cited by the Director, see: C-41/90 *Höfner & Elser v Macrotron* [1991] ECR I-1979, paragraph 21; Case C-343/95 *Cali & Figli v Servizi Ecologici Porto di Genova* [1997] ECR I-1547, paragraph 16; *Irish Aerospace (Belgium) NV v Eurocontrol* [1992] 1 Lloyd's Rep 383, at 398. It is irrelevant that GISC is a self-regulatory rather than a statutory organisation. Under English law a



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self-regulatory organisation may form an integral part of a governmental framework for the regulation of financial activity: see *R v Panel on Take-overs and Mergers ex p Datafin* [1987] 1 QB 815.

(ii) Even if a market for regulatory services does exist, GISC submits that regulation by a single regulator falls outside Article 81(1) and the Chapter I prohibition under the rule of reason: see *Gøttrup-Klim*, paragraphs 34 and 36. Such a system is necessary to avoid fragmented and ineffective regulation. The GISC Rules are limited to what is necessary to enable regulation by a sole regulator to function properly.

(iii) The IIB is a trade association representing a particular group of intermediaries in the broker sector, and is ill-suited to the role of an independent and impartial regulator.

157. As regards Rule F42, it is not sufficient to allege a distortion of competition for a decision of an association of undertakings to fall within the Chapter I prohibition: a prevention, restriction or distortion of competition is only caught if it is *appreciable*. The Director found no evidence that membership of GISC would lead to significant numbers of intermediaries exiting from the market. There is nothing to stop an intermediary from joining the IIB and advertising its membership.

158. As regards the arguments put forward by ABTA, ABTA is not a suitable regulator of the sale of insurance policies by its members. ABTA does not carry out any monitoring of its members in relation to the sale of travel insurance policies and the provisions of ABTA's present Code of Conduct relating to insurance are minor and of little benefit. There is a clear need for GISC to regulate the sale of insurance policies by ABTA members.

159. GISC membership fees for ABTA members are proportionate and fair. To the extent that ABTA charges fees for regulation duplicated by GISC, ABTA could reduce its own fees correspondingly.

160. In oral submissions, GISC disputed the allegation that it is an insurer led or dominated organisation since (i) the majority of start-up funding for GISC came from insurance intermediaries, and not from insurers; (ii) less than half of GISC's board members come from insurers; and (iii) less than half of the members on the working parties set up to develop the GISC Rules were from insurers.

161. GISC emphasised that it does not engage in economic or commercial activity: see the Advocate General's Opinion in *Wouters*. GISC, however, opposed the Director's suggestion that the

Tribunal should make a reference under Article 234 of the Treaty on the question whether GISC was an undertaking, because of the delay involved.

162. In any event, regulation by a single regime is reasonably necessary for an effective scheme of regulation and as such falls outside Article 81(1) under the rule of reason (*Gøttrup-Klim*; *European Night Services*). Rule F42 is the least restrictive means of ensuring that GISC acts as an effective self-regulatory organisation. If GISC fails, general insurance will be brought under the responsibility of the FSA under the FSMA. That is the answer to the question of "who guards the guardian" raised by the IIB and referred to in the Kay & Vickers article.

163. In response to ABTA's submissions that the GISC regime would impose increasing costs on its members, or drive them overseas, GISC submitted, notably, that there is no credible evidence to support either claim. Similarly there is no evidential basis for IIB's arguments on differentiation or membership costs.

164. Finally, should either appeal succeed, GISC requested the Tribunal to set a short deadline for the Director to reach a fresh decision. GISC will not be in a position to commence full regulation until it is clear that the Rules do not offend the Act.

165. GISC's intervention is supported by a witness statement by its Chief Executive, Christopher Woodburn. On the issue of a single regulatory regime, Mr Woodburn argues that a fragmented system delivers ineffective regulation and is confusing for consumers. He also contends that a single system is pro-competitive: GISC creates a level playing field, to the particular benefit of small firms, whereas different systems of regulation based on different standards could lead to competitive inequalities and distort competition. Mr Woodburn stresses that:

> "it is paramount to the new system of regulation of general insurance that consumers have a single reference point. GISC branding ought to lead to greater consumer confidence that their interests are safeguarded appropriately regardless of the distribution channel chosen. I hope that GISC branding is particularly helpful to consumers in relation to the newest retailers of insurance products such as supermarkets which under the GISC regime will be competing on a level playing field with more traditional sellers of insurance."

## VIII THE FINDINGS OF THE TRIBUNAL

### *The Issue*

166. The main issue in this case is whether the GISC Rules, and in particular Rule F42, "have as their object or effect the prevention, restriction or distortion of competition within the United Kingdom" within the meaning of section 2(1)(b) of the Act. In determining that question, we

are required, by section 60 of the Act, to act with a view to ensuring that there is no inconsistency between the principles we apply and the decision we reach, on the one hand, and the principles laid down by the Treaty and the decisions of the Court of Justice and the Court of First Instance in determining any corresponding question arising out of Community law, on the other hand: see section 60(1), (2), (5) and (6)(b). For present purposes, the "corresponding question" is the meaning and effect of the words "have as their object or effect the prevention, restriction, or distortion of competition" in Article 81(1) of the Treaty. In resolving the issues before us we must, in addition, have regard to any relevant decision or statement of the Commission of the European Communities: section 60(3).

167. We stress at the outset that the issue before us is the interpretation of section 2(1)(b) of the Act on the basis of the facts before us. The issue before us is *not* whether the general insurance sector should be regulated or, if so, what regulatory system should be adopted. Similarly, a decision by this Tribunal as to whether or not the GISC Rules or any part of them are caught by section 2(1)(b) does *not* imply any value judgment, one way or the other, as to whether the GISC Rules should be implemented, or in what form. Nor does it imply any view as to the relative capabilities, as regulators, of any of the private parties before us. It is simply a decision on the question whether, as the Director contends, the Rules fall outside the Act altogether or, as the appellants contend, the GISC Rules fall within section 2(1)(b). Similarly, if the GISC Rules do fall within section 2(1)(b), that is not the end of the matter. In accordance with the structure of the Act, which closely follows that of Article 81, it is then for the Director to proceed to examine whether the GISC Rules qualify for an individual exemption from the Chapter I prohibition under sections 4 and 9 of the Act.

***Synopsis of the relevant law***

168. It is convenient to begin with some brief general comments on the structure of Article 81 and on how we understand the concept of an agreement "having as its object or effect the prevention, restriction or distortion of competition" is to be applied to Community law. In our respectful view, the law on this point is usefully summarised by Advocate General Léger in his opinion of 10 July 2001 in *Wouters*, a case concerning the rules of the Dutch Bar Association, at paragraphs 88 to 127.

169. In analysing an agreement under Article 81(1) the first step is normally to determine the 'object' of the agreement: Case 56/65 *Société Technique Minière* [1966] ECR 235 at 249. In general, the cases in which it has been held that the 'object' of the agreement is to restrict competition are cases involving price fixing or market sharing of one form or another: see e.g. Case 41/69 ACF

*Chemiefarma v Commission* [1970] ECR 661, paragraph 128 (market sharing); Case 123/83 *BNIC v Clair* [1985] ECR 391, paragraph 22 (fixing minimum prices); Case 45/85 *VDS* [1987] ECR 447, paragraph 41 to 43 (recommendation to increase insurance premiums). Such agreements 'by their nature' restrict competition and Commission is not required to examine whether the agreement in fact had the effect of restricting competition: Cases 56 and 58/64 *Consten and Gruding v Commission* [1966] ECR 299, at 342; Cases T- 25/95 etc. *Cimenteries CBR v Commission* [2000] ECR II-491, paragraph 1531.

170. However, if it is not plain that the object of the agreement is to restrict competition, it is necessary to consider the effects of the agreement, taking into account the economic context in which the undertakings operate, the products or services covered by the agreements, the structure of the market concerned and the actual conditions in which it functions: see *Société Technique Minière* at 249 to 250; Case C-399/93 *Oude Luttikhuis* [1995] ECR I-4515, paragraph 10 and, most recently, cases 180 to 184/98 *Pavlov* [2000] ECR I-6451, paragraph 91. In analysing the effect on competition it is necessary to consider the competition that would occur in the absence of the agreement in dispute: *Société Technique Minière*, at p. 250.

171. In order for Article 81(1) to apply it has to be shown that the effect on competition is appreciable. In Case 5/69 *Völk v Vervaeke* [1969] ECR 295, the Court of Justice said at paragraph 7:

> "... an agreement falls outside the prohibition of Article 81(1) when it has only an insignificant effect on the markets, taking into account the weak position which the parties concerned have on the market of the product in question".

In Case 22/71 *Béguelin Import v. GL Export* [1971] ECR 949, the Court of Justice said, at paragraph 16:

> "... in order to come within the prohibition imposed by Article 81, the agreement must affect trade between Member States and the free play of competition to an appreciable extent."

172. In determining whether there is an appreciable effect on competition, the primary criterion is normally "the position and importance of [the parties] on the market concerned", taking account of the structure of the market in question (see *Société Technique Minière* at 250). In the Commission's current *Notice on Agreements of Minor Importance* (OJ 1997 C372/13), it is said that an agreement does not have an appreciable effect if the aggregate shares held by all the participating undertakings do not exceed 5% of the relevant market in the case of a horizontal agreement (i.e. an agreement between undertakings operating at the same level of production or marketing), or 10% of the relevant market in the case of undertakings operating at different economic levels (i.e. a vertical agreement). The Commission's more recent *Notice on Vertical*

*Restraints* (0J 2000 C291/1) indicates that, in certain cases, a vertical agreement may not bring about an appreciable restriction on competition even if the parties have a market share of over 30%, (see paragraphs 121 to 133 of the *Notice on Vertical Restraints*), 30% being the threshold above which vertical agreements do not benefit from the block exemption provided by Regulation 2790/99 (OJ 1999 L336/21). Similarly, in the Commission's *Notice on Horizontal Cooperation Agreements* (OJ 2001 C3/2) the Commission indicates that outside the category of price fixing and market sharing agreements, which normally fall automatically within Article 81(1), the most important factor for determining whether a horizontal cooperation agreement falls within Article 81(1) is the position of the parties in the market affected and the structure of the market (see section 3.1 of that Notice). In relation to both the *Vertical Restraints Notice* and the *Horizontal Cooperation Agreements Notice,* the Commission indicates, that in determining market shares, the guidance given in its *Notice on Market Definition* (OJ 1997 C (372/5)) should be taken into account. Apart from market shares, there may be other circumstances where, for one reason or another, an agreement cannot be said to have an appreciable effect on competition: a classic example is where two competitors form a joint venture to develop a new product which neither has the resources to develop alone: see the *Notice on Horizontal Cooperation Agreements*, at paragraph 24.

173. The concept of "appreciable effect" may be illustrated notably by reference to the judgment of the Court of First Instance in Cases T-374/94 etc., *European Night Services v Commission* [1998] ECR II -3141. In that case, the principal railway companies of the United Kingdom, France, Belgium and Germany set up a joint venture to run night passenger services from various destinations in Great Britain to various Continental destinations through a joint company, ENS. The Commission held that Article 81(1) applied, notably because competition was restricted as between the parent companies of ENS, who had disabled themselves from providing overnight passenger services other than through ENS, and for various other reasons. On appeal, the Court of First Instance held, first, that there was insufficient material before the Court to establish that the effect of the agreement was appreciable since the projected market shares of the parties hardly reached or exceeded the threshold of 5% for an agreement to be caught by Article 81(1) according to the Commission's *Notice on Agreements of Minor Importance*: see [1995] ECR II-3141, paragraphs 90-103. Secondly, as regards competition between the parent companies of ENS, the Court held that each of the national railway companies concerned was not in competition with the others on its national network, and the hypothesis that any of those railway companies could or might at some future date set up rival night rail services through the Channel Tunnel in competition with the others was economically quite unrealistic, not least because of the scale of the investment involved: see [1995] ECR II - 3141, at paragraphs 133 et seq. At paragraph 136 of its judgment, the Court said that in

assessing an agreement under Article 81(1), "account should be taken of the actual conditions in which it functions, in particular the economic context in which the undertakings operate, the products or services covered by the agreement and the actual structure of the market concerned (...) unless it is an agreement containing obvious restrictions of competition such as price-fixing, market-sharing or the control of outlets (...) In the latter case, such restrictions may be weighed against their claimed pro-competitive effects only in the context of Article 81(3) of the Treaty, with a view to granting an exemption from the prohibition in Article 81(1)".

174. Apart from the issue of "appreciable effect", there is another line of cases in Community law which seem to imply the existence of a form of "rule of reason" in the interpretation of Article 81(1). The "rule of reason" is a shorthand and somewhat dangerous phrase for the various techniques adopted over the years by the courts of the United States to mitigate the absolute prohibition of "every contract, combination (...) or conspiracy in restraint of trade" to be found in section 1 of the Sherman Act 1890, which has no provision for exemption equivalent to Article 81(3). In effect, the US courts have drawn a distinction between agreements that are prohibited "per se" under section 1 of the Sherman Act and agreements which may be justified under the "rule of reason". In over simplified terms, an agreement is prohibited 'per se' under the Sherman Act if it is an obvious restriction on competition (e.g. price fixing). However, under the rule of reason an agreement which is not under US law prohibited "per se" may fall outside section 1 of the Sherman Act if the pro-competitive effects of the agreement are judged to outweigh the anti-competitive effects.

175. Some authorities deny the existence of a rule of reason altogether: see Advocate General Cosmas in his opinion in Case C-235/92P *Montecatini v Commission* [1999] ECR I-4539, paragraph 45. However, Advocate General Léger was prepared to accept, at paragraph 103 of his opinion in *Wouters,* that under Article 81(1) the Court of Justice "has made limited application of the rule of reason in some judgments. Confronted with certain classes of agreement, decision or concerted practice, it has drawn up a competition balance-sheet and, where the balance is positive , has held that the clauses necessary to perform the agreement fell outside the prohibition laid down by Article 81(1) of the Treaty". Some of the cases where something resembling a 'rule of reason' approach seems to have been applied, include an exclusive dealing agreement necessary to enable a small undertaking to penetrate a new market (*Société Technique Minière*), qualitative criteria for selecting retailers in a system of selective distribution (Case 26/76 *Metro v Commission* [1977] ECR 1875, paragraphs 20 to 22); the grant of an exclusive patent licence for the dissemination of a new product (Case 258/78 *Nungesser v Commission* [1982] ECR 2015, paragraphs 54 to 58); a non-competition covenant entered into by the vendor of a business (Case 42/84 *Remia v Commission* [1985] ECR 2545, at paragraphs

17 to 20); clauses essential to the performance of a franchising agreement (Case 161/84 *Pronuptia* [1986] ECR 353, paragraphs 14-17) and a provision in the statutes of an agricultural co-operative forbidding dual membership of any other association in competition with the co-operative (Case C-250/92 *Gøttrup Klim* [1994] ECR I–5641).

176. However, as Advocate General Léger stresses at paragraph 104 of his opinion in *Wouters*, any 'rule of reason' in Community competition law "is strictly confined to a *purely competitive* balance-sheet of the effects of the agreement. Where, taken as a whole, the agreement is capable of encouraging competition on the market, the clauses essential to its performance may escape the prohibition laid down in Article 81(1) of the Treaty. The only 'legitimate goal' which may be pursued in accordance with that provision is therefore exclusively competitive in nature". It follows from that conclusion that an appreciable restriction of competition is not taken outside Article 81(1) by the fact that it pursues some public interest objective, as Advocate General Léger points out at paragraphs 105 to 108 of his opinion in *Wouters*. In that case, a rule of the Dutch Bar Association prohibiting multi-disciplinary partnerships was argued to fall outside Article 81(1), not on the ground that it was pro-competitive, but on the ground that it protected such matters as independence and loyalty to the client. Advocate General Léger rejected this argument on the ground that "[i]n the first place, it amounts to introducing into the wording of Article 81(1) of the Treaty considerations which are linked to the pursuit of a public-interest objective. In the second, it sets all the questions of fact and of law in the context of that provision. It implies that the Court should consider, in the light of Article 81(1) of the Treaty exclusively, not only the question of determining whether a restriction of competition exists but also whether or not it might be justified. Such an interpretation is liable to negate a great part of the effectiveness of Article 81(3)...". The conclusion of Advocate General Léger on this point is supported by the judgment of the Court of First Instance in Case T-144/99 *Institute of Professional Representatives before the European Patent Office v Commission*, 28 March 2001. In that case, the Court of First Instance rejected an argument to the effect that professional codes of conduct could fall outside Article 81(1) on the basis of public interest considerations. The Court held that rules which organise the exercise of a profession cannot as a matter of principle fall outside Article 81(1) merely because they are asserted to be in the public interest; a case by case assessment is necessary to determine whether competition is appreciably affected : see paragraphs 62 to 67 of the judgment.

177. As the Court of First Instance indicates in *European Night Services*, there is in any event no scope for the application of any "rule of reason" type analysis in the case of agreements containing "obvious restrictions of competition such as price fixing, market sharing or the control of outlets" (paragraph 136 of the judgment, cited above). Similarly the Commission has

consistently taken the view that the ambit of any rule of reason in Community law is strictly limited, because otherwise there would be little scope for the application of Article 81(3). In the Commission's *White Paper on Modernisation of the Rules Implementing Articles 81 and 82 of the EC Treaty* (OJ 1999 C132/1), the Commission argues that "the structure of Article 81 is such as to prevent greater use being made of [a "rule of reason"] approach: if more systematic use were made under Article 81(1) of an analysis of the pro- and anti-competitive aspects of a restrictive agreement, Article 81(3) would be cast aside, whereas any such change could be made only through revision of the Treaty" (paragraph 57 of the White Paper).

178. It follows that any given agreement will fall within the scope of Article 81(1) if it (a) constitutes an appreciable restriction on competition, and (b) there is no proper scope for the application of any so-called "rule of reason". In these circumstances, any positive benefits of the agreement may be examined only in the context of a possible exemption under Article 81(3).

***Preliminary Analysis of Rule F42 under section 2(1)(b)***

179. In applying the above principles to the GISC Rules, it is appropriate to consider first Rule F42, not least because it is clear on the evidence that GISC exists in its present form only because the insurer members of GISC have agreed to observe and enforce it. Indeed, it was only by virtue of a prior understanding among the members of the ABI that they were prepared to accept a rule along the lines of Rule F42 that GISC could be launched in the first place: see the "empowerment of GISC" discussed at paragraphs 42 to 45 above.

180. Rule F42 provides:

> "subject to any Rule waiver issued by GISC, Members shall not, and shall ensure that their Appointed Agents and Sub-Agents shall not, in the course of their General Insurance Activities, deal directly with any person in circumstances which would involve that person in engaging in General Insurance Activities as an Intermediary where that person is not a Member."

181. That Rule does not preclude any intermediary from dealing with any insurer, whether or not that insurer is a Member of GISC, nor does it explicitly require all insurers in the United Kingdom writing general business to join GISC, although the vast majority have done so. Rule F42 does, however, prohibit the insurer members of GISC from dealing with any intermediary who is not a member of GISC or the agent or sub-agent of such a member. Equally, it is not seriously disputed that it is, in effect, mandatory for any intermediary in the general insurance sector to be a Member of GISC or the appointed agent or sub-agent of a Member, otherwise the vast majority of insurers in the United Kingdom will not deal with that intermediary.

182. In our view, Rule F42 is, at first sight, to be regarded as a provision having as its object or effect a restriction or distortion of competition within the meaning of Article 81(1) of the Treaty and section 2(1)(b) of the Act.

183. That is so, in the first place, because Rule F42 limits the freedom of the insurer members of GISC to deal with whom they please. Freedom to compete implies the freedom to choose how, where, on what terms and with whom to do business. A contractual restriction which limits the intermediaries with whom an insurer may deal, entered into by a large group of competing suppliers (the insurer Members of GISC) and extending to intermediaries of all kinds, is, on its face, a restriction on competition. As the Court of Justice said in one of its earliest decisions under Article 81(1): "[it is] inherent in the provisions of the Treaty relating to competition that each economic operator must determine independently the policy which he intends to adopt in the common market including the choice of the persons and undertakings to which he makes offers or sells..." Cases 40/73 *Suiker Unie v Commission* [1975] ECR 1663, paragraph 173. On those grounds alone, Rule F42 falls, prima facie, within the Chapter I prohibition.

184. In the second place, from the point of view of the intermediaries concerned, an important aspect of the freedom to compete is the freedom to decide how and in what manner insurance is to be arranged on behalf of clients, or advice or other services rendered. Moreover, it is, in our view, an important part of the competitive freedom of an undertaking to decide whether to join any particular association relevant to its business and, if so, whether to accept any rules for the conduct of business and the associated disciplinary procedures, promulgated by that association. The imposition of mandatory rules for the conduct of business, coupled with a mandatory requirement to join a particular association, represent, in themselves, a significant fetter on the competitive freedom of an insurance intermediary to do business as it wishes. It is one thing voluntarily to accept certain minimum standards; it is quite another thing to have those standards imposed involuntarily through the exercise of market power by a group of suppliers acting collectively. On those grounds too, Rule F42 falls, prima facie, within the Chapter I prohibition.

185. However, as already indicated, it is necessary to examine Rule F42 in its context in order to determine whether it has, actually or potentially, an *appreciable* effect on competition. In that regard, we are told that Rule F42 applies to more than 85% of the insurers active in the general insurance market of the United Kingdom. The insurers to whom it applies include most of the household names and, notably, the top five or six companies which alone account for 50-60% of the market. The general insurance market of the United Kingdom is worth some £27 billion. Approximately 6,000 intermediaries, including all Lloyd's brokers, have so far joined or applied

to join GISC. It is conceded that it would be difficult, if not impossible, for an intermediary active in that market, of which there are some 15,000 in total, to remain outside GISC.

186. In those circumstances, applying the normal rules for assessing "appreciability" already referred to, we find that Rule F42 is to be regarded as an "appreciable" restriction on competition, affecting, as it does, the freedom to deal of the vast majority of insurers and intermediaries active in the general insurance market in this country.

187. We are reinforced in this view by the fact, established on the evidence before us, that in practice the GISC Rules can only be brought into force by means of a collective boycott or refusal to deal on the part of all or most of the major insurance companies in the United Kingdom. That is clear from the proposals for the "empowerment"of GISC set out at paragraphs 43 to 44 above, which show that the only way in which "all firms ... can be brought within the regulatory net" is by the insurer members of GISC agreeing to deal only with intermediaries who belong to GISC or their appointed agents or sub-agents. The practical effect of that approach is shown by the commercial pressure applied to intermediaries, set out in paragraph 82 above. In effect, the only way for the GISC regime to work is for unwilling intermediaries to be effectively coerced into membership by a collective refusal to deal by insurers, accompanied, in some cases, by the threat that the insurer will deal directly with the intermediary's client if the intermediary does not join GISC (see the letter from Iceni Motor Facilities of 6 March 2001).

188. Leaving aside the question whether the 6,000 intermediaries who have so far joined or applied to join GISC have done so purely voluntarily or as a result of commercial pressure, it is established, on the evidence before us, that, as at the date of the hearing, some 9,000 to 10,000 intermediaries had, for whatever reason, not joined GISC. Even making allowance for a degree of uncertainty caused by the existence of these proceedings, it is striking that, with the deadline for joining GISC only a short time away, nearly two thirds of the estimated number of intermediaries have not done so. We have direct evidence that a significant number of intermediaries – namely the 1,000 member firms of the IIB, representing over half of the independent broking practices of the United Kingdom, together with the 2,500 members of ABTA, strongly object to joining GISC.

189. In our view, a collective boycott or refusal to supply, such as is required by Rule F42, undertaken by the vast majority of insurance companies in the United Kingdom in respect of up to 10,000 intermediaries, in itself amounts to an appreciable restriction or distortion of competition within section 2(1)(b) of the Act.

190. We note, moreover, that Rule F34 of the GISC Rules, set out at paragraph 67 above, serves to prevent a Member from resigning from GISC unless any outstanding general insurance activities "are properly completed" or responsibility for compliance with the GISC Rules is accepted by another Member. While the meaning of "properly completed" is not clear, that Rule would seem to make it effectively impossible for an undertaking to leave GISC without either discontinuing business altogether or ceding its business to another GISC Member. It follows that, however onerous the GISC Rules were to be, or, in future, become, or however inappropriate they were to be to the particular business concerned, that undertaking would have no practical means of escape from the GISC Rules once it has been compelled, by the market power of the insurers in question, to become a member of GISC. The practical difficulties of ever leaving GISC seem to us significantly to reinforce the restrictive effects of Rule F42.

191. The fact that those promoting GISC consider that it is in the public interest that all intermediaries in the United Kingdom join GISC, does not take Rule F42 outside the ambit of section 2(1)(b): that is a consideration relevant only to an exemption under section 4, as demonstrated by the Opinion of Advocate General Léger in *Wouters* and the decision of the Court of First Instance in *Institute of European Patent Agents* cited at paragraph 176 above.

192. For the foregoing reasons, on a preliminary analysis, Rule F42 seems to us to fall clearly within section 2(1)(b) of the Act. We therefore turn to consider whether the Director's reasoning in the GISC decision compels us to a contrary conclusion.

***The Director's reasoning on Rule F42 in the GISC Decision***

193. The Director deals with Rule F42 at paragraphs 34 and 35 of the GISC Decision, where two arguments are advanced. The first argument , at paragraph 34, is that Rule F42 does not require all intermediaries to join GISC, because those who do not wish to join GISC have the alternative of becoming agents or sub-agents of those that do join. This argument, which is repeated in the penultimate sentence of paragraph 35, we describe as "the agency point". The second argument, in the second sentence of paragraph 35, is that the Director "does not have any indication that Rule F42 will result in a significant number of intermediaries exiting from the market and that competition will be reduced appreciably". We refer to this as "the exit test". On those two grounds, the Director concludes that Rule F42 "will not give rise to an appreciable restriction or distortion of competition".

194. Dealing first with the agency point, the Director, without formally abandoning it, has scarcely relied on the agency point in the proceedings before us, and, in our view, rightly so. The

principal weakness of the agency point is, as both the IIB and ABTA point out, the effect of Rule F24 of the GISC Rules. Rule F24 provides:

> "Insurers may not appoint an Independent Intermediary as an Appointed Agent or permit an Independent Intermediary to be appointed as their Appointed Sub-Agent for the purposes of offering or selling their General Insurance Products.
>
> An Independent Intermediary may only be appointed as an Appointed Agent or Appointed Sub-Agent of one Intermediary".

Under the definitions in the GISC Rules, an "Independent Intermediary" means an "Intermediary who, in respect of any product type, offers or sells the products of more than one Insurer". A "product type" is defined as "any category of products which are competing or substitutable for one another".

195. We understand it to be common ground that the general effect of these complex provisions is that an intermediary who does not wish to join GISC but opts instead to be the Appointed Agent of an insurer (or the Appointed Sub-Agent of an Appointed Agent) can not deal with any other insurer in respect of products of the same product type – i.e. products which compete with each other. Similarly, if an intermediary who does not wish to join GISC chooses to become the Agent or Sub-Agent of an Independent Intermediary, as defined, Rule F24 again has the effect that the Agent or Sub-Agent cannot deal with any other Independent Intermediary.

196. The members of the IIB and other independent brokers carry on the business of giving independent broking services, the essence of which is their ability to place clients' business on the best terms in the market. Agency status, under Rule F24 of the GISC Rules, would simply destroy the functions of such brokers as independent intermediaries and would, in consequence, have a seriously detrimental effect on competition in the general insurance market. It is, in our view, important that there should be a substantial independent broking sector in the field of general insurance, able to "shop around" and give the client impartial advice, without being tied to any one insurer. The acceptance of Agency status under Rules F42 and F24 would however bring about the opposite result and largely eliminate the independence of the broking sector.

197. Similar considerations apply to travel agents. Travel agents typically sell the insurance offered by tour operators (to be found in the holiday brochure), insurance offered by a range of insurance companies, or insurance arranged by themselves or through intermediaries such as the members of the Association of Travel Insurance Intermediaries. Once again, the effect of a travel agent accepting Agency status under the GISC Rules is simply to reduce to one the number of insurance companies or independent intermediaries with whom the travel agent may deal. Instead of having the pick of the market, the travel agent is tied to the insurer (or

intermediary), whose agent s/he is in respect of all products that are competing or substitutable for one another. In that connection, we note from a letter from GISC to ABTA dated 18 June 2001 that GISC regards single trip, multi-trip and annual travel policies as substitutable for each other, and also regards the tour operators' travel policies as substitutable for the independent travel policies offered by the agent. In consequence, GISC seems to see little or no scope for a travel agent having Agency status to deal with more than one insurer or intermediary. It would appear to follow that the acceptance by travel agents of Agency status under GISC Rules is likely to give rise to a significant restriction of competition in the supply of travel insurance and, in consequence, a substantial reduction in consumer choice.

198. For these reasons we are not satisfied that the agency point mentioned in paragraph 34 of the GISC Decision mitigates the restriction on competition in Rule F42. If anything, the provisions of Rule F24 appear to reinforce the restrictive effects of Rule F42.

199. Turning to the "exit test" at paragraph 35 of the GISC Decision, we take the Director to mean that Rule F42 is not a restriction of competition, because not many intermediaries will leave the market altogether, (rather than, for example, becoming an agent instead of an intermediary with all the limitations implicit in such a move) as a result of having to comply with the GISC Rules or, in other words, that the GISC Rules are not so onerous that intermediaries will leave the market altogether because they are unable or unwilling to comply with them.

200. We can understand why the Director asked himself whether, for example, the GISC Rules were likely to be so onerous or expensive that a significant number of intermediaries would leave the market, with a consequent reduction in competition and consumer choice. In our view, however, a negative answer to that question is not in itself sufficient to demonstrate that Rule F42 is not a restriction of competition within the meaning of section 2(1)(b). It is not sufficient because it does not address the principal question of law with which the Director was confronted, namely, whether (i) the obligation on the vast majority of United Kingdom general insurers under Rule F42 to deal only with GISC Members or their Agents or (ii) the de facto obligation on the vast majority of intermediaries in the United Kingdom to join GISC, are to be regarded in themselves as appreciable restraints on competition for the purposes of section 2(1)(b).

201. It seems to us that the Director's conclusion, that not many intermediaries will leave the market *when* the GISC Rules become compulsory, merely side-steps what we consider to be the relevant and logically the first question, namely, whether the fact that the GISC Rules *are* compulsory by virtue of Rule F42 is in itself a restriction of competition within the meaning of

the Act. In other words, the Director's assumption that most intermediaries will choose to become members of GISC rather than see themselves excluded from the market, does not in our view logically demonstrate the absence of any restriction on competition within the meaning of the Act; it merely demonstrates, on the contrary, the market power of the insurer Members of GISC and the effectiveness of their collective agreement to compel most intermediaries to join GISC. The decisive question, to our mind, is not how many intermediaries will or will not succumb to the pressure of the insurers rather than exit the market, but whether the collective agreement among the insurers to compel all intermediaries to join GISC is, in itself, a restriction or distortion of competition within the meaning of the Act.

202. In any event, even assuming that an "exit test" has some relevance to the issues before us, we are not satisfied, on the evidence, that the Director's suggestion that few intermediaries will exit the market is a correct or complete appreciation of the facts. As at the date of the hearing, there were around 9,000 to 10,000 intermediaries who had not so far joined GISC. The point made to us by GISC, at the end of the hearing, was that a substantial number of these intermediaries were likely to opt for agency status, in one form or another, rather than become members of GISC in their own right (see paragraph 85 above). If that is correct, it seems to us that one effect of the GISC Rules may well be to cause a substantial shift in the structure of the market away from intermediaries, free to deal with whomsoever they please, to a system of tied agency arrangements of one form or another. Although that is not "exit from the market" in the sense of ceasing to do business, if what GISC told us was right, it would, or might, represent a substantial exit from the market of intermediaries who at present are not tied to any one insurer.

203. If, therefore, what GISC told us was right, one effect of the GISC Rules could be to cause the exit from the market of a certain number – perhaps a substantial number – of intermediaries who are at present able to deal with several insurers but who choose to transform themselves into Appointed Agents dealing with only one insurer in respect of general insurance products of the same product type. That seems to us to represent, at least potentially, a significant distortion of competition.

204. We are not satisfied, on the evidence before us, that this aspect of the matter has yet been the subject of adequate investigation by the Director, an issue to which we shall return when considering the orders to be made in this case.

205. For those reasons, the Director's reasoning in the GISC Decision does not, of itself, persuade us to modify the view we have already expressed that Rule F42 gives rise to an appreciable restriction or distortion of competition, for the reasons given at paragraphs 179 to 192 above.

*The Director's principal argument*

206. However, it has become apparent, since the GISC Decision, that the "exit test" there referred to is part of a wider argument which is in fact the principal argument addressed by the Director in this case. That argument, in essence, is that the GISC Rules, *in themselves,* do not have any anti-competitive consequences for the reasons set out at paragraphs 29 to 32 of the GISC Decision; therefore Rule F42, which is merely there to enforce rules that do not restrict competition, cannot itself be regarded as having as its object or effect an appreciable restriction or distortion of competition. On this approach, the Director is really able to finesse Rule F42 altogether, on the basis that a mandatory rule, which is there to enforce rules which are for the protection of the consumer and which do not themselves restrict competition, cannot be said to restrict competition either.

207. In our view this approach to Rule F42 does not emerge, at least at all clearly, in the GISC Decision itself, but it is signalled, at least in outline, at paragraphs 16 to 19 of the ABTA Decision (paragraph 108 above).

208. The same approach is indicated, albeit succinctly, at paragraphs 20 and 21 of the IIB Decision (paragraph 104 above).

209. In our respectful view, the Director's approach is erroneous.

210. For reasons that will shortly become apparent, we are not satisfied that the GISC Rules are in themselves, neutral in their competitive effects (see paragraphs 219 et seq below). But even if we were satisfied, which we are not, that the GISC Rules have no anti-competitive effects in themselves, we would still consider that Rule F42 is to be regarded in law as a provision having as its object or effect the prevention, restriction or distortion of competition. The essential reason is the mandatory nature of the GISC system. The means adopted for compelling observance by the intermediaries of the GISC regime is a horizontal agreement among competing undertakings, namely the insurers, not to deal with certain persons who do not respect certain rules which they (the insurers), together with others, consider that it is in the interests of the industry and the public to observe. As we have said, by so agreeing, the insurers have deprived themselves of an essential and intrinsic element of undistorted competition, namely the freedom of an undertaking to deal with whom it pleases without being restricted in that regard by an agreement made with its competitors.

211. Similarly a substantial number of intermediaries who, for whatever reason, consider it inappropriate or unnecessary to join GISC, are placed, in effect, in a situation of "take it or leave

it," the choice being to join GISC or go out of business. In our view, as we have already said, the *compulsion* to join a particular association and accept its rules seems to us, on the ordinary meaning of words, to be a restriction on the competitive freedom that the intermediaries in question would otherwise enjoy. They would not otherwise be required, for example, to pay fees to GISC, maintain specified solvency margins, segregate monies, obtain professional indemnity cover, and deal with the client in the particular way in which the GISC Rules compel them to do. Whether those compulsory requirements are *justified* is a separate matter for consideration only under section 4, and is not a reason for regarding the mandatory rules imposed by a decision of an association of undertakings as falling outside section 2(1)(b). When such restrictions or mandatory rules are accepted, or imposed, by the vast majority of the suppliers on all the intermediaries in the whole of an industry in the United Kingdom with a turnover of £27 billion, it is impossible to say that the restriction is not "appreciable" in the sense that concept is normally understood in Community Law.

212. In this connection, we do not find Cases C-180 to 184/98 *Pavlov* [2000] ECR I-6451, heavily relied on by the Director on the question of "appreciable effect", particularly helpful to the Director's case. In that case, legislation in the Netherlands provided for supplementary pension schemes to top up the low basic pension provided by the State. Many employers set up such schemes for their employees. The system applicable to the professions was that representative professional organisations could set up occupational pension schemes and then apply to the Minister for membership of that scheme to be compulsory for all members of that profession. Such a scheme had been set up by the Dutch association for medical specialists, and membership had become compulsory by a decree made by the Minister. Mr Pavlov and others claimed that the requirement of compulsory membership of the scheme was contrary to Article 81(1). The Court held, first, that although under its case law similar arrangements under Netherlands Law applying to employees fell outside the scope of Article 81(1), in the case of self-employed medical specialists the decision to set up an occupational pension scheme and apply to the Minister for a decree making membership of the scheme compulsory was a decision of "an association of undertakings", because self-employed medical specialists, unlike employees, were "undertakings". The Court then held, at paragraphs 91 to 97:

> "91 It is settled case-law that, in defining the criteria for the application of Article 81(1) of the Treaty to a specific case, account should be taken of the economic context in which undertakings operate, the products or services covered by the decisions of those undertakings, the structure of the market concerned and the actual conditions in which it functions (Case C-399/93 *Oude Luttikhuis and Others* [1995] ECR I-4515, paragraph 10).
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> 92. In this respect, it must be borne in mind that a decision of the kind just mentioned means that all the members of a profession arrange their



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supplementary pension with one body and under the same conditions, except for their basic pension, which they may freely obtain from any authorised insurance company.

93. The conclusion must be that such a decision, which standardises in part the costs and supplementary pension benefits of medical specialists, restricts competition as far as concerns one cost factor of specialist medical services, inasmuch as one of its effects is that those medical practitioners do not compete with one another to obtain less costly insurance for that part of their pension.

94. However, as the Advocate General, observes at paragraphs 138 to 143 of his Opinion, the restrictive effects of such a decision on the specialist medical services market are limited.

95. The decision in question produces restrictive effects only in relation to one cost factor of the services offered by self-employed medial specialists, namely the supplementary pension scheme, which is insignificant in comparison with other factors, such as medical fees or the cost of medical equipment. The cost of the supplementary pension scheme has only a marginal and indirect influence on the final cost of the services offered by self-employed medical specialists.

96. Furthermore, it should be observed that the implementation of a supplementary pension scheme managed by a single fund allows self-employed medical specialists to share the risks insured against whilst achieving economies of scale in the management of contributions and payment of pensions and in the investment of assets.

97. It follows from the foregoing that a decision by the members of a profession to set up a pension fund entrusted with the management of a supplementary pension scheme does not appreciably restrict competition within the common market."

213. In our view, *Pavlov* is a rather special case which must be seen in the context of the social security and pensions legislation widely applicable not only in the Netherlands but also in several Member States. Nonetheless, it emerges from *Pavlov* that the Court of Justice regarded the *compulsory* nature of the occupational pension scheme in question as, in principle, a restriction of competition (paragraph 93). Transposing that to the present case, it would seem to follow, a fortiori, that the compulsory nature of the GISC Rules would bring Article 81(1) into play. On the issue of "appreciability", however, the main factor that in our view distinguishes *Pavlov* from the present case is that in *Pavlov* there was no restriction on the persons to whom the specialists could supply their medical services. In the present case, there is such a restriction accepted by the vast majority of the suppliers and imposed on all the intermediaries in a market to a value of £27 billion, which is why, in our view, the test of "appreciability" is satisfied.

214. We appreciate that the fundamental point on which we differ from the Director is essentially a point of law and that none of the authorities cited to us by either side precisely match the circumstances of the present case. We have, therefore, approached the matter from first principles and have been unable to find anything in Community law that permits us to avoid the conclusion that Rule F42 is intrinsically a restriction on competition for the purposes of Article 81(1), quite irrespective of whether or not the mandatory rules which it supports are *in themselves* anti-competitive or whether the GISC Rules serve some wider public interest. In effect, we treat Rule F42 as analogous to "the control of outlets" within the ambit of the principle set out by the Court of First Instance at paragraph 136 of its judgment in *European Night Services*, with the consequence that benefits flowing from the Rule F42 fall to be examined under section 4, not section 2, of the Act.

215. In reaching that conclusion we bear in mind that, although section 60 of the Act enjoins us to construe section 2 consistently with Community law, our primary task, as a United Kingdom tribunal, is to construe the statute with which we are concerned. In our judgment, as a matter of the ordinary meaning of words, a provision such as Rule F42, whereby a group of suppliers, acting collectively, agree not to deal with certain persons, is a provision which has as its object or effect the restriction or distortion of competition. As we have said, the freedom to deal with whom one pleases is the essence of the competitive process, and a horizontal agreement whereby numerous suppliers collectively agree to deprive themselves of that freedom and to impose certain rules on others seems to us to be, in itself, a restriction of competition as those words are ordinarily understood in the English language.

216. Had Parliament wished to take arrangements such as the GISC Rules outside the ambit of the Act it could have so provided. However, insurance broking and related activities do not figure in the exclusions for professional rules in Schedule 4 of the Act, although many of the rules maintained by the IBRC were akin to at least some of the professional rules maintained by bodies which do figure in that Schedule. Similarly, Schedule 3 contains a large number of 'General Exclusions' but a system such as the GISC Rules does not figure among them. It would have been otherwise if the obligations of the GISC Rules were imposed in order to comply with a legal requirement (paragraph 5(1)), or if the GISC Rules were excluded by an order by the Secretary of State on the grounds that there were 'exceptional and compelling reasons of public policy' why the Chapter I prohibition should not apply (paragraph 7(1)), but neither of those provisions apply either. In addition, the Secretary of State has not exercised his power under section 3(3)(a) of the Act to provide for one or more additional exclusions, which he may do under section 3(4) in respect of certain agreements which in his view (a) do not in general have an adverse effect on competition or (b) are, in general, best considered under

Chapter II of the Act or the Fair Trading Act 1973. We note also that it would appear to be possible, if the scope of the FSMA were extended, by order under section 22 of the FSMA, to cover general insurance, for the GISC Rules to fall outside the Chapter I prohibition pursuant to section 164 of the FSMA, were GISC to become authorised by the FSA, and were the GISC Rules to "consist of provisions the inclusion of which in the agreement is encouraged by any of the authority's regulating provisions". In these circumstances, competition scrutiny of the GISC Rules would take place not under Chapter I of the Act but under the provisions of sections 159 to 163 of the FSMA which envisage an examination by the Director and, if necessary, consideration by the reporting side of the Competition Commission.

217. In the absence of action under any of these statutory provisions, the fact that the Government appears to be generally supportive of self-regulation in the general insurance industry, or even of the establishment of GISC, does not affect the statutory interpretation of section 2(1)(b) at which we have arrived, although it may well be relevant to an exemption under sections 4 and 9.

***Conclusion on Rule F42***

218. For all these reasons, we find that Rule F42 falls within the Chapter I prohibition.

***GISC as a "sole regulator"***

219. Having arrived at that conclusion, it is strictly speaking unnecessary for us to consider a number of the other arguments that have been addressed to us on the question whether the GISC Rules restrict or distort competition, but we do so for completeness. The remaining issues mainly revolve around the competitive effects said to flow from the fact that GISC has set itself up as the sole provider of a regulatory scheme for general insurance.

220. On this part of the case the IIB submits, essentially, that competition is restricted or distorted because GISC excludes the possibility of an alternative regulatory body or certification scheme for independent brokers, prevents such brokers from differentiating themselves from others in the general insurance sector and creates conflicts of interest between these brokers and the insurers who dominate GISC. This leads to a general lowering of standards (paragraphs 123-124, 126-127, 129 above).

221. ABTA submits that the Director has implicitly taken the view that GISC should be the regulator for the travel insurance activities of ABTA members, thus leading to an unnecessary duplication of costs, whereas what he should have done was to compare, in the context of an exemption

under section 4, the advantages and disadvantages of regulation by ABTA as compared with regulation by GISC (paragraphs 131, 137, 139 above).

222. The Director, supported by GISC, essentially denies the factual premises of the submissions of the IIB and ABTA, but submits that, in any event, the issue of whether GISC should be a sole regulator is essentially a regulatory, rather than a competition, issue. Regulatory issues, including the issue of competition between regulators, fall outside the scope of the Chapter I prohibition, because they do not involve "economic activities" and GISC is not "an undertaking" (see e.g. paragraphs 142, 149-150, 156 above).

***The issues raised by the IIB***

223. It is convenient to deal first with the arguments advanced by the IIB which, in our view, raise three questions: (i) does GISC exclude the creation of alternative regulatory or certification schemes in the general insurance sector?; (ii) if so, does that at first sight restrict or distort competition to an extent which merited investigation by the Director?; (iii) if so, do the legal arguments advanced by the Director justify the absence of such an investigation?

*– Does GISC exclude alternative regulatory schemes?*

224. In addressing this question, we have taken "regulatory" systems to mean organised schemes in the general insurance sector covering the development and enforcement of standards on such matters as professional competence, training, obligations towards the client, protection of clients' monies, preparation of accounts, professional indemnity insurance, complaint handling procedures, provision of a compensation fund, and so on. Schemes of this nature aim to ensure the quality of the product offered, from the point of view both of professional standards and of consumer protection. Such schemes are in many respects equivalent to certification schemes in which suppliers offering products to a particular standard or quality are entitled to promote themselves as fulfilling the requirements for certification and to use a particular designation or quality mark. That is illustrated in the present case by the promotion by GISC of the GISC logo as a quality mark or brand (see paragraph 68 and 165 above) and the attempts of the IIB to promote the designation "Institute Registered Broker" under IBRC Mk II.

225. In considering whether GISC has the object or effect of excluding any alternative schemes of this kind, we observe, first, that the object of GISC is to establish "a single regulatory scheme to monitor and enforce standards" in the general insurance sector (see Rule A2). That has always been the object of GISC, as shown by the documents relating to the "empowerment" of GISC to which we have already referred, and is one of the principal underlying objectives of Rule F42.

226. That objective is further reinforced by GISC's policy on waivers, from which it emerges that GISC does not wish to grant any waivers which might have the effect of allowing any other body to undertake regulation in this sector. As GISC said in its letter to the IIB of 15 March 2001 "The waiver which the IIB requests would effectively provide certain intermediaries (whose main business activity is insurance) with a complete "opt-out" from GISC and would therefore fragment and completely undermine the single regulatory structure. This would be contrary to the core objective of GISC set out in ... Rule 2" (see paragraph 86 above).

227. Secondly, and contrary to the finding of the Director, at paragraph 24 of the IIB Decision, to the effect that it is still open to undertakings such as independent brokers to agree to subject themselves to higher regulatory standards, the evidence before us is that it is unlikely that it would be possible to establish another regulatory scheme for the independent broking sector *in addition* to GISC. There is, in effect, nothing to challenge the evidence of the independent brokers filed by the IIB (e.g. Messrs Kirsch, Greenaway, Fry, Foster Taylor and Harris) that, once independent broking firms had been required to join GISC, it would be difficult to establish an additional regulatory body for the independent broking sector. Quite apart from the fact that such brokers would then be paying regulatory fees to two organisations, any second regulator for the independent broking sector would have to have its own monitoring system and its own compliance procedures geared to its own higher regulatory standards. In those circumstances such brokers would face two sets of compliance costs and two monitoring systems, in addition to two sets of fees. We think it unlikely, in those circumstances, that an additional regulator for the broking sector would be a feasible proposition; at the least, the establishment of such a regulator is made much more difficult by the GISC Rules. That conclusion is confirmed by the fact that the effect of the establishment of GISC has already been to cause the IIB to close its own regulatory division, making the staff redundant, and not to launch IBRC Mk II. Competition to GISC from a rival regulatory scheme has thus already been eliminated.

228. On that basis we conclude that the GISC Rules, and notably Rule F42, have both the object and the effect of excluding, or at the least making much more difficult, the establishment of alternative forms of self regulation or certification in the independent broker sector, or indeed any other sector, of the general insurance industry in the United Kingdom. Indeed, it seems to us that, in approving the GISC Rules as falling outside section 2 of the Act, the Director must have approved, or at least not have objected, to GISC's core objective of establishing itself as the sole provider of a regulatory scheme for the general insurance sector.

*– Does the exclusion of alternative regulatory schemes at first sight restrict or distort competition to an extent that merited investigation by the Director?*

229. We next address the question whether the de facto exclusion, by GISC, of an alternative scheme of regulation for the independent broking sector gives rise, at first sight, to restrictions or distortions of competition which merited investigation by the Director.

230. In their article Kay & Vickers express the view that self regulatory organisations tend to act in the interests of their members, and may be inefficient in enforcing or promoting higher standards if they are under no competitive pressure to do so. For these reasons, Kay and Vickers suggest that competition between self regulatory organisations may be desirable (see pp. 239 to 241). In particular, situations in which persons cannot trade unless they are members of a particular self regulatory body "should normally be resisted except where the service provided is a public rather than a private one" (see p. 238).

231. The GISC Rules give rise to a situation very close to that which Kay & Vickers suggest, at p. 238 of their article, "should normally be resisted", in that intermediaries in the general insurance sector cannot in practice trade unless they are members of GISC. However, it is unnecessary for us in this case to enter into a theoretical debate. We are confronted by a specific factual situation, which is that the setting up of GISC has caused the collapse of a proposed alternative regulatory or certification scheme, namely IBRC Mk II, which was supported by some 1,000 broker firms, representing, we are told, half the independent broking sector, who did not wish to be regulated or certified by GISC. It seems to us, at first sight, that that situation in itself gives rise to a restriction or distortion of competition within the meaning of section 2(1)(b) of the Act.

232. In effect the evidence before us suggests that one way in which independent brokers are able to compete with insurers' direct selling operations and other intermediaries is by promoting themselves as offering higher 'quality' standards of professional competence and consumer protection. One potentially important means of competing in this way is for independent brokers to establish their own regulatory or "quality assurance" scheme (such as IBRC Mk II) by means of which they may collectively promote themselves as meeting the quality standards of their own scheme. The evidence of the IIB with regards to its attempts to launch IBRC Mk II indicates the importance which a substantial part of the independent broking sector attaches to the establishment of its own regulatory or certification scheme as a means of competing with insurers and other intermediaries. We conclude that there is plainly a market for the provision of regulatory or certification services to independent brokers as an alternative to, and in

competition with, GISC. To the extent that the Director found to the contrary at paragraph 18 of the IIB Decision, we reject that finding on the basis of the evidence before us.

233. It seems to us, therefore, at first sight, that the position of GISC as "sole regulator" restricts or distorts competition in the provision of competing regulatory or certification services for which there is a demand from independent brokers in the general insurance sector. That, on the evidence before us, is potentially a restriction or distortion of competition in the market for regulatory or certification services in the general insurance sector which merited investigation by the Director.

234. We are reinforced in that view by the fact, already mentioned, that once compelled to join, an intermediary faces practical difficulties in leaving GISC, except by discontinuing its business altogether or ceding its business to another member (Rule F34). It follows that, however high the GISC fees were to become, however inappropriate were to be the standards it develops, or however inefficiently it were to conduct its business, the option of leaving to join an alternative regulatory scheme is not in practice open. Even if GISC does not misconduct itself, the option of belonging to an alternative regulatory scheme, for example one that does not exclude its own liability, as GISC does, or which promotes higher standards or, for example, offers a compensation fund, is not in practical terms an option for any intermediary in the general insurance industry. In preventing, apparently in perpetuity, the emergence of an alternative to GISC, it does seem to us that competition from alternative regulatory schemes is potentially eliminated altogether.

235. Moreover, in our view, at first sight, the elimination of an alternative regulatory or quality assurance scheme for the independent broking sector also tends to restrict or distort competition in the separate market in which independent brokers are competing against the direct sales organisations of insurance companies, and other intermediaries, in selling or advising on general insurance products.

236. As we have already indicated, a potentially important element of competition in this, as in most other markets, is the ability to differentiate the product offered, notably by establishing a particular brand or image. GISC itself places considerable emphasis on establishing the GISC logo as a brand (paragraphs 68 and 165 above). The evidence before us is, however, that the inability to launch schemes such as IBRC Mk II is likely to make it more difficult for the independent broking sector to differentiate itself from the generality of suppliers of insurance by promoting its own distinctive image, based (as the IIB sees it) on higher regulatory standards, through the medium of an alternative regulatory scheme. In the absence of GISC, the members

of the IIB would have the competitive freedom to promote themselves distinctively on the basis of their membership of such an independent scheme. The effective exclusion of that possibility, by the establishment of GISC seems to us, at first sight, to be a potential restriction or distortion of competition in the market for the selling, advising or broking of general insurance services.

237. It seems to us that that potential restriction or distortion of competition is re-enforced in the present case by the fact that GISC itself comprises of a number of constituencies with different and opposing interests. It is a particular (and unusual) feature of this case that GISC, a body partly composed of suppliers (the insurers), seeks to exercise regulatory and disciplinary powers over the customers of those suppliers (the intermediaries). In addition, the insurer members of GISC sell insurance direct, in competition with intermediaries. In some sectors, particularly the consumer sector, insurers may have a substantial interest at gaining market share at the expense of independent intermediaries, or in promoting sales through tied outlets through agency agreements. Independent brokers, for their part, have an overriding interest in preserving their independence from insurers, since the essence of the service they provide is that of offering impartial advice in the best interests of the client.

238. In such circumstances it seems to us, at first sight, that the independent broking sector has a particular competitive need to differentiate, even to distance, itself from other Members of GISC. That sector depends very largely on the public perception that there are advantages in seeking impartial advice from a broker, whose duty it is to act in the client's best interest independently of the insurers, whether it is in placing the business or in handling any subsequent claims. It seems to us possible that that perception could be weakened if independent intermediaries are forced to belong to, and be disciplined by, a body in which insurers' interests are very strong.

239. The IIB also submits that GISC will have the effect of preventing higher standards emerging in the general insurance sector and has already had the effect of lowering standards. In this regard, there is some evidence before us that the GISC regime contemplates lower standards as compared with those of the previous IBRC regime or IBRC Mk II. For example, under the GISC Rules the liability of GISC is excluded, only firms rather than individuals are regulated, audit requirements may be waived by a procedure of "self-certification", breach of the Commercial Code does not appear in itself to be a disciplinary matter and no compensation fund is provided. Since GISC seeks to bring within its net all kinds of intermediaries, it seems to us not implausible that the general standard of regulation may settle at a lower level than that desirable for certain specific sectors such as independent brokers. Again, without expressing any view on the relative advantages and disadvantages of the GISC Rules and IBRC Mk II, it

seems to us that the question whether the establishment of GISC would tend to militate against the independent broking sector maintaining higher standards, and thus restrict or distort competition, was a question meriting investigation by the Director.

240. In the IIB Decision, the Director takes the view that it was unnecessary for him to take into account the possibility of the lowering of regulatory standards, and in particular, that "it was not necessary and would not have been appropriate for the Director to carry out a comparative analysis of the different types of regulation that may currently or in the future exist in the industry" (paragraph 23).

241. We find ourselves unable to agree with that approach. It seems to us that, once it was appreciated that the GISC Rules created a monopoly, in this instance a monopoly in the regulation of the general insurance industry, it was incumbent on the Director to examine potential effects on competition of the creation of that regulatory monopoly. It having been submitted to him on credible evidence that one of the effects of that monopoly was to make more difficult the maintenance of higher regulatory standards, and thus to diminish competition on product quality, which is one of the essential aspects of competition, the Director should, in our view, have investigated whether that evidence did in fact support the conclusion that GISC's regulatory monopoly did tend to restrict or distort competition in the respect alleged.

242. We are unpersuaded that the restrictions of competition identified above are materially affected by GISC's submission that the threat of statutory regulation under the FSMA will suffice to ensure that GISC acts solely in the public interest. That is a quite different issue. In any event, the possibility that the present or any future Government might, at some unknown future date, wish to replace GISC with statutory regulation under the FSMA, and if so in what circumstances, is far too uncertain a consideration for us to take into account when analysing restrictions or distortions of competition under section 2(1)(b) of the Act.

243. We also observe that a number of the possible consequences of the exclusion of alternative regulatory or certification regimes would be avoided if there were a realistic possibility for a waiver of the GISC Rules where such an alternative scheme was in place. Any such waivers would have to be granted on the basis of objective and transparent criteria, and any refusals of waiver would have to be open to challenge by some appropriate and independent procedure. Since, however, that is not the case at present, it does not seem to us that the waiver provisions of the GISC Rules, as presently applied, affect the analysis set out above.

244. For the foregoing reasons, it seems to us that the position of GISC as "sole regulator" in itself may give rise to restrictions or distortions of competition of the kind we have indicated in paragraphs 229 to 243. Taken cumulatively, such restrictions seem to us to be likely to have an appreciable effect, given that at least 1,000 independent broking firms are potentially affected. For present purposes we do not need to find as a fact that there are such restrictions or distortions of competition; it is enough for us to find on the evidence that the likelihood of such appreciable restrictions or distortions of competition is sufficiently significant to have merited further investigation by the Director. We so find.

***The Director's arguments in law***

245. It is, however, common ground that the Director did not in fact investigate any of the above matters. He did not do so on the ground set out in paragraph 18 of the IIB Decision that "in light of European case law" GISC's regulatory function "does not constitute an economic activity", and that "for the purposes of the Act", GISC is not "an undertaking". In the Director's view, matters pertaining to "regulatory functions" are as a matter of law outside the scope of the Chapter I prohibition.

246. We have difficulty in accepting the Director's starting point that a clear and precise line can be drawn between "regulatory policy", on the one hand, and the sphere of competition law on the other. We have already noted that in certain sectors the promotion of regulatory, certification or quality assurance schemes for the protection of the consumer forms an intrinsic part of the competitive process, particularly where consumers themselves are ill placed to judge the quality or suitability of the products in question. As Kay and Vickers state "the connections between competition and regulation, and the ways of combining them are numerous and complex" (p. 222 of their article). Similarly the recent Oftel publication *The benefits of self regulation and co-regulation to consumers and industry* of July 2001, deals, among other things, with the many ways in which competition and regulation interact.

247. We do not, however, need to pursue any theoretical debate as to what are the proper spheres of competition policy and regulatory policy respectively, since, in our respectful view, the ground on which the Director declined to investigate any issues arising out of GISC's position as "sole regulator" was erroneous in law.

248. In the first place, the Director's argument that GISC itself carries on no economic activities and is thus not an undertaking, even if correct, does not take the restrictions on competition we have just identified outside section 2(1)(b) of the Act. That is because the restrictions in question derive from a "decision by an association of undertakings" or, alternatively, because the Rules

of GISC constitute an agreement or concerted practice between the members of GISC, as the Director found at paragraph 24 of the GISC Decision.

249. It is well established that, irrespective of the precise legal nature of an association, Article 81(1) "applies to associations in so far as their own activities or those of the undertakings belonging to them are calculated to produce the results which it aims to suppress" Cases 209/78 etc *Heintz van Landewyck v Commission* [1980] ECR 3125, paragraph 88, Joined Cases 96/82 etc *NAVEWA v Commission* [1983] ECR 3369, paragraph 20, see also Case 123/83 *BNIC v Clair* [1985] ECR 391. In the present case, the restrictions on competition identified above are all consequences of the decision to set up and implement the GISC Rules, made by what is conceded to be "an association of undertakings", or the consequences of an underlying agreement or concerted practice between the members of GISC (particularly the insurer members) to observe those Rules and in particular Rule F42. Accordingly, the restrictions or distortions of competition resulting from the GISC Rules fall within the scope of the Chapter I prohibition.

250. This analysis is confirmed, in our view, by the approach of Advocate General Léger in his opinion in *Wouters* at paragraphs 56 to 86. There Advocate General Léger concluded that the Dutch Bar Association was an "association of undertakings" for the purposes of Article 81(1), with the consequence that its regulatory rules fell within the scope of that Article. Advocate General Léger said, at paragraph 83 of his opinion:

> "if a body is composed, as it is in this case, exclusively of private economic operators, the competition authorities must necessarily be allowed to scrutinise all its actions in the light of the Treaty. The reasons which must underpin a broad interpretation of the field of competition law have been clearly set forth by Advocate General Jacobs in his Opinion in *Albany*. According to Mr Jacobs: 'It can be presumed that private economic actors normally act in their own and not in the public interest when they conclude agreements between themselves. Thus, the consequences of their agreements are not necessarily in the public interest. Competition authorities should therefore be able to scrutinise private actors' agreements even in special areas of the economy such as banking, insurance or even the social field'".

251. It is thus unnecessary for us to consider whether GISC itself is an undertaking. Since, however, the matter has been argued, we add the brief comments set out below.

252. It is common ground that Article 81 of the Treaty applies to the carrying on of "economic activities" by "undertakings". As appears from the opinion of Advocate General Jacobs of 17 May 2001 in Case C-475/99 *Ambulanz Glöckner*, the concept of undertaking encompasses every entity engaged in an economic activity regardless of the legal status of the entity and the way it

is financed. The basic test is whether the entity in question is engaged in an activity which consists in offering goods and services on a given market and which could, at least in principle, be carried out by a private actor in order to make a profit (paragraph 67). By contrast, while public bodies carrying on economic activities may be regarded as undertakings, "activities in the exercise of official authority" are sheltered from the application of the competition rules (paragraph 72 of that opinion). The test is whether the activity in question is to be analysed as "the exercise of public powers" or as "economic activities": Case 118/85 *Commission v Italy* [1987] ECR 2599, paragraph 7. One test for whether the activity in question constitutes the exercise of public powers, or of official authority, is whether the activity in question "is connected by its nature, its aim and the rules to which it is subject with the exercise of powers which are typically those of a public authority" (see paragraph 76 of the opinion of Advocate General Jacobs in *Ambulanz Glöckner*, citing Case 364/92 *Eurocontrol* [1994] ECR I-43, paragraph 30).

253. To illustrate the difference between the exercise of "public powers" or "official authority" on the one hand and "economic activity" on the other hand, in *Ambulanz Glöckner* itself Advocate General Jacobs concluded that the provision of ambulance services, including emergency services, was an "economic activity" and thus within the rules on competition, since those were not services that must *necessarily* be carried out by public entities (paragraph 68 of his opinion). On the other hand, the grant or refusal by a public authority under statute of an authorisation to provide ambulance services fell outside the rules on competition, since it was "a typical administrative decision taken in the exercise of prerogatives conferred by law which are usually reserved for public authorities" (paragraph 76). Other illustrative examples of the exercise of public authority falling outside Articles 81 and 82 of the Treaty include the arrangements for international air traffic control made by the European Organisation for the Safety of Air Navigation, an international organisation set up and run by 14 Contracting States in pursuance of an international Convention (see *Eurocontrol*, cited above); the fixing by public authorities under statute of tariffs for the use of German waterways (Case C-153/93 *Germany v Delta Schiffahrts* [1994] ECR I-2517); and anti-pollution surveillance carried out by virtue of a public authorisation which was held to be "a task in the public interest which forms part of the essential functions of the State as regards protection of the environment in sensitive areas" and thus "connected by its nature, its aim and the rules to which it is subject with the exercise of powers ... which are typically those of a public authority..." Case 343/95 *Cali & Figli v SEPG* [1997] ECR I-1547, at paragraphs 22 to 23).

254. Applying those principles to the present case, we note first that GISC is a private company that has been set up by the industry itself without any statutory basis. It exists solely by contract.

GISC is not accountable to Parliament, nor to Ministers, nor indeed to anyone other than those in the industry who belong to GISC. As far as the constitution of GISC is concerned, GISC is run by a Board of Directors most of whom are, or have been, active in the industry. At present only two out of the Board of some 16 members are "public interest" directors recruited, so we are told, through head-hunters and not appointed by a public authority. It is true that it is currently proposed that there should be five "public interest directors", but that still leaves the "outside" directors in a substantial minority vis-à-vis the ten "industry" directors (see paragraphs 53 to 55 above). There is no independent chairman (without industry connections). It is also proposed that in future the directors will be elected by the Members of GISC, who will become shareholders in the company, six directors being elected by intermediaries and four directors elected by insurers. This change is proposed, notably, in order that "the Board would be directly accountable to regulated businesses" and in order to give "the regulated businesses a greater say in the running of the company". There is to be weighted voting, on the basis that "a large business in the industry should, in principle, have a greater number of votes than a small business". A number of these changes are proposed on the basis of the principles of the Combined Code, which is a publicly available document dealing with the principles of corporate governance relevant to listed public companies in the United Kingdom (see paragraphs 55 to 58 above).

255. On this basis GISC appears to us to have the features normally to be found in a private sector organisation or company accountable to its members, rather than a publicly constituted body exercising "public powers". We note also that, in the cases cited to us where the exercise of official or public authority was held to fall outside the competition rules, the activity in question had been exercised on some statutory basis of one kind or another. In the present case, GISC lacks any such statutory foundation.

256. We doubt whether, as a matter of Community law, the notion of the exercise of "official authority" or "public powers" can extend to cases where the legal basis of the activity in question is not to be found in the public law of the Member State but relies entirely on contract between private parties. Even if the Government is supportive of the principle of self regulation in the general insurance sector - which may not be quite the same thing as supporting a monopoly regulator for the whole sector, as shown by the Treasury paper of April 1998 cited at paragraph 38 above – the Government is not, constitutionally speaking, the legislature. Statements by Government ministers are not the same thing as a legal basis founded in public law. Again, as a matter of statutory interpretation, we would not expect to find that an activity could be taken outside section 2 of the Act on the basis of ministerial statements made in

Parliament rather than on the basis of the various exclusions and order making powers to be found in section 3 and schedules 1 to 4 of the Act.

257. Lastly, while it is true that the assumption of regulatory powers in respect of general insurance could properly be an activity of the State, for example under the FSMA, the setting up of a framework for promoting professional standards and consumer protection in general insurance is not an activity which, by reason of its intrinsic nature, can *necessarily* only be carried out by public authorities, as the case law appears to require. Self evidently GISC, the IIB and ABTA are all private sector bodies who have sought to establish self-regulatory or quality assurance schemes of one kind or another in the industries in which they operate. While we do not doubt the good intentions of those concerned, it seems to us clear that each of those bodies is acting not solely in the public interest but also in the commercial interests of their members in promoting the various schemes in question. In the case of GISC, emphasis has been placed on developing the GISC brand, creating what GISC sees as a "level playing field", and avoiding the threat of statutory intervention. Although GISC itself is not run for profit, the particular structure set up under the GISC Rules would hardly have been adopted if the industry did not see real commercial advantages in proceeding in the way it has. It seems to us that Advocate General Léger, at paragraphs 144 to 154 of his opinion in *Wouters,* was considering a different factual situation, namely regulatory powers conferred by statute (see paragraphs 154 and 258(3) of that opinion). Similarly, the two domestic cases cited to us, *Institute of Chartered Accountants v Customs & Excise* [1999] 1WLR 701 and *R v Panel on Takeovers and Mergers ex p Datafin* [1987] 1 QB 815, were each decided in a different factual and legal context.

258. In all those circumstances we can see no compelling reason why GISC should not be regarded as itself an undertaking although, as we have said, we do not need to decide that point for the purposes of this judgment, nor make any reference to the Court of Justice under Article 234 of the Treaty.

***Conclusion on GISC as a "sole regulator"***

259. For the foregoing reasons we conclude that the Director erred in declining to investigate the potential restrictions or distortions of competition identified in paragraphs 229 to 243 above.

***GISC's submission based on the 'rule of reason'***

260. GISC, but not the Director, submits that the GISC Decision can be supported on a 'rule of reason' analysis, by analogy with Case C-250/92 *Gøttrup-Klim* [1994] ECR I-5641. The essence of the argument, supported by Mr Woodburn's statement, is that the GISC Rules are the

least restrictive way of achieving a pro-competitive aim, namely a proper system of consumer protection, which avoids fragmented and ineffective regulation, while providing a level playing field without the distortions caused by having different standards of regulation (see paragraphs 156, 162 and 165 above).

261. We leave open the question of whether there is any real scope for a 'rule of reason' approach to the construction of section 2(1)(b) of the Act. Even if there was, a rule of reason analysis, in our view, could not apply in the present case in the light of our findings at paragraph 214 above and the judgment of the Court of First Instance in *European Night Services* at paragraph 136. On those grounds alone, we reject GISC's submissions. In our view any justification for the GISC Rules must take place in the context of section 4, not section 2(1)(b), of the Act.

262. Moreover, even if it could be applied, in our view *Gøttrup-Klim* could not support the contested Decisions in the present case.

263. *Gøttrup-Klim* concerned an agricultural co-operative, DLG, whose object was to provide its members with farm supplies (such as fertilizers) at the lowest obtainable prices. When some of DLG's members set up a rival co-operative to purchase farm supplies in competition with DLG, the latter amended its statutes to prohibit its members from belonging to two agricultural co-operatives simultaneously, while providing that a member could withdraw from DLG on five years notice instead of the previous ten years. On the question whether DLG's statutes fell within Article 81(1), the Court of Justice held at paragraphs 33 to 36:

> "33. Where some members of two competing cooperative purchasing associations belong to both at the same time, the result is to make each association less capable of pursuing its objectives for the benefit of the rest of its members, especially where the members concerned, as in the case in point, are themselves cooperative associations with a large number of individual members.
>
> 34. It follows that such dual membership would jeopardize both the proper functioning of the cooperative and its contractual power in relation to producers. Prohibition of dual membership does not, therefore, necessarily constitute a restriction of competition within the meaning of Article 81(1) of the Treaty and may even have beneficial effects on competition.
>
> 35. Nevertheless, a provision in the statutes of a cooperative purchasing association, restricting the opportunity for members to join other types of competing cooperatives and thus discouraging them from obtaining supplies elsewhere, may have adverse effects on competition. So, in order to escape the prohibition laid down in Article 81(1) of the Treaty, the restrictions imposed on members by the statutes of cooperative purchasing associations must be limited to what is necessary to ensure that the cooperative functions properly and maintains its contractual power in relation to producers.

> 36. The particular features of the case at issue in the main proceedings, which are referred to in the questions submitted by the national court, must be assessed in the light of the foregoing considerations. In addition, it is necessary to establish whether the penalties for non-compliance with the statutes are disproportionate to the objective they pursue and whether the minimum period of membership is unreasonable."

264. The Court, examining the whole factual circumstances, went on to hold that the restrictions in question did not go beyond what was necessary to maintain DLG's bargaining power vis-à-vis producers and that the minimum period of notice was not unreasonable.

265. The facts of *Gøttrup-Klim,* which deals with the somewhat special situation of agricultural co-operatives, are very far from those of the present case. In particular, whereas in *Gøttrup-Klim* the rule at issue merely prohibited dual membership and envisaged the possibility of leaving the co-operative after a reasonable period, in the present case intermediaries are obliged to belong to GISC and, it appears, have no real possibility of leaving. *Gøttrup-Klim*, therefore, does not assist GISC on the facts of that case.

266. In any event, as Advocate General Léger points out in *Wouters*, putting it at its highest, any rule of reason analysis is limited to a strictly "competition balance sheet" and cannot take into account any matters of wider public interest. Putting on one side the various public interest arguments advanced by the Director and GISC, in our view the remaining material before us does not demonstrate, at first sight, that the restrictions of competition we have identified in Rule F42 and in the regulatory monopoly conferred on GISC are, or might be, outweighed by purely competition-related advantages. The Director does not contend to the contrary.

267. We therefore reject GISC's submissions based on the "rule of reason".

***Other issues***

268. In the light of the conclusions we have reached, there is no need for us to rule on the arguments put to us by the IIB and ABTA on the issue of discrimination in membership fees, or the argument of the IIB concerning the GISC Rules on segregation of monies. Similarly, we do not need to deal with ABTA's arguments relating to duplication of costs or the possible distortions caused by insurers or intermediaries operating offshore in order to avoid the GISC Rules. We are confident, however, that the Director will have regard to the arguments presented by the parties on these points in the course of his further examination of the GISC Rules.

269. Similarly, it is not appropriate for us to accede to the IIB's request that we should ourselves consider the question of an exemption under section 4. That is a matter for the Director. Since

the effect of our judgment is that the GISC Rules now fall to be examined by the Director under section 4 of the Act, we need make no specific order in that regard. We do not consider it appropriate to set a deadline for the Director's decision.

***Procedure***

270. Although not entirely relevant to the substance, this case has perhaps highlighted the somewhat cumbersome nature of the procedure under section 47 of the Act, which does not confer on an interested person, who is not a party to an agreement, the right to appeal directly to this Tribunal against an adverse decision of the Director, without going through the section 47 procedure. In this particular case, it is unfortunate that, for whatever reason, nearly six months passed before the IIB, in particular, was able to bring its complaint against the GISC Decision before this Tribunal. That delay was detrimental to the IIB, who in the meantime had to close its regulatory division, and damaging to GISC because it has delayed for a substantial period the final resolution of its notification to the Director. We hope that this issue can be addressed in future, both from the administrative point of view and from the perspective of a possible modification to the Act. More generally, from the point of view of transparency in the procedure, we can see advantages in the Director adopting the administrative practice, in decisions such as the GISC Decision, of indicating briefly the substance of any adverse comments he has received and his response to them.

***Conclusion***

271. In the result, we find that Rule F42 of the GISC Rules falls within section 2(1)(b) of the Act for the reasons given in paragraphs 179 to 218 above. Since it is conceded that all the other requirements of section 2 are satisfied, the consequence is that Rule F42 falls within the Chapter I prohibition. We further find that certain other restrictions or distortions of competition, identified in paragraphs 223 to 244 above, potentially bring Rule F42, together with other aspects of the GISC Rules, within the ambit of section 2(1)(b). Those matters are therefore remitted to the Director for further investigation pursuant to paragraph 3(2)(a) of Schedule 8 of the Act, together with the matters set out in paragraphs 202 to 204 above. In consequence of those conclusions, we also set aside the IIB and ABTA Decisions under paragraph 3(2) of Schedule 8 of the Act. Acting under paragraph 3(2)(d) and (e) of Schedule 8 of the Act, we further withdraw the GISC Decision under section 47 of the Act, and find that the Chapter I prohibition is infringed, for the reasons we have given in paragraphs 179 to 218. We propose to hear further argument on the question of costs.

## IX ORDERS

272. On those grounds the Tribunal:

1. Sets aside the decisions of the Director dated 11 May 2001 concerning the Rules of the General Insurance Standards Council addressed to the Institute of Independent Insurance Brokers, and to the Association of British Travel Agents Limited, respectively

2. Withdraws the decision of the Director dated 24 January 2001 entitled Notification of the Rules of the General Insurance Standards Council

3. Decides that the Rules of the General Insurance Standards Council fall within the prohibition imposed by Chapter I of the Competition Act 1998, by virtue of Rule F42

4. Remits to the Director the issues referred to in paragraphs 202 to 204 and 223 to 244 of this judgment

5. Reserves the question of costs for further argument

Christopher Bellamy Ann Kelly Adam Scott

Delivered in open court 17 September 2001

Charles Dhanowa
Registrar

IN THE COMPETITION COMMISSION

APPEAL TRIBUNAL

Case No. 1005/1/1/01

New Court
Carey Street
London WC2A 2JT

19 March 2002

Before:

SIR CHRISTOPHER BELLAMY (The President)
PROFESSOR ANDREW BAIN OBE
PATRICIA QUIGLEY

Sitting as a tribunal in Scotland

BETWEEN:

ABERDEEN JOURNALS LIMITED

Applicant

and

THE DIRECTOR GENERAL OF FAIR TRADING

Respondent

Supported by

ABERDEEN INDEPENDENT LIMITED

Intervener

Mr Nicholas Green QC (instructed by Mr Craig Pouncey of Messrs Herbert Smith) appeared for Aberdeen Journals Limited

Mr Mark Hoskins (instructed by Ms Amanda Dadley for the Director of Legal Services, Office of Fair Trading) appeared for the Director General of Fair Trading

Mr Fergus Randolph (instructed by Mr John Hill of Messrs Shoosmiths) appeared for Aberdeen Independent Limited

Heard at the Court of Session, Edinburgh, on 11 December 2001

**JUDGMENT (Non-confidential version)**

Note: Excisions in this judgment relate to commercially confidential information: Section 56 and Schedule 8, paragraph 4(3) of the Competition Act 1998

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**Note:** For simplicity, this judgment will refer throughout to Articles 81 and 82 of the EC Treaty, whether in citations from judgments or otherwise, notwithstanding that the original citation referred to Articles 85 and 86 of the EC Treaty which were renumbered as Articles 81 and 82 by the Treaty of Amsterdam with effect from 1 May 1999.



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## I INTRODUCTION

### *The statutory framework*

1. This case concerns the application of section 18 of the Competition Act 1998 ("the Act") which provides:

> "18. – (1) Subject to section 19, any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom.
>
> (2) Conduct may, in particular, constitute such an abuse if it consists in–
>
> (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
>
> (b) limiting production, markets or technical development to the prejudice of consumers;
>
> (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
>
> (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contracts.
>
> (3) In this section-
>
> "dominant position" means a dominant position within the United Kingdom; and
>
> "the United Kingdom" means the United Kingdom or any part of it.
>
> (4) The prohibition imposed by subsection (1) is referred to in this Act as "the Chapter II prohibition".

2. Section 18 of the Act is closely modelled on the corresponding provisions of Article 82 of the Treaty establishing the European Community ("the Treaty"). So far as possible, the Act is to be interpreted and applied consistently with the principles of Community law: see section 60.

3. Section 36(2) of the Act provides that on making a decision that conduct has infringed the Chapter II prohibition, the Director may require the undertaking concerned to pay him a penalty in respect of the infringement. Under section 36(3), such a penalty may be imposed only if the Director is satisfied that the infringement has been committed intentionally or negligently. By virtue of section 36(8), no penalty fixed by the Director may exceed 10 per cent of the turnover of the undertaking as determined in accordance with the Competition Act 1998 (Determination of Turnover for Penalties) Order 2000 (SI 2000 No. 309). Any penalty so imposed is recoverable as a civil debt following the expiry of the period for appealing to this Tribunal, or the determination of any such appeal: section 37.

4. Section 38(1) of the Act requires the Director to publish guidance as to the appropriate amount of any penalty. Under section 38(8) the Director must have regard to that guidance when setting the amount of the penalty. The Director has published such guidance entitled *Director General of Fair Trading's Guidance as to the Appropriate Amount of a Penalty* (OFT 423, March 2000).

5. Any person in respect of whose conduct the Director has made a decision within the meaning of section 46(3) of the Act may appeal to this Tribunal against, or with respect to, that decision: sections 46(2) and 48(1).

6. The powers of this Tribunal to determine appeals under section 46 are set out in paragraph 3 of Schedule 8 of the Act, which provides:

> "3.–(1) The tribunal must determine the appeal on the merits by reference to the grounds of appeal set out in the notice of appeal.
>
> (2) The tribunal may confirm or set aside the decision which is the subject of the appeal, or any part of it, and may–
>
> (a) remit the matter to the Director,
>
> (b) impose or revoke, or vary the amount of, a penalty,
>
> (c) grant or cancel an individual exemption or vary any conditions or obligations imposed in relation to the exemption by the Director,
>
> (d) give such directions, or take such other steps, as the Director could himself have given or taken, or
>
> (e) make any other decision which the Director could himself have made.
>
> (3) Any decision of the tribunal on an appeal has the same effect, and may be enforced in the same manner, as a decision of the Director.
>
> (4) If the tribunal confirms the decision which is the subject of the appeal it may nevertheless set aside any finding of fact on which the decision was based."

7. The procedure governing appeals to this Tribunal is set out in the Competition Commission Appeal Tribunal Rules 2000, S.I. 2000 No. 261 ("the Tribunal Rules").

***Background to the appeal***

8. Aberdeen Journals Limited ("Aberdeen Journals") is a subsidiary of Aberdeen Journals Holdings Limited, which is in turn owned by Northcliffe Newspapers Group Limited ("Northcliffe"). Northcliffe is owned by Daily Mail & General Holdings Limited, which is in turn owned by Daily Mail & General Trust plc. The ultimate holding company for all of these companies is Rothermere Continuation Limited, based in Bermuda.

9. Aberdeen Journals publishes three newspaper titles: a paid-for daily morning title, the *Press & Journal*, which is available throughout the north of Scotland; a paid-for daily title, the *Evening Express*, which is focussed on Aberdeen and its outlying areas; and a free weekly title, the *Herald & Post*, which is distributed mainly in urban Aberdeen.

10. In March 1996, at the instigation of Mr Keith Barwell, Aberdeen Independent Limited ("Aberdeen Independent") launched a free weekly newspaper in Aberdeen, the *Aberdeen & District Independent* ("the *Independent*").

11. Aberdeen Independent submitted a complaint to the Director on 28 May 1999 alleging that the *Herald & Post* was pricing its advertising space at significantly below "market value". The Director initially investigated this complaint under the Fair Trading Act 1973. After 1 March 2000 that investigation became an investigation under the Act to determine whether Aberdeen Journals had breached the Chapter II prohibition.

12. On 23 November 2000 the Director issued a written notice to Aberdeen Journals in accordance with Rule 14 of The Competition Act 1998 (Director's rules) Order 2000 S.I. 2000 No. 293 ("the Director's Rules") stating that he proposed to make a decision that Aberdeen Journals had infringed the Chapter II prohibition by charging excessively low rates for advertising in the *Herald & Post* with a view to driving the *Independent* out of the market. On the information available to him, the Director considered that the infringement continued at least for the period from 1 March until the end of July 2000, but was likely to continue until September 2001.

13. In accordance with Rule 14(7) of the Director's Rules, Aberdeen Journals submitted written representations to the Director on 2 February 2001 and attended an oral hearing on 15 February 2001.

14. On 16 July 2001 the Director adopted Decision No. CA98/5/2001 entitled "*Predation by Aberdeen Journals Ltd*" ("the Decision"). The Decision found that Aberdeen Journals had abused a dominant position in the market for the supply of advertising space in local newspapers (paid-for and free) in the Aberdeen area in the period from 1 March until 29 March 2000. Paragraph 116 of the Decision states that:

> "Aberdeen Journals, dominant on the market for the supply of advertising space in both paid-for and free local newspapers in Aberdeen or the circulation area of the *Herald & Post*, supplied advertising space in the *Herald & Post* at below average variable cost. This raises a presumption of predation that Aberdeen Journals has failed to rebut by providing an objective justification. The Director therefore finds that Aberdeen Journals predated for the period from 1 March until 29 March 2000 .

15. For that infringement of the Chapter II prohibition, the Decision imposed on Aberdeen Journals a penalty of £1,328,040.

16. Pursuant to section 46(2) of the Act, Aberdeen Journals appealed to this Tribunal against the Decision by an appeal lodged on 14 September 2001.

## II THE DECISION

### *The Director's findings on dominance*

17. In the Decision, the Director found that the relevant market for the purposes of his analysis was the market for the supply of advertising space in both paid-for and free local newspapers within the Aberdeen area or the circulation area of the *Herald & Post* (paragraphs 14 to 48 of the Decision). In coming to this conclusion the Director considered, contrary to the submissions of Aberdeen Journals, that advertising space in the daily paid-for *Evening Express* is in the same relevant market in the local Aberdeen area as advertising space in the weekly free local newspapers, the *Herald & Post* and the *Independent* (see paragraphs 16 to 31, 40 and 43 of the Decision). The Director further considered that the three local newspapers in question constituted a separate market from other forms of media such as the internet, local radio, recruitment agencies, property centres, direct mail, leaflets, publications such as *Exchange & Mart* or *AutoTrader*, and directories (see paragraphs 32 to 42 of the Decision). Finally the Director found the relevant geographic market for the purpose of his analysis was Aberdeen, or the circulation area of the *Herald & Post* (paragraphs 45 to 48).

18. As regards the issue of dominance, the market shares of the parties are set out in Annex 4 of the Decision. The Director found that Aberdeen Journals' market share of advertising in local newspapers in the Aberdeen area in the period from January to March 2000 was [ ] [over 70] per cent by value and [ ] [over 60] per cent by volume (paragraph 53 of the Decision). On the basis of those market shares, coupled with what the Director held to be significant barriers to entry, the Director considered that Aberdeen Journals had a dominant position in the supply of advertising space in both paid-for and free local newspapers in Aberdeen or the circulation area of the *Herald & Post* (paragraphs 53 to 58 of the Decision).

### *The Director's findings on abuse*

19. As to whether Aberdeen Journals has abused that dominant position, the Director relies on the matters set out at paragraphs 59 to 116 of the Decision. He considers that the legal principles to be applied are those to be derived under Community law from Case C-62/86 *AKZO Chemie*

*v Commission* [1991] ECR I-3359 (*"AKZO* ), and Case T-83/91 *Tetra Pak v Commission* [1994] ECR II-755, confirmed on appeal, Case C-333/94P *Tetra Pak v Commission* [1996] ECR I-5951, (*"Tetra Pak II"*). Within that framework, the Director took into account the policy followed by the *Herald & Post* in relation to advertising rates, pagination and distribution; the relationship between the revenue of the *Herald & Post* and its costs; the intentions of Aberdeen Journals as disclosed in certain internal documents; and certain arguments advanced by Aberdeen Journals by way of defence.

*Advertising rates, pagination and distribution of the Herald & Post*

20. According to the Director, the key features that Aberdeen Journals can vary in producing the *Herald & Post* are (i) advertising rates; (ii) pagination (i.e. the number of pages in each edition); and (iii) distribution (i.e. the number of copies distributed of each edition, also known as circulation): see paragraph 71 of the Decision. According to the Director, Aberdeen Journals took the following action on each of these aspects.

21. The average advertising rate of the *Herald & Post* was cut shortly after the launch of the *Independent* from £[ ] [over £3] per single column centimetre ("sscm") in April 1996 to £[ ] [less than £1.50] per sscm in May 1996. The rate was further cut in October 1998 to below £[ ] per sscm. In March 2000, the average rate was £[ ] [less than £1.50] per sscm. That was raised to £[ ] [less than £1.75] per sscm in April 2000. The average rates for May, June and July 2000 were £[ ], £[ ] and £[ ] [in all cases less than £1.75] per sscm. (See paragraph 72, and Annex 2, Graph 1, to the Decision.)

22. Pagination of the *Herald & Post* was increased from under 100 pages a month in the period up to April 1996, to 148 pages in May 1996. Subsequently pagination rose, until it was mainly between 350 and 480 pages per month in the period between September 1998 and October 1999 (i.e. weekly papers containing 84 to 96 pages). Between November 1999 and March 2000, pagination declined to between 300 and 380 pages per month. Pagination in March 2000 was 388 pages. Pagination was cut back in April 2000 to 220 pages per month, and remained at about that level until July 2000. (See paragraph 74 and Annex 2, Graph 2, to the Decision.)

23. From October 1995 to April 1998 the distribution of each weekly edition of the *Herald & Post* was between 80,000 and 100,000 copies. Distribution increased to above 120,000 per edition in November 1998, but between October 1999 and March 2000 distribution declined to between 100,000 and 108,000 copies. In March 2000, average distribution was 102,600 copies for each weekly edition. This was cut to 83,974 copies in April 2000, and remained at about that level until July 2000. (See paragraph 76, and Annex 2, Graph 3, to the Decision.)

*Costs and revenues of the Herald & Post*

24. Monthly figures for the costs and revenues of the *Herald & Post* were supplied to the Director by Aberdeen Journals for the period October 1995 to July 2000. The figures supplied were those reported in the management accounts of the *Herald & Post*, which set out the "directly attributable costs" and "directly attributable revenue" allocated to the *Herald & Post* by Aberdeen Journals. The principal costs so allocated were (i) the cost of newsprint; (ii) editorial costs; (iii) costs relating to sales of advertising; and (iv) distribution costs. The net balance between such "directly attributable costs" and "directly attributable revenue" constitutes the *Herald & Post's* "contribution" (positive or negative) to Aberdeen Journals' financial results, as shown in the management accounts (paragraphs 67 to 69 to the Decision).

25. On this basis, paragraph 78 of the Decision sets out the *Herald & Post's* contribution to Aberdeen Journals' financial results for the period October 1995 to July 2000. In summary, paragraph 78 of the Decision shows that before the launch of the *Independent,* the *Herald & Post's* contribution was positive. However, after the launch of the *Independent*, in 1996, the *Herald & Post* incurred substantial deficits which continued throughout the period up to July 2000. According to the management accounts of Aberdeen Journals, the deficit incurred by the *Herald & Post* for March 2000 was £[ ]. Further deficits were recorded in the months of April, May, June and July 2000.

26. In the Decision, the Director considered that the "losses" of the Herald & Post shown in the management accounts were "very significant in the context of the revenue being earned". During the period from November 1998 to September 1999, the "losses" of the *Herald & Post* were over 75 per cent of its revenue. In March 2000 the "losses" of the *Herald & Post* represented 42 per cent of its revenue. The Director says that the "losses" of the *Herald & Post* since April 2000 have been less significant, but were still 12 per cent of revenue in July 2000. (See paragraph 78 to 81, and Graphs 4 and 5 at Annex 2, to the Decision.)

27. The Director, however, noted, at paragraphs 69 and 70 of the Decision, that certain costs, including "printing and ink/plate costs", are not allocated to the *Herald & Post* in the management accounts of Aberdeen Journals. According to the Director, adding these costs to the "loss" (i.e. negative contribution) of the *Herald & Post* in the month of March 2000 increased the negative contribution of the *Herald & Post* from £[ ] to £[ ] during that month. Similarly, in the period April to July 2000 the negative contribution of the *Herald & Post* is increased when those costs are included.

28. Turning to the question of the fixed and variable costs of the *Herald & Post*, in the Decision the Director defines "fixed costs" as those that do not vary with output, whereas "variable costs" are those that do vary with output. For the purposes of this case, the Director has assessed "variable" costs as those that could be varied within the period of a single month, on the basis notably that one month is the period "over which short term planning for the *Herald & Post* might be determined". The Director, however, avers that such a short period "errs against a finding of predation" (see paragraph 82 of the Decision).

29. On that basis, the Director accepted that, over one month, there was a fixed element to the costs of the editorial staff and the advertising team of the *Herald & Post*, but that the costs of newsprint and distribution are variable (paragraph 83 of the Decision). According to the Director, in the 45 months between July 1996 and March 2000, the revenue of the *Herald & Post* exceeded the costs of newsprint and distribution on only five occasions, most recently in April 1998. In March 2000, the revenue of the *Herald & Post* was £[ ], which did not cover the newsprint and distribution costs of £[ ]. However, in April, May, June and July 2000 the costs of newsprint and distribution were covered by revenue (paragraphs 83 and 84 and graph 6 at Annex 2 to the Decision).

30. In the Decision, at paragraphs 85 to 87, the Director also carried out a further analysis of costs for the months of March to July 2000, in order to determine the variable costs of the *Herald & Post* on the basis of what costs could be avoided if the *Herald & Post* were not produced for a month. On the basis of this further analysis, the Director considered that Aberdeen Journals had failed to price above average variable costs regarding the *Herald & Post* in March, May and June 2000. Specifically as regards the month of March 2000, the Director found that the revenue of the *Herald & Post* was £[ ] and that its variable costs, including an allocation for common costs, were £[ ], giving a deficit of £[ ] for that month (see paragraphs 85 to 87 of the Decision).

*Aberdeen Journals' intentions*

31. At paragraphs 88 to 90 of the Decision, the Director found that it was Aberdeen Journals' intention to use the *Herald & Post* strategically to expel the *Independent* from the market by means of incurring heavy losses on that title. In support of that conclusion, the Director set out, at paragraph 88 of the Decision, extracts from a number of internal memoranda between staff of Aberdeen Journals and Northcliffe supplied to the Director by Aberdeen Journals. The citations in the Decision are as follows:

*'Memo dated 12 July 1996, Mr Alec Davidson (Managing Director of Northcliffe) to Mr Alan Scott (Managing Director of Aberdeen Journals):*

Under the heading '*Herald & Post*': 'You view the *Herald & Post* as a tactical tool in the company's armoury. Barwell's [Keith Barwell owns the *Independent*] move to Aberdeen has caused you to increase your efforts on this and if and when he goes away you will leave a three month gap between that happy event and running it down again.'

'Next year's figure [the annual budget] would include the £500,000 investment we are making against Barwell. Whilst you thought it possible that Barwell would cease publication by Christmas this cannot be built into the budget.'

*Memo dated 1 April 1997, Mr Davidson to Mr Ian Lovett (Commercial Systems Manager at Aberdeen Journals):*

After references to whether the *Independent* is making a profit, or loss, 'Finally, please keep your foot on their neck!'

*Memo dated 12 May 1998, Mr Davidson to Mr Scott:*

'You perceive the *Independent* to be less of a threat to you and therefore propose to fight it with the *Herald & Post*, not the paid-for titles. We authorise an additional £50,000 to be invested into that and this will be taken into account when calculating your strive payments at the end of the year. I would be tempting fate if I recorded that you think the *Independent* may cease publishing by the end of this financial year but here goes anyway!'

'You also proposed to place greater separate focus on the *Herald & Post* so that it is our only title pitched against the *Independent*. Again, this is agreed for this could be an area where we could make substantial profit progress over the next 18 months to 2 years, given that we are successful in closing them down.'

*Memo dated 29 July 1998, Mr Michael Pelosi (Deputy Managing Director at Northcliffe) to Mr Scott:*

'the closure of the *Aberdeen Independent* would allow you to reduce gradually investment in the *Herald & Post*, resulting in additional profits of between £0.5 m and £1m.'

*Memo dated 6 December 1999 from Mr Davidson to Mr Scott:*

'You agree to produce 2 scenarios as far as the *Independent* is concerned. The first assumes that we acquire them. The second assumes that you are given a sum of money to neutralise them.'

*Memo dated 5 January 2000 from Mr Davidson to Mr Taymour Ezzat (then Northcliffe's London Financial Controller):*

'The purpose of your visit is to help Aberdeen construct three operational and financial scenarios relating to the *Aberdeen Independent*. These can be summarised as: 2.1 To continue with the existing policy 2.2 To purchase the *Aberdeen Independent*; and 2.3 To considerably enhance our existing activity with a view to denying the *Independent* all commercial oxygen.'

*Review of Aberdeen Independent by Mr Ezzat (undated, but responsive to Memo dated 5 January 2000 from Mr Davidson to Mr Ezzat):*

After reviewing competition between Aberdeen Journals and *Independent*: 'The current position is one of stalemate' (page 2). Recommendation (page 5): 'to purchase the *Independent* from Barwell and merge the title with our own free title ... Unfortunately Barwell is currently on a roll and may feel that he can demand a higher price. NNG will therefore need to move forward by developing

> the Herald & Post and increasing the pressure on Barwell. ... Our response to Barwell was very vigorous and most publishing entrepreneurs would not have been able to fund these losses over four years.
>
> Assuming the OFT risk is minimal, open negotiations with Barwell as we need to bring his price expectations down. On the basis that he will not accept our views, we need to continue with the development of the Herald & Post at the same time.
>
> NNG have to be prepared to maintain this approach for a sustained period (6 to 12 months) in order to convince Barwell that we will not allow the Independent to break even.
>
> I believe that maintaining the pressure on Barwell by attacking the Independent more aggressively and satisfactorily resolving the OFT queries will eventually ensure he will accept our offer.'

32. On the above evidence, the Director presumed what he describes as "predation" by Aberdeen Journals in March, May and June 2000, contrary to the Chapter II prohibition. The *Herald & Post*'s revenue was below average variable cost during that period (see paragraph 30 above), even taking into account only costs which were regarded as variable over a reference period as short as one month (paragraph 91 of the Decision).

*Aberdeen Journals' arguments before the Director*

33. According to paragraphs 93 to 112 of the Decision, Aberdeen Journals raised three counter arguments to rebut the Director's presumption of predatory conduct. Those arguments were that: (i) Aberdeen Journals was merely meeting competition; (ii) by 1 March 2000 Aberdeen Journals had changed its strategy, so no predation could be established after that date; and (iii) in any event, there was no predation in May and June 2000 by Aberdeen Journals since extra costs were incurred in those months because the threat of industrial action in Aberdeen compelled it to print the *Herald & Post* in Leicester.

34. As to those arguments, the Director considered (i) that Aberdeen Journals did not react proportionately to the *Independent's* entry, but rather initiated and maintained a strategy designed to expel the *Independent* from the relevant market, using the *Herald & Post* as a "fighting title" (paragraphs 93 to 96 of the Decision); (ii) that there was no significant change in the situation after 1 March 2000 so as to rebut the presumption of predation during the month of March (paragraphs 97 to 111); but (iii) that the cost increase in May and June 2000, resulting from the printing of the *Herald &Post* in Leicester, as a result of the threat of industrial action in Aberdeen, amounted to an objective justification displacing the presumption of predation in those two months (paragraph 112 of the Decision). On that basis, there remained only one month in which predation was found, namely March 2000.

*The Director's conclusion on infringement*

35. On the basis of the evidence before him, the Director found, at paragraph 114 of the Decision, that there was "a clear, unbroken chain of conduct" linking Aberdeen Journals' predatory conduct before 1 March 2000 with its conduct once the Chapter II prohibition had entered into force on that date. There was no objective justification for that conduct. In particular, there was insufficient evidence to rebut the presumption that Aberdeen Journals had engaged in predatory conduct by its failure to cover its average variable costs from 1 to 29 March 2000 (paragraphs 114 to 116 of the Decision). The Director further considered that trade within the United Kingdom was likely to be appreciably affected by Aberdeen Journals' conduct (paragraphs 117 and 118). Accordingly, the Director concluded that Aberdeen Journals had infringed the Chapter II prohibition (paragraph 119 of the Decision).

*The penalty*

36. The Director further held that the infringement had been committed intentionally or negligently and imposed a penalty of £1,328,040, pursuant to his powers under section 36 of the Act. The Director's calculations of the penalty are set out at paragraphs 126 to 133 of the Decision. At paragraph 121 of the Decision the Director found that no directions were necessary under section 33 of the Act "[s]ince Aberdeen Journals has provided evidence to the Director that it has ceased predating."

## III THE PROCEDURE BEFORE THE TRIBUNAL

37. Aberdeen Journals' application to the Tribunal was lodged at the Registry on 14 September 2001. Notice of the appeal was published in the London, Edinburgh and Belfast Gazettes on 21 September 2001 and also on the Tribunal's website, www.competition-commission.org.uk, pursuant to Rule 13 of the Tribunal Rules.

38. By a request lodged at the Registry on 12 October 2001, Aberdeen Independent requested permission to intervene in support of the Director pursuant to Rule 14 of the Tribunal Rules. That application was granted at the case management conference held on 16 October 2001.

39. At the case management conference of 16 October 2001 the Tribunal also considered, in accordance with Rule 16 of the Tribunal Rules, whether these proceedings were before a tribunal in England and Wales, in Scotland or in Northern Ireland. After hearing argument, the Tribunal ruled, in its judgment of 16 October 2001, that the proceedings were proceedings

before a tribunal in Scotland and that, pursuant to Rule 16(3), it was appropriate to hold the oral hearing in Scotland.

40. At the case management conference on 16 October 2001 it was also agreed that certain documents for which confidentiality was claimed would be disclosed by Aberdeen Journals to the legal advisers of Aberdeen Independent. It appears that difficulties later arose as to the scope of the confidentiality claimed by Aberdeen Journals in respect of certain documents upon which the advisers to Aberdeen Independent wished to take their clients' instructions. In such circumstances, the correct course is to make an application to enable the Tribunal to settle the principles applicable and the application of those principles in the particular case. In the present case, however, no application was made to the Tribunal to resolve this dispute, and Aberdeen Independent did not pursue the matter at the oral hearing.

41. The Director's defence was lodged on 29 October 2001. Aberdeen Independent's statement of intervention was lodged on 7 November 2001. Aberdeen Journals lodged a short reply on 14 November 2001. Copies of the *Evening Express*, *Herald & Post* and *Independent* were supplied by the parties following the Tribunal's request of 1 November 2001.

42. By various letters dated 19, 23 and 29 November and 3, 6 and 7 December 2001 passing between the Tribunal and the parties, the Tribunal sought to establish how far the printing costs associated with the production of the *Herald & Post,* other than ink, plate and film costs, notably staff costs had been taken into account in the Decision, and asked for details of such costs. The outcome of these exchanges was that Aberdeen Journals identified certain additional costs and the Director accepted that staff printing costs had not been investigated. Aberdeen Independent questioned both the appropriateness and the reliability of the cost allocations made by Aberdeen Journals and provided data on its own costs. We take no view on these matters in this judgment.

43. Skeleton arguments were exchanged in accordance with an agreed timetable shortly before the oral hearing. Aberdeen Journals' skeleton annexed some 40 US and Australian cases. The oral hearing took place on 11 December 2001 at the Court of Session in Edinburgh.

44. A note on the US and Australian case law was lodged by Aberdeen Journals on 19 December 2001. Further letters to the Tribunal on the issue of printing costs were lodged by Aberdeen Journals on 18 December 2001, the Director on 8 January 2002 and Aberdeen Independent on 11 January 2002.

45. Aberdeen Journals requests:

— that the Decision be set aside in whole or in part;
— that the penalty be set aside or reduced;
— a declaration that Aberdeen Journals' conduct in the period 1 to 29 March 2000 did not infringe section 18 of the Act;
— that the Director pay Aberdeen Journals' costs; and
— such further and other relief as the Tribunal may consider appropriate.

46. The Director requests the Tribunal:

— to dismiss Aberdeen Journals' appeal; and
— to order Aberdeen Journals to pay interest on the penalty from 17 October 2001 at a rate consistent with the rate at which a commercial lender would have loaned an equivalent sum to Aberdeen Journals for the period in question.

47. Aberdeen Independent submits that the Tribunal should:

— dismiss Aberdeen Journals' appeal; and
— order Aberdeen Journals to pay its costs.

48. In his defence the Director reserved his position on costs. By letter of 7 February 2002 he sought to be heard on the issue of costs in the light of the Tribunal's judgments on costs in *The Institute of Independent Insurance Brokers and Association of British Travel Agents Limited v Director General of Fair Trading* (29 January 2002) and *Napp Pharmaceutical Holdings Limited and subsidiaries v Director General of Fair Trading* (6 February 2002).

## IV THE ISSUES

49. In the light of the arguments of the parties, the issues in this case concern principally (i) whether the Director has correctly defined the relevant market; (ii) if so, whether Aberdeen Journals is dominant in that market; (iii) if so, whether Aberdeen Journals' pricing policy in relation to the *Herald & Post* in March 2000 constituted an abuse of that dominant position; (iv) whether any such abuse may affect trade within the United Kingdom; and (v) if so, whether any, and if so what, penalty should be imposed on Aberdeen Journals.

50. In this case, as in others under the Chapter II prohibition, these issues are interrelated and should not be compartmentalised in a formal way. However, we address first the parties' submissions on the interrelated issues of the definition as to the relevant market and Aberdeen Journals' alleged dominance.

## V THE RELEVANT MARKET AND DOMINANCE

51. In the Decision, the Director held that the relevant market is the market for the supply of advertising space in both paid-for and free local newspapers in Aberdeen or the circulation area of the *Herald & Post* (paragraphs 14 to 48).

52. Alternatively, said the Director, the alleged abuse of predation "is not sensitive" to the submission made by Aberdeen Journals to the Director, in the course of the administrative procedure, to the effect that advertising in paid-for newspapers, and in free newspapers, respectively, constitute different markets. Even on that view, said the Director, Aberdeen Journals would be dominant in the narrower market of advertising space in paid-for newspapers in Aberdeen, since it was the only supplier of paid-for newspapers in that area. On that analysis, Aberdeen Journals would still have abused its dominant position in the supply of advertising space in paid-for newspapers in Aberdeen by its predatory conduct on the closely associated market of advertising space in free newspapers in Aberdeen (paragraphs 49 to 52 of the Decision).

53. As to dominance in the Director's primary market – the supply of advertising space in paid-for daily and free weekly newspapers in the Aberdeen area – the Director held that Aberdeen Journals had a market share of [ ] [over 70] per cent by value and [ ] [over 60] per cent by volume in the first quarter of 2000. In addition, according to the Director, competition against Aberdeen Journals was weak. Its only direct competitor, the *Independent*, was subject to an aggressive strategy of predation. Moreover, significant barriers to entry existed, not least Aberdeen Journals' strong reputation for fighting potential entrants seeking to establish competing titles (paragraphs 53 to 58 of the Decision).

### A. ARGUMENTS OF THE PARTIES

***Aberdeen Journals' submissions***

54. Aberdeen Journals submits that the Director should establish his case to the criminal standard of "beyond all reasonable doubt" or some proxy thereof. In this case the Director has not sufficiently proved the relevant market relied on in the Decision. In particular, it is not established that the relevant market in the Aberdeen area includes both advertising space in the daily paid-for *Evening Express* and advertising space in the free weekly titles, the *Herald & Post* and the *Independent*. According to Aberdeen Journals, the correct relevant market in this case is that for free newspapers in Aberdeen. In that market, Aberdeen Journals has no dominant position.

55. Aberdeen Journals draws attention to the fundamental importance of correct market definition in competition cases (see the Director's Guideline on *Market Definition* (OFT 403) and Case 31/80 *L'Oréal* [1980] ECR 3775), notably in order to ensure that the "special responsibility" imposed on a dominant undertaking is not imposed in relation to markets in which the undertaking does not hold a dominant position (Case 322/81 *Michelin v Commission* [1983] ECR 3461, paragraph 10; *Claritas (U.K.) Limited v the Post Office and Postal Preference Service Limited* [2001] ECC 12, paragraph 44).

56. According to Aberdeen Journals, in order to define the relevant market (a) there must be a detailed description and assessment of the characteristics of the products in question and (b) account must be taken of the competitive conditions, of the structure of supply and demand on the market, and of the views of customers and consumers (Case 6/72 *Continental Can v Commission* [1973] ECR 215, paragraphs 35 and 37; *Michelin,* cited above, at paragraph 37; Case T-83/91 *Tetra Pak v Commission* [1994] ECR II-755 at page 793; Case T-9/93 *Schöller v Commission* [1995] ECR II-1611 at paragraph 40; and OFT 403, paragraph 3.1). In this case, says Aberdeen Journals, the Director has failed to fulfil those requirements.

57. Firstly, the Decision makes almost no mention of the "particular characteristics" of the products concerned. The Director's descriptions of the newspapers in question are inadequate. In particular, there is no description at all of the advertising base of either the *Independent,* or the *Evening Express,* nor any proper comparison of those products, in demand terms, with the *Herald & Post.*

58. Secondly, as regards the "competitive conditions on the market", Aberdeen Journals points out that the Director has not included an analysis of the reaction of advertisers in Aberdeen to the "hypothetical monopolist test" set out in the Director's own guidance (OFT 403, paragraph 2.8) in order to assess the product market on the demand side. Moreover, the Director has not used the monthly volume and revenue figures submitted by Aberdeen Journals and Aberdeen Independent to examine how a relative price increase in one newspaper leads or might lead to advertisers switching to another newspaper.

59. Indeed, submits Aberdeen Journals, the Director has included no evidence in the Decision on the substitutability of paid-for daily newspapers for free weekly newspapers, or vice versa. The Director's various assertions in the Decision as to advertisers seeing "scope for switching between advertising in the free and paid-for local titles" (paragraph 25) or as to "the overlap in advertisers using the papers" (paragraph 30) are unsupported by evidence. Such evidence as

does exist suggests that the *Herald & Post* and the *Independent* are the closest substitutes in the Aberdeen area, as the Director himself finds in paragraph 22 of the Decision.

60. Aberdeen Journals notes that the only evidence from advertisers on which the Director relied in the Rule 14 Notice, namely a survey of Aberdeen advertisers, has not been referred to in the Decision. Aberdeen Journals considers that this survey was unrepresentative and did not address the correct questions. However, in so far as any conclusions can be drawn, this survey provides virtually no support for the Director's proposition that free and paid-for newspapers formed a single market at the material time.

61. According to Aberdeen Journals, the Director's market definition is further flawed since he has made no analysis of the market during the period of the infringement – 1 to 29 March 2000 – as he is bound, as a matter of law, to do. According to Aberdeen Journals, it is unlawful for the Director to rely on facts and matters arising before 1 March 2000 in order to establish his case after that date. The Director relies on no evidence from advertisers relating to March 2000, nor has he attempted to include an analysis of the extent to which the same advertisers used both the *Evening Express* and the free weekly titles in the period 1 to 29 March 2000.

62. In particular, Aberdeen Journals submits that the Director cannot rely on the letter to the Director of 10 February 2000 from Mr Scott, the Managing Director of Aberdeen Journals, as he does in paragraph 23 of the Decision. That letter merely records Mr Scott's perception of what Aberdeen Independent's strategy was in 1996, and does not express agreement with that strategy. That letter further indicates Mr Scott's view that the distribution area of the *Evening Express* and the *Herald & Post* are different; that the response of Aberdeen Journals to the launch of the *Independent* was to lower the advertising rates of the *Herald & Post,* not those of the *Evening Express*; that the paid-for and free newspapers operate in different "layers" of the market; that there are differences between the *Evening Express* and the *Independent* in respect of quality, news coverage, editorial content, readership and target audience. In any event, the letter of 10 February 2000 does not show a competitive relationship between the paid-for and the free titles in March 2000, by which time the quality of the *Herald & Post* had deteriorated sharply and its advertising rates had risen. Other citations from the letter of 10 February 2000, relied on by the Director in paragraph 23 of the Decision, are taken out of context.

63. Aberdeen Journals further argues that the Director has not rebutted its case that the free weekly and paid-for daily newspapers in Aberdeen form two separate markets since they have very different characteristics, and a very different appeal to advertisers. In support of this, Aberdeen Journals relies on a witness statement from Mr Scott. In that statement Mr Scott emphasises,

notably, that readership per copy for the paid-for titles in Aberdeen is as much as double that of the free titles; readers spend less than half the time reading the free titles as they do the paid-for titles; 27 per cent of the *Evening Express*'s distribution is outside urban Aberdeen; the demographic targets of the *Evening Express* and the *Herald & Post* are different, the former being directed more towards those aged between 15 and 44 with a lower proportion of AB readers; unlike the free newspapers, the paid-for newspapers depend on long term credibility in their editorial coverage; and the paid-for daily titles provide advertisers with a more focussed platform than do the weekly free newspapers.

64. According to Aberdeen Journals, the Director counters this very specific evidence regarding the characteristics of the titles concerned with only very general assertions. His reliance (at paragraph 19 of the Decision) on reports of the reporting panels of the Competition Commission (namely *Johnston Press plc and Home Counties Newspapers Holdings plc*, June 1998, Cmnd 3962, paragraph 2.9, and *Portsmouth & Sunderland Newspapers plc and Johnston Press Plc/Newsquest (Investments) Limited/News Communications and Media Plc*, June 1999, Cmnd 4358, paragraph 2.22) is an inadequate basis for concluding that free and paid-for newspapers compete. In particular the *Portsmouth & Sunderland* report concludes merely that "paid-for and free newspapers ***may*** directly compete for readers and advertisers" and makes it clear that a *specific* analysis is required in each case (paragraph 4.23). Moreover, the report of the reporting panel of the Competition Commission on *News Communications & Media plc and Newsquest (Investments) Limited/Johnston Press plc/Trinity Mirror plc,* April 2000, Cmnd 4680 (paragraph 2.24) shows that a detailed analysis of specific titles' editorial content and readership profiles is required. The Director also omits to mention the most recent report of the reporting panel of the Competition Commission, *Regional Independent Media Limited and Gannett UK Limited/Johnston Press Plc/Guardian Media Group plc*, November 2000, Cmnd 4887, which concluded (at paragraph 4.34) that advertisers view advertising in daily and weekly titles as complements, rather than substitutes.

65. Aberdeen Journals also criticises as unsubstantiated the Director's contention that "the geographic targeting of the *Evening Express* is not sufficiently different" to justify its exclusion from the relevant market (paragraph 28 of the Decision), and his failure to take into account the difference in frequency of publication between the daily *Evening Express* and the two weekly free newspapers (paragraph 30 of the Decision) as a relevant factor.

66. In oral argument Aberdeen Journals emphasised that it would be artificial to take into account any "gravitational pull" there may be for advertisers from the paid-for *Evening Express* to the free newspapers in a period when the latter were at their most attractive in terms of rates,

pagination and distribution because of the competitive battle between them. According to Aberdeen Journals, what the Director needs to demonstrate is a significant amount of substitution between the titles concerned in normal market conditions, and not just some switching at the margins in atypical conditions.

67. Moreover, according to Aberdeen Journals the Managing Director of the *Independent*, Mr Robins, supports Aberdeen Journals' view of the market. In his letter to the Director of 8 March 2000 Mr Robins stated, after consulting Mr Barwell:

> "The relevant product market that the *Herald & Post* competes in is the local newspaper market, and more specifically the local free newspaper market We are their only direct competitor within both these markets. Both the other newspapers within Aberdeen are daily, paid-for titles owned by Aberdeen Journals"

68. Furthermore, according to Aberdeen Journals, the Director's conclusions (at paragraphs 32 to 42 of the Decision) that other advertising media are not close substitutes for advertising in newspapers, is not supported by any evidence from advertisers in Aberdeen. Aberdeen Journals identifies a number of instances of what it considers to be evidence demonstrating that advertisers in Aberdeen are in fact using, or would potentially use, the internet, local radio, or directories as substitutes for newspapers, and that media such as *AutoTrader* and direct mail are viable, potential substitutes given appropriate market conditions. According to Aberdeen Journals, the Director's arguments that other media are considered by advertisers as complements, not substitutes, for newspapers, applies equally to the relationship between paid-for daily newspapers and weekly free newspapers. Moreover, the Director's own survey suggests that the internet is and was viewed by advertisers as a substitute for newspapers.

69. According to Aberdeen Journals, the Director's alternative argument (at paragraphs 49 to 52 of the Decision) that, even if he accepted Aberdeen Journals' submissions on market definition, Aberdeen Journals would be dominant on the market for the supply of advertising space in paid-for newspapers in Aberdeen, and would have abused that dominant position on an associated market for free titles, cannot be taken into account as it was not put to Aberdeen Journals in the course of the administrative procedure. In any event, there is no analysis in the Decision which could enable the Director to conclude that there were "strong associative links" between the titles and markets in question, in the period 1 to 29 March 2000.

70. Aberdeen Journals, in its reply, denies that the Director is entitled to rely on any fact or matter other than that which is contained in the Decision. According to Aberdeen Journals, the Director has improperly embellished the Decision by relying in the defence on extracts from documents not referred to in the Decision, namely Appendix 2 to the Aberdeen Journals' letter

of 10 February 2000; a memorandum from Mr Pelosi to Mr Davidson dated 21 May 1999; the memorandum dated 20 July 1999 from Mr Davidson to Mr Scott; and the summary of a meeting with Mr Barwell which took place on 5 August 1999. At the oral hearing Aberdeen Journals maintained that, as a matter of law, the Director was not entitled to rely on this evidence.

71. Finally, as regards "dominance", even if the Director has correctly defined the relevant market, Aberdeen Journals submits that the *Herald & Post* had no ability to behave independently of its advertisers, and of the *Independent* in the period 1 to 29 March 2000. In particular, as a result of the changes in advertising rates, pagination and distribution which took place at the *Herald & Post* during March 2000, a number of advertisers ceased advertising in the *Herald & Post*. That shows that the *Herald & Post* was not "behaving independently" of its advertisers.

72. In any event, in this case, the Director cannot establish dominance on the basis of the market shares alone. First, having defined the relevant market as "Aberdeen or the circulation area of the *Herald & Post*" the Director wrongly proceeds to include the total sales of the *Evening Express* in the calculation of Aberdeen Journals' market share. Secondly, the circumstances during 1 to 29 March 2000, when Aberdeen Journals was increasing advertising rates for a product which was of less value to advertisers constitute "exceptional circumstances" displacing the presumption in Case 85/76 *Hoffman-La Roche v Commission* [1979] ECR 461, paragraph 41, that dominance can be established by market share alone. In the present case, the remaining market share is taken by the *Independent*, which has progressively increased its market share at the expense of the *Herald & Post*. The Decision does not analyse whether the *Herald & Post* in fact held a "position of economic strength" in March 2000. As regards free newspapers in Aberdeen, in March 2000, the *Independent's* share was between 65 and 72 per cent by value whereas that of the *Herald & Post* was between 35 and 28 per cent. Accordingly Aberdeen Journals was not dominant during that period.

***The Director's submissions***

73. The Director submits, in the defence, that the standard of proof he has to meet on the issues in the case, including the issue of market definition, is the civil standard of the balance of probabilities.

74. According to the Director, in defining the relevant product market, the starting point is to identify the product concerned. In this case, that required examination of the nature of the advertising which appears in the *Herald & Post*. Paragraph 35 of the Decision amounts to a

detailed assessment of the objective characteristics of that product. Thereafter, the Decision concludes (at paragraphs 21-25) that the *Herald & Post*, *Independent* and *Evening Express* are reasonable substitutes for each other from the point of view of the type of advertisers who advertise in the *Herald & Post*. As a result, the relevant product market encompasses advertising space in all three titles.

75. The justification for this conclusion is provided in the Decision (at paragraphs 23 and 24) by reference to the written submissions sent by Aberdeen Journals to the Office of Fair Trading ("the Office") dated 10 February 2000. Those submissions recognise that the *Independent*, both historically and until at least February 2000, posed a significant threat to both the *Herald & Post* and the *Evening Express*.

76. In addition, the Director refers to a number of further statements contained in Appendix 2 to Aberdeen Journals' submissions of 10 February 2000 to the effect that the *Independent* is or was seen by Aberdeen Journals as competing with the *Evening Express*.

77. The Director also refers to a number of other documents supplied by Aberdeen Journals to the Director, including memoranda from senior figures in both Northcliffe and Aberdeen Journals, namely a memorandum of 21 May 1999 from Mr Pelosi (Deputy Managing Director of Northcliffe) to Mr Davidson (Managing Director of Northcliffe); a memorandum of 20 July 1999 from Mr Davidson to Mr Scott (the Managing Director of Aberdeen Journals); a "summary of a meeting with Keith Barwell" which took place on 5 August 1999; and a "Review of Aberdeen Independent" prepared by Mr Ezzat (the London Financial Controller of Northcliffe) in January 2000. (The Director no longer relies on a document concerning a customer referred to in paragraph 25 of the defence).

78. According to the Director, the weight of this direct evidence, indicating the shared view of the main protagonists as to the scope of the relevant product market, and their conduct on that market, was sufficient to determine what the relevant market was in this case.

79. In relation to the specific arguments raised by Aberdeen Journals on the relevant market, the Director responds as follows:

— the Director did not include an analysis of the reaction of advertisers in Aberdeen to the "hypothetical monopolist test" since (i) it is not obligatory as a matter of law, (ii) it is questionable whether such an analysis is meaningful where predatory conduct has suppressed prices below normal competitive levels and it is unclear what such levels

would be; and (iii) in any event the conduct of the parties provides powerful, direct evidence as to the relevant market;

— given the existence of direct evidence of the substitutability of the *Herald & Post* and *Independent* (free weeklies) and the *Evening Express* (paid-for daily) there was no need to adopt an abstract analysis of potential competition between paid-for daily newspapers and free weekly newspapers;

— there was no need to rely on the evidence from advertisers which was referred to in the Rule 14 Notice, given the direct evidence as to the relevant product market provided by the participants' conduct in that market;

— the evidence (and specifically Aberdeen Journals' written submission of 10 February 2000) establishes that the relevant market in 2000 remained the supply of advertising in paid-for and free local newspapers. There is nothing to suggest that the position changed between February and March 2000;

— Aberdeen Journals' case that in March 2000 there were two separate markets in Aberdeen, i.e. for free weekly and paid-for daily, newspapers respectively, is sufficiently rebutted by the contemporaneous documents;

— nothing in the reports of the reporting panel of the Competition Commission cited by Aberdeen Journals contradicts the Director's market definition which is based on specific and direct evidence of the operation of the market;

— the statement made by Mr Robins in his letter dated 8 March 2000 to the Director that "the relevant product market that the *Herald & Post* competes in is the local newspaper market, and more specifically the local free newspaper market" is ambiguous and is not inconsistent with a conclusion that the *Herald & Post* competes in the local newspaper market. In addition, the summary of the meeting of 5 August 1999 makes it clear that Mr Barwell believes that the *Independent* competes with both the *Herald & Post* and the *Evening Express*;

— in relation to whether other advertising media provide substitutes for advertising in local newspapers in Aberdeen, the Decision, at paragraphs 32 to 40, sufficiently demonstrates that other media are not "close substitutes" for advertising in newspapers in Aberdeen;

— the Decision is not based on, and does not depend upon, the alternative analysis of the relevant market contained in paragraphs 49 to 52. The Director does not rely on those paragraphs in the context of this appeal.

80. As regards the additional documentary evidence referred to in the defence but not in the Decision, the Director submitted that the Decision refers to, and quotes from, Aberdeen Journals' submission dated 10 February 2000; paragraph 43 of the Decision relies generally on

"the submissions" made by Aberdeen Journals; the passages relied on are taken from that submission and the documents provided as part of that submission; Aberdeen Journals cannot be prejudiced, since the submission of 10 February 2000 was made by Aberdeen Journals itself and is referred to in the Decision; the documents concerned raise no new issues; and the material was before the Director when he took the Decision.

81. As to "dominance", the Director considers that the market shares and other factors relied on in the Decision suffice to establish dominance in accordance with *Hoffman-La Roche*, cited above, and Case T-30/89 *Hilti v Commission* [1991] ECR II-1439, paragraph 92, upheld on appeal, Case C-53/92P *Hilti v Commission* [1994] ECR I-667. There are no exceptional circumstances here to rebut the presumption that flows from Aberdeen Journals' high market shares. The few customers lost by the *Herald & Post* when advertising rates were increased in March 2000 is not inconsistent with dominance, and did not prevent that publication from returning to "profitability". In any event, the changes in advertising rates, pagination and distribution made at the *Herald & Post* were as a result of pressure from the Office, not market circumstances. Finally, Aberdeen Journals' challenge to the definition of the relevant geographical market is purely formal, no facts being advanced to support it.

***Aberdeen Independent's submissions***

82. Aberdeen Independent submits that Aberdeen does have a separate market for local newspapers due to its somewhat isolated geographical position from the rest of the United Kingdom which allowed advertising rates to be up to 10 times the national average. According to Aberdeen Independent, this fact and the lack of competition encouraged Mr Barwell to enter the market. Moreover, there is clear demand substitution between all three newspapers in the relevant market. Advertisers, especially those in the property and motor trade, will swap readily between the free and paid-for newspapers or use both types in which to advertise their goods or services. As regards dominance, Aberdeen Journals relies on the Director's submissions and refers to barriers to entry faced by the *Independent*.

83. Aberdeen Independent relies on a witness statement submitted by Mr Barwell. Mr Barwell states his view that the Director has correctly defined the relevant market. Advertisers advertise in all three of the publications in issue, particularly in the property and motors sections.

84. In oral submissions, Aberdeen Independent emphasised that the fact that advertisers advertise in both free and paid-for newspapers in Aberdeen shows that there is interchangeability on the

demand side: if the free newspapers did not exist, advertisers would have no choice except the *Evening Express*.

85. Aberdeen Journals considers that Mr Barwell's evidence is inadmissible and should not be relied upon by the Tribunal.

B. THE RELEVANT LAW

86. We first set out the relevant law. In order to fall within the Chapter II prohibition, it must be established that the undertaking in question has a dominant position. As traditionally defined, a dominant position is:

> "a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by allowing it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of the consumers."

See Case 85/76 *Hoffman-La Roche v Commission* [1979] ECR 461, paragraph 38; Case T-228/97 *Irish Sugar v Commission* [1999] ECR II-2969, paragraph 70.

87. However, as the Director points out at paragraph 12 of the Decision:

> "such a [dominant] position does not preclude some competition ... but enables the undertaking which profits by it, if not to determine, at least to have an appreciable influence on the conditions under which that competition will develop, and in any case to act largely in disregard of it so long as such conduct does not operate to its detriment."

*Hoffman-La Roche v Commission*, cited above, at paragraph 39.

88. In order to determine whether, in any given case, an undertaking has the necessary degree of economic strength or, to use the more modern term, market power, so as to give rise to dominance, it is self-evidently necessary to define the market in which that market power is said to exist. As the Commission of the European Communities ("the Commission") has put it in paragraph 2 of its *Notice on the definition of relevant market for the purposes of Community competition law* ("the Commission's *Notice on Market Definition*") OJ 1997 C372/5:

> "Market definition is a tool to identify and define the boundaries of competition between firms ... The objective of defining a market in both its product and geographic dimension is to identify those actual competitors of the undertakings involved that are capable of constraining those undertakings' behaviour and of preventing them from behaving independently of effective competitive pressure."

89. The Director's Guideline on *Market Definition* OFT 403, March 1999, follows the same approach:

> "The approach described in this guideline is not mechanical, it is a conceptual framework within which evidence can be organised. The Director General will not follow every step described below in every case. Instead, he will look at the areas of evidence which are relevant to the case in question – and will often be constrained by the extent to which evidence is available. Market definition is not an end in itself, but rather a step which helps in the process of determining whether undertakings possess, or will possess, market power." (paragraph 1.5)

90. As both the Commission's *Notice on Market Definition*, and the Director's Guideline on *Market Definition*, cited above, make clear, the concept of the relevant market includes both the *relevant product market*, i.e. those products which compete with each other to a sufficient extent to exercise a competitive constraint, and the *relevant geographic market* i.e. the geographic area in which competition between the relevant products takes place.

91. As far as the relevant product market is concerned, the Court of Justice said in *Hoffman-La Roche*, cited above,

> "The concept of the relevant market in fact implies that there can be effective competition between the products which form part of it and this presupposes that there is a sufficient degree of interchangeability between all the products forming part of the same market in so far as a specific use of such products is concerned." (paragraph 28).

92. In its judgement in *Tetra Pak II* [1994] ECR II-755, the Court of First Instance held at paragraph 63:

> "A preliminary point to note is that, according to settled case-law, the definition of the market in the relevant products must take account of the overall economic context, so as to be able to assess the actual economic power of the undertaking in question. In order to assess whether an undertaking is in a position to behave to an appreciable extent independently of its competitors and customers and consumers, it is necessary first to define the products which, although not capable of being substituted for other products, are sufficiently interchangeable with its products, not only in terms of the objective characteristics of those products, by virtue of which they are particularly suitable for satisfying constant needs, but also in terms of the competitive conditions and the structure of supply and demand on the market (see the judgment of the Court of Justice in Case 322/81 *Michelin v Commission* [1983] ECR 3461, paragraph 37)."

93. In Case T-9/93 *Schöller v Commission* [1995] ECR II-1611 the Court of First Instance emphasised that

> "it is settled law that account must also be taken of the consumer's point of view" (paragraph 40)

94. The overall effect of the above case law is summarised in the judgment of the Court of First Instance in Case T-504/93 *Tiercé Ladbroke v Commission* [1997] ECR II-923 at paragraph 81:

> "According to settled case-law, for the purposes of applying Article 82 of the Treaty, the relevant product or service market includes products or services which are substitutable or sufficiently interchangeable with the product or service in question, not only in terms of their objective characteristics, by virtue of which they are particularly suitable for satisfying the constant needs of consumers, but also in terms of the conditions of competition and/or the structure of supply and demand on the market in question (Case 31/80 *L'Oréal* [1980] ECR 3775, paragraph 25; Case 322/81 *Michelin v Commission* [1983] ECR 3461, paragraph 37; Case C-62/86 *AKZO Chemie v Commission* [1991] ECR I-3359, paragraph 51; Case T-30/89 *Hilti v Commission* [1991] ECR II-1439, paragraph 64, and Case T-83/91 *Tetra Pak v Commission* [1994] ECR II-755, paragraph 63)."

95. Decisions of the Court of Justice or the Court of First Instance on specific issues concerned with demand side substitution in defining the relevant market include Case 27/76 *United Brands v Commission* [1978] ECR 207 at paragraphs 12 to 35, (bananas distinct from the wider market for fresh fruit), *Hilti*, cited above, [1991] ECR II-1439 at paragraphs 64 to 78 (powder activated fastening systems a distinct market from other fastening systems, upheld on appeal [1994] ECR I-693) and *Tetra Pak II*, cited above, [1994] ECR II-755, paragraph 72, and [1996] ECR I-5931 paragraph 19 (longer term substitutability between plastic cartons and other packaging materials insufficient to establish a wide relevant market for packaging materials for liquid foods).

96. The foregoing cases indicate that the relevant product market is to be defined by reference to the facts in any given case, taking into account the whole economic context, which may include notably (i) the objective characteristics of the products; (ii) the degree of substitutability or interchangeability between the products, having regard to their relative prices and intended use; (iii) the competitive conditions; (iv) the structure of the supply and demand; and (v) the attitudes of consumers and users.

97. However, this check list is neither fixed, nor exhaustive, nor is every element mentioned in the case law necessarily mandatory in every case. Each case will depend on its own facts, and it is necessary to examine the particular circumstances in order to answer what, at the end of the day, are relatively straightforward questions: do the products concerned sufficiently compete with each other to be sensibly regarded as being in the same market? Are there other products which should be regarded as competing in the same market? The key idea is that of a competitive constraint: do the other products alleged to form part of the same market act as a competitive constraint on the conduct of the allegedly dominant firm?

98. In cases where the products concerned have similar objective characteristics, and cater for similar groups of consumers, there will be no particular difficulty in finding that the products

fall within the same market (e.g. that bananas from different Caribbean islands all form part of the market for bananas). But if the question is more complex (e.g. whether the relevant market is not limited to bananas but also includes fresh fruit) a number of approaches exist for identifying the products which form part of the relevant market. These may include an assessment of "demand side substitution" (namely how far it would be open to customers to switch to alternative products, notably in the event of a price increase by the allegedly dominant company) as well as an assessment of "supply side substitution" (namely how far and how quickly other suppliers might enter the market, again in the event of a price increase by the allegedly dominant company).

99. In dealing with these issues, both the Commission's *Notice on Market Definition* and OFT 403 mention various economic techniques for determining whether products may properly be regarded as substitutable with each other. One such technique is the so-called "SSNIP test", namely whether in normal competitive circumstances a Small but Significant and Non-transitory Increase in relative Prices (say 5 to 10 per cent) would result in customers switching to an alternative supplier, and if so whether such substitution would be enough to make the price increase unprofitable because of the resulting loss of sales (see e.g. the Commission's *Notice on Market Definition*, paragraphs 15 to 19; OFT 403, paragraphs 3.1 to 3.6). This test is also part of the "hypothetical monopolist" test, under which it is assumed that the allegedly dominant firm is the only supplier of the products in question (say advertising space in a daily paid-for newspaper). One then asks whether such a monopolist would be constrained in setting its prices by the possibility that it might lose customers to an alternative product (say a weekly free newspaper offering advertising at cheaper rates). If the number of customers who might switch to the alternative product is large enough to constrain the hypothetical monopolist from setting prices above the competitive level as it wishes, then the two products may be regarded as being in the same market (see OFT 403, 2.6 to 2.11).

100. Similar questions arise when delineating the relevant geographic market, which is essentially the area over which substitution takes place:

> "Under the scheme of Article 82 of the Treaty, definition of the relevant geographical market, like that of the product market, calls for an economic assessment. The geographical market can be defined as the territory in which all the traders concerned are exposed to objective conditions of competition which are similar or sufficiently homogenous."

(See *Tiercé Ladbroke*, cited above, paragraph 102).

101. These issues may overlap to a considerable extent with the assessment of the closely related question of whether an undertaking is dominant in a particular market: see OFT 415,

*Assessment of Market Power* at pp 6 et seq. In general, the definition of the relevant market should not be an abstract exercise detached from the question of dominance.

102. On the other hand, the economic or econometric techniques mentioned above may in particular circumstances be of limited value, for example because the conditions of competition in the particular market place may already be atypical (see the Commission's *Notice on Market Definition*, paragraph 19), or because no or insufficient reliable data is available. Survey data, if any, may be inconclusive because of the hypothetical nature of the question (see OFT 403, paragraph 3.6) or the difficulty of obtaining sufficiently informed responses. In addition, the particular market circumstances may themselves create their own dynamics. For example, a product which might not appear, in the abstract, to be directly substitutable for another product, may turn out on closer examination to be in fact a significant competitor because of the particular circumstances of the local market at the time in question.

103. In general, evidence as to how the undertakings in question themselves see the market is likely to be particularly significant. As the Director points out at paragraph 2.6 of OFT 403:

> "The idea of a market is familiar. Annual reports, business plans and other documents often refer to the market in which the undertaking operates. This will normally include other undertakings which the undertaking views as its competitors."

104. In the Tribunal's view, contemporary evidence as to how the allegedly dominant undertaking itself views its competitors, and vice versa, may, depending on the particular circumstances, be of decisive importance when it comes to defining the market in any given case.

105. As to the standard of proof which the Tribunal expects the Director to meet on the issue of market definition (and indeed as regards other elements of the infringement alleged) this issue is discussed, by another panel, at paragraphs 91 to 112 of the Tribunal's judgment of 15 January 2002 in *Napp Pharmaceutical Holdings v Director General of Fair Trading* ("*Napp*"). That panel heard submissions on both English and Scots law. The Tribunal held at paragraph 109:

> "In those circumstances the conclusion we reach is that, formally speaking, the standard of proof in proceedings under the Act involving penalties is the civil standard of proof, but that standard is to be applied bearing in mind that infringements of the Act are serious matters attracting severe financial penalties. It is for the Director to satisfy us in each case, on the basis of strong and compelling evidence, taking account of the seriousness of what is alleged, that the infringement is duly proved, the undertaking being entitled to the presumption of innocence, and to any reasonable doubt there may be.

106. We propose to apply that standard in this case.

C: THE TRIBUNAL'S FINDINGS

107. The question whether in this case the Director has defined the relevant market correctly and adequately presents two distinct issues:

1. Was the Director entitled to find in the Decision that the relevant market in the Aberdeen area comprised the advertising space offered by the three local newspapers, i.e. the paid-for daily *Evening Express*, the weekly free *Herald & Post*, and the weekly free *Independent*, or is the advertising space offered by the *Evening Express* to be regarded as being in a separate market from that offered by the *Herald & Post* and *Independent* for the purposes of assessing dominance?

2. Was the Director entitled to exclude from the relevant market other advertising media, notably the internet, local radio, recruitment agencies, property centres, direct mail, leaflets, niche publications and directories?

**Is it established that the relevant market for the purposes of assessing dominance in this case comprises advertising space supplied by the *Evening Express*, *Herald & Post* and *Independent*?**

108. To address this question it is necessary to identify the matters relied on by the Director in the Decision to support his conclusion (at paragraph 44) that

> "the relevant product market is therefore the supply of advertising space in both paid-for and free local newspapers".

***The Director's findings in the Decision***

109. At paragraph 14 of the Decision, the Director said:

> "The Director has assessed possible substitutes for advertising in the *Herald & Post* to define the relevant market, including: other types of newspaper, television, radio, Internet, posters and direct mail."

His analysis of competition between newspapers is set out in paragraphs 16 to 31 of the Decision, which we cite in their entirety, including the footnotes where relevant in the text:

> "2.1.1 *Paid-for vs free*
>
> 2.1.1(i) *Aberdeen Journals' submission*
>
> 16. Aberdeen Journals, in its written and oral submissions responding to the Rule 14 Notice, stated that the free weekly titles, the *Herald & Post* and the *Independent*, are not in the same market as its paid-for daily newspapers, the *Evening Express* and the *Press & Journal*.

17. As evidence to support a narrow market definition comprising just advertising space in its *Herald & Post* and the rival *Independent*, Aberdeen Journals referred to the different characteristics of the titles, in particular, differences in the editorial content, demographic profile of the readership and how they are read. Aberdeen Journals concluded that:

    (a) In terms of readership profile, geographic and demographic focus and editorial credibility, paid-for titles play a substantially different role to free titles, enabling advertisers to communicate their message on a targeted basis;

    (b) The paid-for and free titles in Aberdeen attract, because of their different focus, different types of advertising;

    (c) Advertising yields for different categories of advertising vary widely between paid-for and free titles in Aberdeen; and

    (d) Increases in advertising rates (since March 2000) in the Herald & Post have had little effect on the volumes of advertising placed through the paid titles: similarly advertisers in the paid-for titles did not switch their advertising to the Herald & Post or the Independent when the advertising rates in those titles were very low.' (Aberdeen Journals' Response to the Rule 14 Notice dated 2 February 2001 paragraph 3.36.)

18. Mr Alan Scott, Managing Director of Aberdeen Journals, supported the conclusion that paid-for daily and weekly free papers are complements rather than substitutes because, in his experience:

    - The readership per copy sold for paid-for newspapers is as much as double that of the free newspapers and readers of free newspapers spend, on average, less than half the time reading the newspaper compared with the paid-for title.
    - The *Herald & Post* has a much narrower distribution than the paid-for titles, being focussed on the urban areas.
    - The demographic profiles of the readership of the paid-for titles differs from that of the *Herald & Post*.
    - The credibility of the paid-for titles which is derived from its editorial coverage is said to be important to advertisers as it gives them a *'better publication in which to communicate their message.'*
    - Daily titles provide advertisers with the ability to reach their target audiences at the time that is best suited to them, during the course of the week.

    (Aberdeen Journals' Response to the Rule 14 Notice dated 2 February 2001, Appendix 1, section 1.)

2.1.1(ii) *Competition Commission precedent*

19. Contrary to Aberdeen Journals' submissions, the Competition Commission has concluded in several recent investigations that free and paid-for newspapers compete (Johnston Press plc and Home Counties Newspapers Holdings plc, Monopolies and Mergers Commission Report, June 1998, paragraph 2.9). It found:

    > 'Competition between newspapers for readers and advertisers depends largely on the degree of editorial content. Usually, but not invariably, free newspapers have a lower quality and proportion of editorial content than paid-for newspapers. Advertisements are, however, read as a source of information and interest and, to this extent, paid-for and free newspapers may directly compete for

readers and advertisers.' (Portsmouth & Sunderland Newspapers plc and Johnston Press plc/Newsquest (Investments) Ltd/News Communications and Media plc, Monopolies and Mergers Commission June 1999, paragraph 2.22.)

20. Accordingly, the Commission recognised the different characteristics of these titles and their complementary nature from the perspective of the publisher and readers, but concluded that free and paid-for newspapers were in the same market.

2.1.1(iii) *Director's finding*

21. The information on the characteristics of the paid-for and free newspapers and their readership provided by Aberdeen Journals does not provide conclusive evidence of a narrow market definition separating free from paid-for titles. Two newspapers need not share identical characteristics to be in the same market. Some advertisers may have strong preferences to advertise in one paper while others may regard the newspapers as complements. Some advertisers may consider the choice between the 'better' quality paid-for paper and the lower quality free paper to be a close one.

22. Aberdeen Journals' statement that advertisers did not switch from the *Herald & Post* to the paid-for *Evening Express* when its relative advertising rates increased after 1 March 2000 also does not demonstrate separate 'free' and 'paid-for' markets (Aberdeen Journals' Response to the Rule 14 Notice dated 2 February 2001, Appendix 1, section 1, page 6). While the *Independent's* rates remain low, the closest substitute for the *Herald & Post* is the *Independent*. Advertisers are therefore more likely to switch to the *Independent* in response to an increase (from what had been a very depressed level) in the *Herald & Post* rates than the paid-for titles.

23. That advertising space in the paid-for daily *Evening Express* and free weekly titles (*Independent* and the *Herald & Post*) are in the same market is supported by Aberdeen Journals' commercial rationale for the increased pagination of the *Herald & Post* and cut in advertising rates following the launch of the *Independent*. To explain its strategy, Aberdeen Journals stated (Submission to OFT dated 10 February 2000):

> '[2.4] the Independent was launched as a title specifically targeted at our paid-for Evening Express title and its distribution area was focused squarely on the principal circulation area of our evening paper
>
> [W]e needed to respond to the launch of the Independent by lowering the advertising rates of the Herald & Post to what advertisers told us was necessary to enable us to retain their business. We had and have no wish to exit this layer of the advertising market and to do so would have made the Evening Express vulnerable.
>
> [2.6] The Aberdeen market has now seen, for a period of four years, an effective war of attrition between our *titles* and the Independent.
>
> [3.1] [T]he Independent poses a real threat to the advertising revenues of both our evening title [i.e., the Evening Express] and the Herald & Post.'
>
> (Emphasis added)

24. This submission demonstrates (notwithstanding Aberdeen Journals' subsequent oral submissions to the contrary) that Aberdeen Journals expected, in deciding

to cut rates for advertising in the free *Herald & Post*, that advertisers in the paid-for *Evening Express* would switch to the *Independent* if it did not do so. Aberdeen Journals therefore considered that the *Independent* would be a threat to at least one of its paid-for titles as it expected that advertisers would consider the *Independent* to be a substitute for advertising in the *Evening Post* [sic]. (While an undertaking's views of certain competition law concerns may credibly change once it has sought qualified advice, in this instance, Aberdeen Journals' original explanation for its actions is more persuasive than its subsequent explanation.)

25. The Director therefore concludes that on the demand side advertisers see scope for switching between advertising in the free and paid-for local titles.

2.1.2 *Distribution area*

26. Advertising in the free *Herald & Post* is largely by local businesses, events, attractions and people. Aberdeen Journals states that the circulation areas for Aberdeen Journals' paid-for daily titles the *Press & Journal* and the *Evening Express* are wider than those of the *Herald & Post* and the *Independent*. In particular, Aberdeen Journals states that while the free newspapers are heavily focussed on the urban area, 73% of the circulation of the *Press & Journal* and 27% of the circulation of the *Evening Express* is outside the urban area of Aberdeen (statement of Mr. Alan Scott, Aberdeen Journals' Response to the Rule 14 Notice dated 2 February 2001, Appendix 1, page 2, paragraph 2). The *Press & Journal* is therefore a regional paper, while the *Evening Express* is local, focussed on the Aberdeen area and its outlying commuter areas (Aberdeen Journals' submission dated 10 February 2000, paragraph 2.1).

27. The Competition Commission has found in relation to newspapers that the '*extent of choice enjoyed by advertisers will depend on whether they wish to reach a purely local readership, a wider regional market or achieve national coverage*' (Johnston Press plc and Home Counties Newspapers Holdings plc, Monopolies and Mergers Commission Report, June 1998 paragraph 4.21.). It concluded that to '*the extent that there is a regional advertising market, therefore, it should be seen as distinct from local advertising markets.*' (New Communications & Media plc and Newsquest (Investments) Ltd/Johnston Press plc/Trinity Mirror plc, Competition Commission Report, April 2000, paragraph 4.34.)

28. The geographic targeting of the *Evening Express* is not sufficiently different from that of the relevant product to justify its exclusion from the relevant market on this ground, particularly in light of the fluctuating distribution areas of the *Independent* and *Herald & Post* since 1996.

29. However, the *Press & Journal* is not focussed on the Aberdeen area, and accordingly is not an efficient substitute for advertisers in the local papers. It therefore does not compete in the relevant market. Similarly, national papers do not sufficiently constrain the pricing of local papers to be included in the same market: they are not an efficient method of reaching Aberdeen consumers.

2.1.3 *Daily vs. weekly titles*

30. In light of the evidence above (in particular paragraph 23) concerning competition between the *Evening Express* and the free titles, the overlap in advertisers using the papers and in distribution areas, the difference in frequency (between the daily *Evening Express*, and the weekly free papers) is not a factor sufficiently compelling to place the *Evening Express* in a separate economic market.

2.1.4 *Conclusion on newspapers in the relevant market*

31. Accordingly, the relevant market comprises at least advertising space in the free local weekly *Herald & Post* and the *Independent*, and the daily local paid-for *Evening Express*."

110. It is also relevant to cite those parts of the Decision which deal with competition between newspapers and other forms of media, to the extent that they bear, at least indirectly, on whether the *Evening Express* should be included in the same relevant market as the *Herald & Post* and the *Independent* for the purposes of this case. At paragraphs 33 to 37 of the Decision the Director said, with reference to the submissions made to him by Aberdeen Journals in a letter from its solicitors dated 10 March 2000:

"33. Aberdeen Journals distinguished between 'Classified' and 'Display' advertising. Classified advertising comprises listings of businesses or items for sale in well established classifications including 'Motor', 'Recruitment' and 'Property'. Display advertisements promote or raise awareness of particular suppliers, events, offers or brands. Aberdeen Journals argued that '*these markets operate separately and are subject to quite different competitive forces.*' It argued that it competed against rival media as follows:

- Classified. Aberdeen Journals argued that in Classified advertising, niche publications (e.g. *Exchange & Mart*) have been the main competition to newspapers, but that the Internet with its powerful search facility and immediacy, presents a significant threat to all forms of classified advertising.

- Property. Aberdeen Journals argued that in Property advertising, newspapers also compete with solicitors who it alleged hold tight control over the property market in the North of Scotland and have Property Centres in each of the main towns/cities within Aberdeen Journals' circulation area. Properties then appear in the weekly Property Register, a magazine that lists all the properties for sale at the Property Centre. Larger firms of solicitors may also have their own in-house monthly magazine.

- Recruitment. In Recruitment advertising, Aberdeen Journals argued that newspapers also compete with recruitment agencies and that the Internet is expanding rapidly.

- Motors. Aberdeen Journals argued that the Motors advertising market is delineated between new and used cars. Motor manufacturers, through their London advertising agencies, increasingly determine how new cars are advertised. The used car market is more fragmented and much of it is still supplied (and advertised) by smaller local dealers. Aberdeen Journals alleges that competition for car advertising is intense with radio and TV competing with newspapers and niche publications. The Internet is also growing in importance with the likes of www.autobytel.co.uk, www.autotrader.co.uk, etc.

- Display/Retail. Aberdeen Journals argued that the Display advertising market is distinct from the Classified market in that it is more relevant to several media – radio, TV, direct mail and leaflets as well as newspapers.

*2.2.2 Constraints exercised by various media*

34. The extent to which these other media provide close substitutes for advertising in local newspapers depends in part on how cost effective they are in conveying a similar image or message to a similar target audience. These media may be complementary, so that advertisers would generally use a wide portfolio of different media.

35. With few exceptions, the demand for advertising space in the *Herald & Post* is from local businesses, events, attractions and people. In the Property and Motor sections the advertisers are local car dealers and estate agents, and in the Recruitment section the vacancies are in the Aberdeen area. The other Classified advertising is by local businesses, such as shops, builders, decorators and financial advisers, or by local people with items for private sale. The display advertising is largely by local retailers, restaurants or leisure attractions.

36. Accordingly, national media, including television and radio and printed publications, are not efficient in reaching this local community of businesses or individuals, but are principally suited to national or regional campaigns. Further, the cost of targeting the local community via such national media is prohibitive. Rates charged by national media do not therefore constrain the rates charged by Aberdeen Journals sufficiently to be within the same relevant market.

37. Each other medium identified by Aberdeen Journals has different characteristics and, accordingly, advantages and disadvantages over newspaper advertising:

- While the Internet is expanding in the provision of advertising, it currently has characteristics that limit its substitutability for newspaper advertising. For many consumers the Internet is not as accessible as the press: they do not have easy access to a computer and many are insufficiently computer literate to use the Internet. Further, although a website may hold ample information, a potential customer may have difficulty finding the relevant site (or knowing it exists) unless it has previously been advertised elsewhere (e.g. in a newspaper). This means that newspaper advertising remains significantly more effective in targeting a certain group of potential customers. The number of businesses that have websites but continue to advertise in the press, often giving the address of the website in their advertisements, supports this. The website can be visited subsequently for more detailed information and a greater range of services than can be provided in a newspaper.

- Local radio is not suitable for conveying detailed or visual information (especially where a significant amount of information requires repeated consultation). It is more suited to repetitive brand promotion and image creation. Local radio is not therefore suitable for Classified or Property advertising. Much Display advertising also contains detailed information including addresses and telephone numbers.

- Recruitment agencies serve a different role and reach a different audience from newspaper advertising. The newspaper advertisement will reach far more people, as people will read it who may not be actively job seeking. As with the Internet, recruitment agencies offer a much fuller service than a job advertisement in a newspaper. Indeed, many recruitment agencies advertise in newspapers.

- Although Property Centres may produce their own magazines, they continue to advertise in the local newspapers, indicating that they are complements to, rather than substitutes for, local newspapers.

..."

111. In the Decision, the Director then went on to reject competition from direct mail, leaflets, niche publications such as *AutoTrader* or *Exchange & Mart*, directories such as *Yellow Pages* and *Thomson*, posters, outdoor advertising and billboards as insufficiently close substitutes for newspapers (paragraphs 37 and 38). The Director then stated at paragraphs 39 and 40 of the Decision:

> "39. The different characteristics of the different forms of media indicate that they are not close substitutes for advertising in newspapers. Aberdeen Journals stated [in its solicitor's letter of 10 March 2000] that the *Herald & Post* may serve '*as a means of "topping up" existing advertising by larger local, regional and national advertisers who will often include advertising in a free newspaper as a low cost part of their marketing mix.*
>
> 40. This conclusion is supported by the strong evidence that Aberdeen Journals has targeted the *Independent* (both in the context of previous complaints relating to 'solus' agreements and in more recent documents, see paragraph 88 below) intending to expel it from the market. This indicates that the strongest competitive threat to Aberdeen Journals stems from rival newspaper publishers in the same geographic area, not producers of other forms of media. It also shows that Aberdeen Journals (by its consistent conduct) considers local newspapers to be a separate market from other forms of media."

112. The forward reference, in paragraph 40 of the Decision, to paragraph 88, is a reference to the internal memoranda of Aberdeen Journals referred to in paragraph 31 above. According to the Director, the documents there cited show that Aberdeen Journals intended "to expel the Independent from the market, by means of incurring substantial losses on the *Herald & Post*" and "to use the *Herald & Post* strategically to expel the *Independent* from the market" (paragraphs 88 and 90 of the Decision). The Director also found, on the basis of the documents cited at paragraph 88, that Aberdeen Journals

> "initiated and maintained a strategy designed to expel [the *Independent*] from the relevant market, using the *Herald & Post* as a 'fighting title'." (paragraph 96 of the Decision)

113. At paragraphs 41 and 42 of the Decision, the Director referred to the report of the reporting panel of the Competition Commission *News Communications & Media plc and Newsquest (Investments) Limited/Johnston Press plc/Trinity Mirror plc,* April 2000, at paragraph 2.28, to support his conclusion that other media, notably the Internet, were not, or not yet, a significant competitive threat to local newspapers.



SYS

114. At paragraphs 43 and 44 of the Decision, the Director stated his conclusions on the relevant product market in these terms:

> "43. The Director, for the reasons set out above, does not accept the case that Aberdeen Journals proposed in response to the Rule 14 Notice, that paid-for and free titles are in separate markets. He is persuaded by the evidence of Aberdeen Journals' own persistent conduct, and the submissions it made during the course of his investigation, together with his Office's analysis of the product market, taking into account several recent Competition Commission reports.
>
> 44. The relevant product market is therefore the supply of advertising space in both paid-for and free local newspapers. Current evidence does not show that there has been a sufficient switch away from newspaper advertising in favour of the Internet to include this in the relevant product market."

115. At paragraphs 49 to 52 of the Decision the Director contended that, even if Aberdeen Journals was correct on its narrow market definition, it would still be dominant in the market for advertising space in paid-for newspapers in Aberdeen and would have abused *that* dominant position by behaving abusively on the neighbouring or associated market for advertising space in free newspapers in Aberdeen. The Director stated:

> 49. "Aberdeen Journals, in its written and oral submissions responding to the Rule 14 Notice issued to it, stated that the free weekly titles, the *Herald & Post* and the *Independent*, are not in the same market as its paid-for daily newspapers, the *Evening Express* and the *Press & Journal* (see paragraphs 16-18 above). However, the alleged abuse of predation is not sensitive to the different market definition proposed by Aberdeen Journals. If the Director had accepted Aberdeen Journals' submissions on market definition, Aberdeen Journals would be dominant on the narrower market it proposed of advertising in the supply of advertising space in paid-for newspapers in Aberdeen: there are no local or regional paid-for titles circulating in the relevant geographic market other than Aberdeen Journals' own.
>
> 50. It is well-established that a dominant undertaking may abuse its position by predating in an associated market (see *Tetra Pak II*). Even if the supply of advertising space in free and paid-for local titles were in separate markets, those 'markets' have strong associative links. Aberdeen Journals has a strong position in both markets, whether separate or combined. There is a large overlap in customer base. Production methods are identical. Aberdeen Journals' own conduct, of reducing prices in the free segment to protect its position in the paid-for segment, reinforces the link. Accordingly, Aberdeen Journals would be in a situation comparable to that of holding a dominant position on the 'markets' in question as a whole.
>
> 51. Aberdeen Journals is part of a major newspaper group that has the funds required for predation in an associated market to be feasible. That Aberdeen Journals (supported financially by Northcliffe) could fund for more than four years the losses made by the *Herald & Post* demonstrates this.
>
> 52. Accordingly, given his findings set out below, the Director would find Aberdeen Journals to have predated on the associated, but (in this hypothesis)

separate market for free titles. Therefore, Aberdeen Journals would still have infringed the Chapter II prohibition, even if the Director had accepted its final submissions concerning market definition, which he does not."

***Analysis***

116. We start by reminding ourselves that the issue of the definition of the relevant market is not a self-contained issue but arises in the context of the wider question of whether Aberdeen Journals had, in March 2000, a dominant position for the purposes of the Chapter II prohibition.

*The alternative bases set out in the Decision*

117. The Decision alleged two bases for finding that Aberdeen Journals did have such a dominant position. The first basis was that Aberdeen Journals had a market share of [ ] [over 70] per cent by value and [ ] [over 60] per cent by volume in a market comprising advertising space in the three local newspapers in the Aberdeen area, namely the *Evening Express*, *Herald & Post* and *Independent* (paragraphs 16 to 31, and 53 of the Decision). The second basis was that Aberdeen Journals would, in any event, be dominant on the narrower market of the supply of advertising space in paid-for newspapers in Aberdeen, since the *Evening Express* is the only local paid-for newspaper circulating in the Aberdeen area (paragraph 49).

118. As the Decision points out (paragraph 50) it is well established that an undertaking with a dominant position in one market may abuse that position by engaging in predatory conduct on a neighbouring or associated market: see *Tetra Pak II* [1994] ECR II-755 at paragraphs 112 to 122 (Court of First Instance) and [1996] ECR I-5951 at paragraphs 21 to 31 (Court of Justice). We would have thought that, at first sight, an analysis of that kind could be potentially relevant, at least in the alternative, in exploring the issues that arise in this case: see also *AKZO*, cited above, [1991] ECR I-3359, at paragraphs 35 to 45 and Case T-65/89 *BPB Industries and British Gypsum v Commission* [1993] ECR II-389, at paragraphs 92 to 97.

119. However, it has emerged in the course of these proceedings that this alternative analysis of the relevant market was not put to Aberdeen Journals during the course of the administrative procedure, either in the Rule 14 Notice or subsequently. In those circumstances, the Director has decided not to seek to support the Decision at this stage on the basis of the alternative hypothesis set out in paragraphs 49 to 52 of the Decision.

120. Although paragraph 3 of Schedule 8 of the Act (see paragraph 6 above) gives this Tribunal wide powers, in the particular circumstances of this case we do not think it would be right for this Tribunal to embark upon an examination of a market definition which is contained in the

Decision but was not put in the administrative procedure. In addition, for this procedural reason, the Director has not sought to rely on this alternative market definition before the Tribunal. The end result is, however, unsatisfactory because it means that the Tribunal is unable to consider, in the alternative, what may be a potentially relevant hypothesis suggested in paragraphs 49 to 52 of the Decision.

*The local newspapers in Aberdeen*

121. Turning then to the relevant market contended for by the Director, namely local newspapers (paid-for and free) in the Aberdeen area, it is common ground that, prior to the launch of the *Independent* in 1996, Aberdeen Journals owned the only two local newspapers circulating in that area, namely the daily paid-for *Evening Express* and the weekly free *Herald & Post*. There would appear to be little doubt that, however the market is defined, Aberdeen Journals had a monopoly in the supply of advertising space in local newspapers in the Aberdeen area prior to 1996, since an advertiser wishing to advertise in a local newspaper in that area would have had no choice but to advertise in one of Aberdeen Journals' two publications.

122. It appears from the figures at Annex 4 to the Decision that, prior to the launch of the *Independent*, the *Evening Express* accounted for around 90 per cent by value of local newspaper advertising, with the *Herald & Post* accounting for around 10 per cent.

123. Into this situation of local monopoly, the *Independent* was launched in 1996. It appears from Annex 4 to the Decision that the total amount of advertising carried in local newspapers in the Aberdeen area increased with the launch of the *Independent* and the expansion of the *Herald & Post* which took place in response to that launch. By the end of 1999, the *Evening Express* appears to have accounted for under 70 per cent by value of advertising in local newspapers in the Aberdeen area, with the *Independent* accounting for around [ ] per cent by value and the *Herald & Post* around [ ] per cent by value. As between the *Independent* and the *Herald & Post*, the former seems to have outsold the latter, in terms of advertising revenue, ever since it was launched. In terms of advertising volume measured in sscm, the amount of advertising carried by the two free papers has ebbed and flowed, with periods of "level pegging", but in the period from around mid-1999 onwards the *Independent* has carried more advertising space than the *Herald & Post*. Since 1998 the two free titles, taken together, have carried more advertising space per quarter than the *Evening Express*, despite the fact that the latter is a daily publication and the former are weekly publications (see generally, Annex 4 to the Decision). Since the middle of 1997 the volume and value of advertising in the *Evening Express* seems at first sight

to have been on a downward trend, while that of the *Independent* seems at first sight to have been on a rising trend.

124. Nonetheless, the *Evening Express* and the *Herald & Post*, taken together, still maintained a market share by value of [ ] [over 70] per cent and [ ] [over 60] per cent by volume in the first quarter of 2000, roughly equivalent to the market shares they had enjoyed during 1999.

125. Against that background, our first task is to determine whether the Director has sufficiently established that the three newspapers in question formed part of the relevant product market in the period to which the Decision relates, namely March 2000, or whether, as Aberdeen Journals submits, the *Evening Express* is to be excluded from the relevant product market.

126. Having regard to the case law to which we have already referred (paragraphs 86 to 103 above) we formulate the question to be addressed at this stage as follows: has the Director established that in March 2000 the activities of the *Independent* in the supply of advertising space in the Aberdeen area constituted a sufficient competitive constraint, or brought sufficient competitive pressure to bear, on the advertising business of the *Evening Express*, for those two newspapers sensibly to be regarded as both competing in the market for advertising space in local newspapers in Aberdeen? If the answer to that question is in the affirmative, then in our view the Director's approach to the relevant market is correct.

*The reports of the reporting panels of the Competition Commission*

127. In support of his view, the Director refers first to various reports by the reporting panels of the Competition Commission, or its predecessor the Monopolies and Mergers Commission, reporting on various proposed newspaper mergers under Part V of the Fair Trading Act 1973 (paragraphs 19 and 20 of the Decision). Aberdeen Journals contends that these reports do not support the Director's case or are, at best, inconclusive. In the reports cited below, we italicise the sentences that seem to us to be most relevant.

128. In its report on the proposed transfer of newspapers between Johnston press plc and Home Counties Newspaper Holdings plc, in June 1998, ("the *Johnston/Home Counties*" report), the Monopolies and Mergers Commission said at paragraph 2.9:

> "2.9. Our inquiry concerns, exclusively, weekly paid-for and free newspapers and their 'slip editions'. These are primarily aimed, in both their editorial and advertising content, at local markets. As we note in paragraph 4.20, weekly paid-for newspapers tend to have a higher editorial content than free weekly newspapers. They have a significantly lower penetration (in terms of households reached) than free newspapers but are more likely to be read. Because they can be purchased at a

variety of outlets, they may also be the only printed source of local news for people living in less densely populated areas where it is uneconomic to distribute free newspapers. Free weekly newspapers typically reach a very high proportion of the households in the areas in which they are distributed but will not necessarily be read to the same extent as paid-for titles. *Some publishers therefore publish both free and paid-for weekly titles as complementary parts of an overall strategy. Nonetheless paid-for and free weekly newspapers are also in competition in particular as far as advertisers are concerned and for the purposes of this inquiry we see them as part of the same market.*"

129. At paragraph 4.20 of the same report the Monopolies and Mergers Commission said:

> "4.20. Newspaper publishers compete for readers and for advertising. The extent of competition for readers between national and local newspapers, between morning and evening newspapers, between daily and weekly newspapers and between weekly paid-for and free newspapers depends to a large degree on the editorial content of the newspapers, where editorial content is taken to be everything in the newspaper except advertisements. Usually, free newspapers have a much lower proportion of editorial content (20 to 30 per cent) than paid-for newspapers (30 to 50 per cent). *Advertisements are, however, read by many people as a source of information and interest and, to this extent, paid-for and free newspapers may compete directly for readers and advertisers. ...*"

130. In its report on the proposed transfer of the newspapers of Portsmouth & Sunderland Newspapers plc to Johnston Press PLC, Newsquest (Investments) Limited/News Communications and Media plc, June 1999, ("the *Portsmouth & Sunderland* report") the reporting panel of the Competition Commission said at paragraph 2.22:

> "2.22. Competition between newspapers for readers and advertising depends to a large degree on their editorial content. Usually, but not invariably, free newspapers have a lower quality and proportion of editorial content than paid-for newspapers. *Advertisements are, however, read as a source of information and interest and, to this extent, paid-for and free newspapers may compete directly for readers and advertisers.*"

(see also paragraph 4.23 of this report, which in effect repeats paragraph 4.20 of the *Johnston/ Home Counties* report).

131. In the report of the reporting panel of the Competition Commission on the proposed transfers of newspapers between News Communications & Media plc and Newsquest (Investments) Limited/Johnston Press plc/Trinity Mirror plc, April 2000, ("the *Trinity Mirror* report") the reporting panel of the Competition Commission stated at paragraph 2.24:

> "2.24. There are two major constituencies for the local and regional press: readers and advertisers. Their readership is fragmented, with many different markets, defined both by geography, and by type of newspaper. Of the almost 1,200 local and regional newspapers that are published at least once a week, only a few compete directly with each other. *The fact that in many areas the same company will publish weekly free and paid-for titles shows that in a local market there may*

*be room for products which are more complementary than competing.* Most newspapers operate in limited, or very limited, localities. Even when they do overlap, they often have very different editorial content, attracting a distinct readership profile for morning dailies, evening dailies, Sundays, and paid-for and free weeklies. To that extent, they cannot normally be regarded as substitutes, one for another. There are, of course, elements of overlap between local and regional newspapers of different types, and between them, the national press (particularly their regional editions) and other media, but in most cases, regional and local newspapers occupy a separate market from other newspapers."

132. At paragraph 4.52 of the *Trinity Mirror* report the reporting panel of the Competition Commission said:

> "4.52. *Paid-for and free weeklies may represent reasonably close substitutes for both readers and advertisers where they operate in the same or overlapping geographic areas.* On the readership side some paid-for weeklies contain a substantial amount of editorial and free titles usually (but by no means always) carry a much lower proportion of editorial content. *In terms of advertising, paid-for and free weeklies are largely in direct competition with one another.*"

133. At paragraph 4.60 of the same report the reporting panel of the Competition Commission stated:

> "It would seem, therefore, that barriers to entry for free newspapers are relatively low and for certain advertising-only publications lower still. Although the barriers to entry for paid-for titles (especially paid-for dailies) are higher than for free newspapers, *we feel that the threat of new entry (most probably by a free newspaper or advertising-only publication) may be considered as a competitive restraint on the commercial activities of incumbent newspaper publishers.*"

134. Finally, in the report on the proposed transfers of newspapers between Regional Independent Media Limited and Gannett UK Limited/Johnston Press plc/Guardian Media Group plc, November 2000, ("the *RIM* report") the reporting panel of the Competition Commission said at paragraph 2.25:

> "2.25. We heard evidence that publishers of local newspapers fought hard to protect their markets from new entry and would, on occasion, maintain a loss-making free newspaper where this supported a paid-for title as part of a layered or segmented market."

135. At paragraph 4.34 of the *RIM* report the reporting panel said:

> "4.34. In terms of the distinction between daily and weekly newspapers, it would again appear that the opportunities for substitution by advertisers between the media are relatively limited, for essentially two reasons. First, daily titles offer advertisers more flexibility than weekly titles in that advertisements can be placed or changed at more frequent intervals. Second, the two types of newspaper tend to be read and used in different ways, with weekly newspapers more likely to be retained by the household over a number of days for reference, compared with dailies whose impact

is more short-lived. *This suggests that advertisers will tend to view the two forms of advertising as complements rather than substitutes, with advertising in dailies being used for immediate impact on the reader, and advertising in weeklies being used to reinforce the advertising message through more detailed information provision.*"

136. The admissibility of evidence before this Tribunal is not governed by the rules of evidence as traditionally applied in court proceedings: Rule 20(2) of the Tribunal Rules. In our view, reports of the reporting panel of the Competition Commission of the kind cited above provide useful background material to the issues which we have to decide in the present case.

137. It seems to us to emerge from the reports cited above that, in the view of the reporting panels of the Competition Commission, paid-for and free newspapers may compete directly for the business of advertisers where they operate in largely overlapping geographic areas: see *Johnston/Home Counties* at paragraphs 2.9 and 4.20; *Portsmouth & Sunderland* at paragraphs 2.22 and 4.23 and *Trinity Mirror* at paragraphs 4.52 and 4.60.

138. As a general proposition, we see little reason to disagree with that view. It seems to us plausible that, for certain advertisers, the possibility of advertising in a weekly free newspaper may well be a viable alternative to taking advertising space in a paid-for daily, depending on the nature of the advertisement, the comparative advertising rates, the number of copies distributed, the target audience and the catchment area to be covered. For example, a higher distribution to a larger number of households at cheaper advertising rates might influence an advertiser to substitute, either wholly or partly, advertising in a free weekly newspaper for advertising in a more expensive paid-for title with a lower circulation, notwithstanding differences in the 'quality' and readership of the newspapers concerned.

139. We accept, however, Aberdeen Journals' submission that in a case of alleged abuse under the Chapter II prohibition, the market concerned must be identified and verified according to the particular facts of the case in question. The reports of the reporting panels of the Competition Commission cited above, while indicative of how advertisers behave in general, do not deal with the specific facts of the present case. In addition, those reports have generally concerned competition for advertising between paid-for local weekly newspapers and free local weekly newspapers, whereas in this case we are concerned with a daily paid-for title and weekly free titles. Reliance on previous reports of the reporting panels of the Competition Commission is not, in itself, sufficient to establish the Director's case.

*Complements and substitutes in advertising*

140. It is also true that, in the *RIM* report, the reporting panel of the Competition Commission expressed the view that the opportunities for substitution by advertisers between daily and weekly newspapers were relatively limited and that advertisers might tend to view daily and weekly titles "as complements rather than substitutes" (paragraph 4.34). In a number of other reports the reporting panels of the Competition Commission have suggested that, in particular circumstances, paid-for and free newspapers, or weekly and daily newspapers, may be viewed as "complementary parts of an overall strategy" (*Johnston/Home Counties*, at paragraph 2.9) or "more complementary than competing" (*Trinity Mirror*, at paragraph 2.24).

141. This is, in effect, Aberdeen Journals' argument, namely that the *Evening Express* and the free titles are complements, not substitutes. We note also that in the Decision itself, the Director uses the notion that products may be "complements rather than substitutes" in order to exclude other media, for example, Property Centres, from the relevant market (paragraphs 34, 37 and footnote 25 of the Decision). He does not, however, apply this distinction to advertising in the *Evening Express*, on the one hand, and the free titles on the other hand. Nor does the Director clarify exactly what is meant in the Decision by "complements rather than substitutes".

142. In our view, in order to address this part of the argument, the terms "complements" and "substitutes" require further clarification. Strictly speaking, we would regard a product as a "complement" to another when their respective uses or consumption may be interrelated, but there is little or no substitutability between them. Thus in strict terms milk may be a complement to breakfast cereal. A rise in the price of cereal may reduce the consumption of cereal, and thus the consumption of milk which goes with it, but in normal circumstances there is no substitutability between cereal and milk.

143. More loosely, however, the word 'complement' may be used simply to mean 'additional'. If we take, for example, property advertising in the Aberdeen area, we understand from the material before us (p. 426 of the bundle) that solicitors in Scotland are also engaged in the buying and selling of houses and have an interest in the local Property Centre, which publishes an advertising-only publication known as the Property Register. All solicitors in Aberdeen active in the property market advertise in the solicitors' Property Register for that area. In addition, some solicitors also advertise in the local press. Estate agents who are not solicitors advertise exclusively in the local press and have no access to the solicitors' Property Register. In this example, if one poses the question whether a rise or fall in charges for advertising in local newspapers would affect the amount of property advertised in the Aberdeen Property

Register, the answer would appear to be in the negative. Since all solicitors advertise in the Property Register as a matter of course, and since estate agents cannot do so, it would appear at first sight that a change in advertising rates in newspapers would have little effect on the volume of property advertised in the Property Register, i.e. there would be little switching between the two. These two media would appear, therefore, at first sight, to be relatively poor substitutes. To the extent that solicitors advertise additionally in the press, such advertising may properly be regarded as a 'complement' rather than as a substitute, assuming that it is not plausible to imagine local solicitors abandoning their own Property Register in favour of advertising in the press.

144. However, depending on the circumstances, the idea that two products are, loosely speaking, "complements" does not necessarily exclude the possibility that they are also substitutes. Thus, a particular advertiser may have an advertising budget that he chooses to divide between different means of communication in the hope of reaching slightly different audiences, so that the different media in question are, in a loose sense, 'complementary'. On the other hand, depending on the products in question, changes in relative advertising rates may still lead to switching between the different means of communication as advertisers choose to devote a greater proportion of their advertising budget to one product rather than another. Thus the comments of the reporting panels of the Competition Commission, cited above, notably in the *RIM* Report, to the effect that in some circumstances daily and weekly newspaper titles or free and paid-for newspapers might be viewed as 'complements rather than substitutes' do not exclude the possibility that advertisers might switch a proportion or even perhaps all their advertising between a daily and weekly title (or between a free and paid-for title) if the changes in the advertising rates made it sufficiently attractive to do so. This decision by advertisers would equally be influenced by such matters as changes in pagination or distribution area, which might make advertising in one kind of newspaper rather than another relatively more attractive.

145. How the matter is to be analysed depends on the facts of the particular case. The issue in the present case, so it seems to us, comes down to how far the Director has established in the Decision that the advertising activities (and in particular the advertising rates) of the paid-for daily *Evening Express* were in March 2000 subject to competitive constraints or competitive pressure from the advertising activities of the free weekly *Independent*, so that those newspapers may sensibly be regarded as forming part of the same relevant market. That in turn largely depends on how far advertising in the *Independent* or the *Herald & Post* in fact represents, in whole or part, a substitute for advertising in the *Evening Express*, or whether the degree of switching between them by advertisers is so minor that they may be properly treated

as complements which do not compete with each other to any significant extent. That issue must be determined first and foremost by reference to the specific facts relied on by the Director.

*The specific facts relied on by the Director*

146. At this stage of the analysis, we encounter the difficulty that the Decision contains hardly any factual description by the Director of the characteristics of the *Evening Express*, as compared to the *Herald & Post* and *Independent*, nor the extent to which the observable circumstances of the market show that the *Independent* competes not only with the *Herald & Post*, but also with the *Evening Express*.

147. In order to lay the factual foundation for the definition of the relevant market, we would have expected the Decision to contain a brief factual description, at least in outline, of the objective characteristics of the products concerned – for example the content of each of the three newspapers in question, the kinds of advertisements carried (e.g. display advertisements, recruitment, property, motors, other trade advertisements, classified, notices, etc), the advertising rates offered by the paid-for and free titles respectively, details of their respective circulations, target audiences and geographical distribution areas.

148. In our view, such a description of the objective characteristics of the products in question is almost always necessary in cases of disputed market definition, because it is on that foundation that the discussion of the relevant product market must rest. In *Continental Can*, cited above, the Court of Justice held that a sufficient description of the markets concerned, and in particular sufficient data on the particular characteristics of the products in question, are essential elements in appraising whether a dominant position exists: [1973] ECR 215 at paragraphs 32 to 37.

149. In the present case, section II of the Decision, entitled "The Facts", contains no description of the three newspapers concerned. Section III, part A of the Decision entitled "Assessment of Dominance" again sets out no findings as to the particular characteristics of the three newspapers concerned.

150. It is true that, in the context of the discussion of competition from media other than newspapers, there is at paragraph 35 of the Decision a brief description of the advertising carried by the *Herald & Post*. A passing mention is also made at paragraph 26. However, leaving aside the inconvenient place in the Decision where such a description is to be found, the

fact is that there is no description of the other two products said to constitute the relevant market, namely advertising carried by the *Evening Express* and the *Independent*.

151. At paragraph 14 of the Decision, it is stated that "The Director has assessed possible substitutes for advertising in the *Herald & Post* to define the relevant market". That in our view is not a sufficient statement of the exercise the Director had to carry out. What it was necessary for the Director to do was to assess not just possible substitutes for advertising in the *Herald & Post*, but whether advertising in the *Independent* was a possible substitute for advertising in the *Evening Express*. Similarly, the Director's submission to the Tribunal (paragraph 74 above) that it was sufficient to describe the *Herald & Post* since that was "the relevant product" overlooks the fact that, for the purpose of the market analysis, the *Herald & Post* was only one of three relevant products. In this case it is necessary to consider not just the characteristics of the *Herald & Post* but those of the *Evening Express* and the *Independent* as well.

152. In paragraphs 17 and 18, the Decision sets out Aberdeen Journals' arguments as to the differences between the paid-for and free titles in Aberdeen, which are to the effect that the *Evening Express* on the one hand, and the *Herald & Post* and the *Independent*, on the other hand, are complements rather than substitutes, for the reasons given in Mr Scott's statement (paragraph 18 of the Decision). At paragraphs 21 and 22 of the Decision the Director seeks to rebut those arguments. However, because there are virtually no facts set out in the Decision as to the extent to which the newspapers in question in fact overlap, in terms of potential advertisers, target audience, type of advertisements carried, and so on, the rebuttal of Aberdeen Journals' arguments, at paragraphs 21 and 22 of the Decision, is not backed by factual elements specific to the present case. The Tribunal does not find it satisfactory that there should be no findings, or even description, in the Decision, as to the objective characteristics of the three newspapers concerned taken into account by the Director in reaching his Decision.

153. As regards the competitive conditions in the market, it is true that, at paragraph 22 of the Decision, the Director explains why, in his view, advertisers in the *Herald & Post* would have been more likely to switch to the *Independent*, rather than to the *Evening Express*, when the *Herald & Post* raised its prices after March 2000, on the grounds that "while the *Independent's* rates remain low, the closest substitute for the *Herald & Post* is the *Independent*." Paragraph 22 does not, however, explain the factual basis on which the Director might consider advertising in the *Independent* to be a sufficient substitute, for the purposes of market definition, with advertising in the *Evening Express*, which is the relevant issue. In particular, as Aberdeen Journals points out, there is no analysis in paragraph 22 of the Decision of the extent to which advertisers in the *Evening Express* switched or considered switching to the *Independent* or the

*Herald & Post* after the launch of the *Independent* in 1996, nor whether the advent of the *Independent* in fact constrained or brought competitive pressure to bear on the advertising rates of the *Evening Express* during the relevant period.

154. According to the Director, however, the fact that advertising space in the *Evening Express* and the free weekly titles is in the same market is nonetheless amply demonstrated by the commercial strategy pursued by Aberdeen Journals, after the launch of the *Independent*, in cutting rates and increasing pagination on the *Herald & Post*. That was done, says the Director in paragraphs 23 to 25 of the Decision, because Aberdeen Journals feared that, if it did not do so, advertisers in the paid-for *Evening Express* would switch to the *Independent*. According to the Director, a letter from Mr Scott, Managing Director of Aberdeen Journals to Mr Bethel of the Office dated 10 February 2000 establishes that

> "Aberdeen Journals ... considered that the *Independent* would be a threat to at least one of its paid-for titles as it expected that advertisers would consider the *Independent* to be a substitute for advertising in the *Evening Post* [sic]." (paragraph 24 of the Decision)

155. We accept in principle that an economic assessment of substitutability between products, whether based on survey evidence or otherwise, is not necessary as a matter of law in defining the relevant market, provided that the matter is sufficiently established from other evidence, for example the undertaking's internal documents. Nonetheless the letter of 10 February 2000, cited at paragraph 23 of the Decision and footnote 14, is the only concrete evidence relied on in the Decision to establish the competitive relationship between the *Independent* and the *Evening Express*. We therefore consider that letter in more detail.

*Aberdeen Journals' letter of 10 February 2000*

156. We set out the letter of 10 February 2000 as fully as necessary, showing in italics the passages at paragraphs 2.4, 2.6 and 3.1 relied on by the Director at paragraph 23 of the Decision:

> "Dear Mr Bethel
>
> Re: Aberdeen Herald & Post
>
> 1. Introduction
>
> 1.1 I am writing in response to your letter of 10 January 2000 which concerned an allegation of predatory pricing made by Aberdeen & District Independent Newspapers Limited ("Independent Newspapers"). This allegation is taken particularly seriously by us and our parent company, Northcliffe Newspapers Group Limited ("Northcliffe") given that it follows closely on the heels of an earlier complaint in relation to a discriminatory advertising policy. As you know, this latter complaint culminated in us giving undertakings to the Secretary of State on 23 December last year.

1.2 We have put together the responses to the questions raised in your letter and these are attached as Appendix 1. You will note that we have in some respects provided you with more detail regarding the background to the position in Aberdeen than you have strictly asked for. We have done this so as to give you the clearest possible picture of the difficult situation currently facing us.

1.3 The fact is that we find ourselves faced in Aberdeen with a very different competitor (i.e. Independent Newspapers) to the standard new market entrant; this competitor has traded at a significant loss in each of the last 4 years and, according to our calculations, is still loss-making. Mr Barwell, the owner of Independent Newspapers, appears to have entered the Aberdeen market in 1996 specifically "to open a free sheet, cause disruption, and sell it to Northcliffe" (see memorandum of 21 December 1998 at Appendix 2). His subsequent behaviour is certainly consistent with this view. Mr Barwell is a man of very substantial financial means and he has on a number of occasions shown a willingness to enter new markets and subsequently sell the title he has set up.

1.4 The approach of the *Independent* in this instance is clearly evidenced by proposals made to Mr Andrew Blair of Aberdeen Journals by the *Independent's* local managing director, Paul Robins, at a meeting which took place (at Mr Robins' request) on 7 February 2000 (see attendance note attached at Appendix 2). The options presented by Mr Robins at this meeting were that Aberdeen Journals should cut back the distribution of the *Herald & Post* and increase its advertising rates in co-ordination with the *Independent*; or that this complaint to the Office would be pursued at a difficult time for Aberdeen Journals (by which he meant the new competition law entering into force on 1 March).

1.5 The background facts are set out more fully in the following paragraphs and the Appendices.

2. <u>The Aberdeen Market</u>

2.1 The Aberdeen market for regional newspapers, and other regional advertisement-bearing publications, closely resembles markets for such products elsewhere in the UK. First, there is our paid-for daily morning *Press & Journal* title which is available throughout the north of Scotland, roughly in the area north of a line from Oban in the west to Montrose on the east coast (which encompasses Aberdeen), with sales extending northwards to Shetland. Second, our paid-for *Evening Express* focuses its circulation more squarely on Aberdeen and its outlying travel-to-work areas. Third, there are two free titles, the *Independent* and *Herald & Post*, and finally, a series of small niche publications. The free and niche categories, unlike the evening and morning titles, focus mainly on densely-populated areas and targeted socio-economic groupings and typically contain less or no editorial.

2.2 This "layering" of the market, gives advertisers access to lower cost advertising media, which do not bear editorial responsibilities and costs to the same extent as paid-for titles. It is quite normal, therefore, to find a free title, such as the *Herald & Post*, operating "beneath" a paid-for evening title in its urban heartland.

2.3 By way of example, of approximately 280 pages published every week by the *Evening Express*, around 210 pages comprise editorial content, whereas the 70 pages published weekly by the *Independent* include only around 20 editorial pages. The *Herald & Post* contains a similar proportion of editorial to that contained in the *Independent*. This obvious difference in editorial approach is

reflected in employment numbers: there are 65 journalists on the *Evening Express* title, but only 4 on the *Herald & Post* and only 6 on the *Independent*.

2.4 The figures attached at Appendix 1 show that the *Herald & Post* has been a loss-making title for four years now, since the introduction of the *Independent*. It is, however, important to look at the level of prices over this period in its proper context:

— *first, the Independent was launched as a title specifically targeted at our paid-for Evening Express title and its distribution area was focused squarely on the principal circulation area of our evening paper.* We believe that, coupled with the advertising rates charged by the *Independent*, this was an inherently unprofitable prospect for a free newspaper, particularly given the distribution and printing costs involved in reaching some of the *Evening Express'* extended circulation areas outside Aberdeen. The *Independent* has been and continues to be loss-making (according to published results and our own internal estimates) thus supporting this point further;

— second, *we needed to respond to the launch of the Independent by lowering the advertising rates of the Herald & Post to what advertisers told us was necessary to enable us to retain their business. We had and have no wish to exit this layer of the advertising market and to do so would have made the Evening Express vulnerable*; the *Evening Express* is a highly reputable evening title committed to the production of high quality, local news coverage (a commitment which Mr Barwell did not, and does not, offer with his free title). It was inappropriate for us to respond to this threat using the *Evening Express* itself (although this was the apparent target of Mr Barwell's launch) because the title plays an entirely different role for readers and advertisers; a paid-for title is specifically chosen by its readers (which enables advertisers to be certain of their target audience), whereas free titles (such as the *Independent*) are unsolicited (and are therefore less valuable from the advertisers' perspective).

2.5 The *Herald & Post* reduced its distribution levels in September 1999 to a more sustainable level from a costs perspective (from 123,000 to 107,000). Mr Barwell has not responded similarly, although the attendance note of Mr Blair's meeting with Paul Robins, managing director of the *Independent*, on 7 February 2000 suggests that, acting in concert, they would be prepared to do so.

2.6 *The Aberdeen market has now seen, for a period of four years, an effective war of attrition between our titles and the Independent.* Quite apart from failing to cover his own title's costs, Mr Barwell has adopted aggressive in-paper tactics to dissuade readers and advertisers from reading or placing advertisements in our titles (our subsequent complaints to the Audit Bureau of Circulation and the Advertising Standards Authority have been upheld, see Appendix 2). These tactics include making incorrect claims about the circulation of our *Evening Express* and making misleading comparisons between the performance of our *Evening Express* and the *Independent*. If the Office has from Mr Barwell similar information to that supplied by us in this letter, this might explain his overall strategy for the *Independent*.

2.7 The fact is, the two titles are competing vigorously. Our *Herald & Post* is able to do so because of its place in a larger regional newspaper grouping. Likewise, the *Independent* is benefiting from the fact that it is owned by a proprietor who appears to have access to substantial financial resources and who is willing to see his own title continue on a significant loss-making basis for as long as it

might take to persuade Aberdeen Journals to exit the market, purchase the *Independent* or enter into a market-sharing arrangement with it.

3. Aberdeen Journals Dilemma

3.1 We currently face a serious dilemma: *the Independent poses a real threat to the advertising revenues of both our evening title and the Herald & Post.* If matching this competition is indeed to be characterised as predatory the only obvious solution would be for us forthwith to increase the rates for advertising in the *Herald & Post* (and possibly to cut back on our distribution area even further) so as to enable us to cover our costs. If we do so, Mr Barwell's demonstrable ability to continue to fund his loss-making title in the long term poses a real commercial threat to the future both of our free and evening titles. Quite apart from this, if we were to respond in the manner suggested by Mr Robins at the meeting on 7 February, we would no doubt be exposed to a claim that we were participating in an agreement which was unlawful under the new UK competition legislation. If, on the other hand, we continue to price our advertising at current levels, Mr Barwell will seek to argue that we are abusing a position of dominance in Aberdeen which also amounts to an infringement of UK competition legislation.

3.2 Alec Davidson, Northcliffe's managing director, mentioned to me that he met you on 17 January and had told you that he was very confused as to the position our company should adopt in these circumstances. To attempt to revert to profitability within the *Herald & Post* at a time when the *Independent* continues to run at a loss may amount to commercial suicide and certainly risks damaging the quality of our titles. It also raises the question of whether we would be exposing ourselves to the risk of sanctions under the new competition legislation as of 1 March. If, on the other hand, we continue to respond to this competition that also raises the question of infringement and sanctions under the new law. The *Independent's* awareness of this dilemma is clear from the terms of the note of Mr Blair's meeting of 7 February and the "resolution" proposed by Mr Robins.

3.3 You will note from some of the internal memoranda which we have attached at Appendix 2 that some of the terms used to describe our (and our parent company's) strategy could be regarded as extremely robust. Obviously, you will draw your own conclusions in relation to this, but you should appreciate that extreme and unusual circumstances such as those which have confronted us for so long now will occasionally engender unmeasured turns of phrase. The fact is, however, that those same internal memoranda also paint a clear picture of a newspaper publisher who is committed to providing a valuable public service through the publication of high quality titles in Aberdeen, to the benefit both of readers and advertisers. As Mr Davidson, for example, stated in his memorandum dated 20 July 1999 (see Appendix 2) "we will continue the battle but become competitive and super efficient so that whatever happens our business will grow".

3.4 Overall, what the Aberdeen marketplace is witnessing is an unfortunate and protracted commercial dispute. It may in fact well be the case that, when the full context of this dispute is appreciated, the Office finds that an attempt is being made to use it as just another weapon in Mr Barwell's armoury: again, Mr Robins' comments at Mr Blair's recent meeting are consistent with such a strategy.

In the light of the information contained in this letter and its Appendices, we believe that it would be useful to have a short meeting with the Office to discuss the

issues further along with our lawyers and representatives of Northcliffe. I shall telephone you soon with a view to arranging this.

Yours sincerely

ALAN SCOTT
Managing Director"

157. This letter is written, apparently on advice, as a formal response to an allegation of predatory pricing made to the Director by Aberdeen Independent. As we have already stated (paragraphs 103 and 104 above), documents emanating from the undertaking concerned showing how that undertaking saw the market and the commercial strategy it had adopted in that market *may* be decisive evidence of what the market is. (See also, as to the importance of contemporary documents in lieu of abstract economic analysis, the judgment in *Napp*, cited above, at paragraphs 251 and 252). Mr Scott's letter of 10 February 2000 seems on its face to show that, in the view of Aberdeen Journals, the *Evening Express* was vulnerable to competition from the *Independent*, notwithstanding the "layering" of the market to which Mr Scott refers. The letter itself refers to the fact that the distribution area of the *Independent* "was focused squarely on the principal circulation area of our evening paper".

158. In at least three places the letter of 10 February 2000 seems to describe the contemporary situation in February 2000 e.g. "The Aberdeen market has *now* seen, for a period of four years, an effective war of attrition between our *titles* (plural) and the Independent"; "The Independent *poses* a real threat to the advertising revenues of *both* our evening title and the *Herald & Post*"; "Mr Barwell's [strategy] *poses* a real commercial threat to the future *both* of our free and evening titles".

159. The following extracts from the letter of 10 February 2000, are cited in the Decision, as evidence that in the Director's view Aberdeen Journals saw the *Independent* as a commercial threat to the *Evening Express*:

> "[2.4] the Independent was launched as a title specifically targeted at our paid-for Evening Express title and its distribution area was focused squarely on the principal circulation area of our evening paper...
>
> [W]e needed to respond to the launch of the Independent by lowering the advertising rates of the Herald & Post to what advertisers told us was necessary to enable us to retain their business. We had and have no wish to exit this layer of the advertising market and to do so would have made the Evening Express vulnerable.
>
> [2.6] The Aberdeen market has now seen, for a period of four years, an effective war of attrition between our *titles* (emphasis added) and the Independent.
>
> [3.1] [T]he Independent poses a real threat to the advertising revenues of both our evening title [i.e. the Evening Express] and the Herald & Post."

160. In addition we note:

> "3.1 If we do so [i.e. increase rates for advertising in the Herald & Post and possibly cut back its distribution area even further] Mr Barwell's demonstrable ability to continue to fund his loss-making title in the long term *poses a real commercial threat to the future both of our free and evening titles*". (Emphasis added)

161. Aberdeen Journals' letter of 10 February 2000 appears to us on a fair reading to be evidence capable of supporting the relevant market contended for by the Director.

*The further documents relied on in the defence*

162. In addition to the letter of 10 February 2000, the Director relies in his defence on various other documents which accompanied that letter to support his conclusion that Aberdeen Journals saw the *Independent* as a competitive threat to the *Evening Express* as well as the *Herald & Post* (see paragraphs 70 and 77 above). Aberdeen Journals objects to the Director being allowed to rely on those documents, since they formed no part of a Rule 14 Notice during the administrative procedure and are not mentioned in the Decision.

163. The first question that rises, therefore, is how far the Tribunal can or should take these further documents into account. To answer that question we recapitulate briefly the procedural framework in which decisions under the Act are taken.

164. Section 31 of the Act provides that, before taking a decision that the Chapter I or Chapter II prohibition has been infringed, the Director must give written notice to the person or persons likely to be affected and give that person or those persons an opportunity to make representations. Rule 14 of the Director's Rules (cited at paragraph 12 above) provides that, before taking an infringement decision, the Director shall give the undertaking concerned a written notice stating "the facts on which the Director relies, the matters to which he has taken objection, the action he proposes and his reasons for it": Rule 14(3). Under Rule 14(7) and (8) the undertaking may make written and oral representations in response to that notice (already colloquially known as "the Rule 14 Notice") and may also inspect the documents in the Director's file: Rule 14(5).

165. These procedures constitute important safeguards for the rights of the defence. In the analogous context of proceedings by the Commission of the European Communities against an undertaking for infringement of Articles 81 and 82 of the Treaty, it has been held that the Commission is not entitled to rely in its decision on documents on which the undertaking has

had no chance to comment during the administrative procedure: see e.g. Case T-4/89 *BASF v. Commission* [1991] ECR II – 1523, paragraph 36; Case C-310/93P *BPB v Commission* [1995] ECR I–865, paragraph 21. This obligation applies equally to documents emanating from the undertaking in question: Case 107/82 *AEG v Commission* [1983] ECR 3151, paragraphs 26 to 27. As the Court said in that case at paragraph 27:

> "In this connection it must be observed that the important point is not the documents as such but the conclusions which the Commission has drawn from them. Since these documents were not mentioned in the statement of objections AEG was entitled to take the view that they were of no importance for the purposes of the case. By not informing the applicant that these documents would be used in the decision, the Commission prevented AEG from putting forward at the appropriate time its view of the probative value of such documents. It follows that these documents cannot be regarded as admissible evidence for the purposes of this case."

166. In addition, when the Director takes a decision as to whether or not the Chapter I or II prohibitions have been infringed, he must give written notice and state in the decision "the facts on which he bases it and his reasons for making it": Rule 15(1)(a) of the Director's Rules. Where the Director makes a direction or imposes a penalty he must inform the undertaking in writing of "the facts on which he bases" the direction or penalty, and his reasons for giving the direction, or requiring the undertaking to pay the penalty, as the case may be: Rule 17(1) and (2) of the Director's Rules.

167. If there is an appeal to the Tribunal, then under paragraph 3 of Schedule 8 of the Act (see paragraph 6 above) the Tribunal must determine the appeal "on the merits by reference to the grounds of appeal set out in the notice of appeal": paragraph 3(1). Rule 20(2) of the Tribunal Rules provides:

> "The tribunal may admit or exclude evidence, whether or not the evidence was available to the respondent when the disputed decision was taken and notwithstanding any enactment or rule of law relating to the admissibility of evidence in proceedings before a court."

168. In the Tribunal's judgment in *Napp* of 15 January 2002, cited above, the Tribunal accepted that it had a discretion under Rule 20(2) of the Tribunal Rules, to permit the Director to rely on new evidence that was not contained in the Decision, but that such discretion should be exercised sparingly, so as not to jeopardise the safeguards provided by Rule 14 of the Director's Rules (paragraphs 114 to 119, 128 to 130, 133 and 134, and 314 of that judgment). The Tribunal envisaged, in particular, that the Director might be allowed to adduce such new evidence where the latter consisted, in essence, of matters going to rebut allegations made in the notice of appeal (paragraph 114). At paragraph 119 of that judgment the Tribunal said:

> "As we have already said in our judgment of 8 August 2001, if, at the judicial stage, an applicant launches an attack which places under close scrutiny particular aspects of the Decision, in principle we do not think that the Director should be denied a reasonable opportunity to reply by adducing rebuttal evidence in support of the points already made in the Decision. Thus we do not accept Napp's principal submission that nothing may be relied on before the Tribunal unless it was relied on in the administrative procedure."

169. However, it seems to us that the situation in the present case is not identical to the situation with which the Tribunal was concerned in *Napp*. The additional evidence adduced by the Director in *Napp* was primarily directed to rebutting various detailed allegations made by the appellants in that case (see paragraphs 121 to 126 of that judgment), or concerned material that came to light after the Director had taken his decision which went to rebuttal issues and completed the evidential picture (paragraphs 307 et seq of that judgment).

170. In the present case, by contrast, the documents on which the Director relies in the defence go directly to an essential part of the case on relevant market which it is up to the Director to establish in the Decision and to put in the course of the administrative procedure. Aberdeen Journals did not know the Director was relying on these documents until the stage when the Director's defence was lodged before the Tribunal.

171. It is true that, as the Director submits, the material upon which he now seeks to rely was provided by Aberdeen Journals themselves, as an appendix of, or as attachments to, the letter of 10 February 2000. It is also true that, in paragraph 4.5 of the notice of appeal, Aberdeen Journals encouraged the Tribunal "to read carefully through the correspondence, which is attached in the Bundle at pages 1-905 . However, the fact that the Director wished to rely on these documents was not drawn to Aberdeen Journals' attention in the Rule 14 Notice, or at any subsequent stage of the administrative procedure, and Aberdeen Journals did not know, during the administrative procedure, what interpretation or weight the Director attached to the documents, or to the underlying facts to which the documents refer: see *AEG v Commission*, cited above. We do not accept that the reference in paragraph 43 of the Decision to "the submissions" of Aberdeen Journals is sufficient to draw attention to the documents in question or to the underlying facts to which they refer. Nor do we accept the Director's argument that decisions would be 'inordinately long' if the Director had to cite every document on which he relied. In this case it is a matter of some five further documents, at first sight material to the issue of the relevant market which, for whatever reason, were not included in the Decision.

172. We accept therefore Aberdeen Journals' submission that, if they were to be relied upon, these documents should have been put to Aberdeen Journals in the course of the administrative

procedure. The Director was aware that Aberdeen Journals was strongly contesting the inferences to be drawn from the letter of 10 February 2000, since that was made clear by Aberdeen Journals during the administrative hearing which took place on 15 February 2001. At that stage, it would have been open to the Director to allow Aberdeen Journals an opportunity to comment on these documents without necessarily serving an entirely new Rule 14 Notice: see *AEG v Commission*, cited above, at paragraph 29, but that was not done.

173. These factual circumstances distinguish this case from *Napp*, where it was not found by the Tribunal that the material admitted as further evidence should have been put during the administrative procedure. The situation in this case is that Aberdeen Journals has not had the opportunity to comment, during the administrative procedure, on additional documents on which the Director now relies to support a primary finding in the Decision to establish his case on the relevant market. As the Tribunal said in *Napp*, at paragraph 116 "it is of obvious importance that, in the administrative procedure, the provisions of Rule 14 of the Director's Rules are properly observed". Moreover, the documents have not been included in the Decision either, so could not have been addressed by Aberdeen Journals in framing its notice of appeal.

174. On the face of Rule 20(2) of the Tribunal Rules, there is nonetheless a discretion to take this additional material into account, notwithstanding that it was not relied on in the Decision or referred to in the Rule 14 Notice. The Director urges us to do so, avoiding an unduly formalistic approach to our function. Such an approach is also suggested by the statement made in the House of Commons by the Minister for Competition and Consumer Affairs (Mr Griffiths) during the passage of the Competition Bill in 1998 (Hansard Col 496) which was cited in *Napp*, at paragraph 118 of that judgment, and which we cite again:

> "It is our intention that the tribunal should be primarily concerned with the correctness or otherwise of the conclusions contained in the appealed decision and not with how the decision was reached or the reasoning expressed in it. That will apply unless defects in how the decision was reached or the reasoning make it impracticable for the tribunal fairly to determine the correctness or otherwise of the conclusions or of any directions contained in the decision. Wherever possible, we want the tribunal to decide a case on the facts before it, even where there has been a procedural error, and to avoid remitting the case to the director general. We intend to reflect that policy in the tribunal rules.
>
> This is an important aspect of our policy, and I shall explain the rationale behind our approach. The Bill provides for a full appeal on the merits of the case, which is an essential part of ensuring the fairness and transparency of the new regime. It enables undertakings to appeal the substance of the decision including in those cases where it is believed that a failure on the part of the director general to follow proper procedures has led him to reach an incorrect conclusion. The fact that the tribunal

will be reconsidering the decision on the merits will enable it to remedy the consequences of any defects in the director general's procedures."

175. We do not entirely rule out the possibility that, in an appropriate case, it would be sufficient to safeguard the "rights of the defence" if a party has an opportunity to comment on a document during the course of an appeal. Generally speaking, however, we think that would be the exception, rather than the rule. In general, it is at the stage of the administrative procedure, when the Director is marshalling his evidence, that the defendant should be afforded the opportunity to comment, as envisaged by section 31 of the Act and Rule 14 of the Director's Rules.

176. We bear in mind, in that connection, that the Act involves the imposition of severe penalties and that proceedings under the Act are "criminal" for the purposes of Article 6(1) of the European Convention on Human Rights and Fundamental Freedoms ("ECHR") (*Napp*, at paragraphs 92 et seq). The administrative procedure required by section 31 of the Act and established under Rule 14 of the Directors' Rules, is there for a purpose, which is to enable the "right to be heard" to be exercised. If we, at the level of the Tribunal, accept that material matters forming part of the Director's essential case need not be put at the administrative stage, whether in the Rule 14 Notice or otherwise prior to the Decision, but can be raised for the first time at the stage of the appeal, the statutory right to be heard during the administrative stage would be materially weakened. In addition, the Director's duty to set out the facts on which he relies and to give reasons in his decisions under Rules 15(1), 17(1) and 17(2) of the Director's Rules would be materially weakened if we were to permit the Director to support an essential part of his case by further facts at the stage of his defence to an appeal, even if the facts emanate from the undertaking in question.

177. Perhaps more importantly, such an approach could give rise to a tendency to transform this Tribunal from an essentially appellate Tribunal to a court of trial where matters of fact, or the meaning to be attributed to particular documents, are canvassed for the first time at the level of the Tribunal when they could and should have been raised in the administrative procedure and dealt with in the decision. We do not think that such a development would be conducive to appropriate rigour in administrative decision making, or to a healthy and fair system of appeals under the Act.

178. Aberdeen Journals has decided to take a formal objection to the documents in question. In those circumstances, for the reasons given above, we do not think we should take the documents in question into account for the purpose of upholding an essential element in the Decision, namely

the definition of the relevant market, in circumstances where (i) the documents are not referred to in the Decision nor in a Rule 14 Notice or equivalent document; and (ii) no convincing reason is advanced for that omission.

*Other evidence from conduct*

179. In support of his definition of the relevant market, the Director also contended that Aberdeen Journals' whole commercial strategy as regards the *Herald & Post* was carried out principally because of the competitive threat posed by the *Independent* to the advertising revenues of the *Evening Express*, as is shown notably by the documents cited at paragraph 88 of the Decision. The only plausible explanation for the prolonged loss making activities of the *Herald & Post* was, according to the Director, a desire to protect the *Evening Express* from competition from the *Independent,* which in his view showed the three products to be in the same market.

180. It is true that, according to the unchallenged facts found in paragraphs 78 to 80 of the Decision the *Herald & Post* made a substantial negative contribution from 1996 onwards. Moreover, the inference which the Director seeks to draw from the documents cited at paragraph 88 of the decision (paragraph 31 above) is that, in reality, the *Herald & Post* was being used as a 'fighting title' to protect the *Evening Express*.

181. On the other hand, apart from the statements by Aberdeen Journals made in the letter of 10 February 2000 which we have already mentioned (paragraphs 156 to 161 above) neither the documents referring to the commercial strategy pursued by Aberdeen Journals in relation to the *Herald & Post,* nor the losses made by that title, are referred to as a factor in the Director's assessment of the competitive relationship between the free weekly titles and the daily paid-for *Evening Express* set out in paragraphs 14 to 31 of the Decision. The forward reference, in paragraph 40 of the Decision, to the documents cited at paragraph 88, occurs only briefly in the context of the Director's consideration of the competitive relationship between newspapers and other forms of media at paragraphs 32 to 42 of the Decision. That reference comes after the Director has come to his conclusion, at paragraph 31, about the relationship between the newspapers in question, and is not linked back to the matters considered at paragraphs 14 to 31 of the Decision. Although there is a reference, at paragraph 43 of the Decision, to Aberdeen Journals' "own persistent conduct", again that is not linked back to paragraphs 14 to 31 of the Decision. Nor is there any discussion of the inferences to be drawn from particular documents mentioned at paragraph 88 as regards the correct definition of the relevant market in March 2000.

*Overall assessment*

182. We turn, in the light of the above, to an overall assessment of the Decision on the question whether the paid-for daily *Evening Express* is in the same market as the free weeklies *Herald & Post* and *Independent* also circulating in Aberdeen.

183. First, the statements made by *Aberdeen Journals* in its letter of 10 February 2000 are evidence which goes to support the Director's case. However, the sentences from that letter quoted in paragraph 23 of the Decision are virtually the only specific evidence of the competitive relationship between the paid-for and free titles relied on under the heading "Director's finding" at paragraphs 21 to 25 of the Decision.

184. In assessing the significance of that letter, the Tribunal has been placed in an unsatisfactory position. First, there is no description in the Decision of the three newspapers in question or the advertising they carry. Hence, there is no solid basis set out in the Decision upon which to assess how far different advertisers (classified, property, motors, display etc.) might regard advertising in the free weekly *Herald & Post* or *Independent* as interchangeable or substitutable for advertising in the paid-for *Evening Express*.

185. That omission, standing alone, could perhaps have been overcome in the context of the Tribunal's procedures since all three parties are well aware of the kinds of advertisements carried and the Tribunal itself has been supplied with copies of the three newspapers concerned. More fundamentally, however, the Tribunal is aware, from the defence, and because it has been encouraged by Aberdeen Journals to read the appeal bundle, that there is considerable additional material in the case file which appears, at first sight, relevant to the present issue. However, the Tribunal does not feel it should take this material into account, essentially because those documents have not been put to Aberdeen Journals in the administrative procedure (see paragraphs 162 to 178 above).

186. The fact that the Decision contains no supporting economically based assessment of substitutability on the demand-side means that the Director has to rely very heavily on the single letter of 10 February 2000. In the light, in particular, of the unsatisfactory circumstances just mentioned, we have difficulty in persuading ourselves that that letter, standing alone, represents a satisfactory foundation on which to rest the definition of the relevant market in this case.

*The procedure now to be followed*

187. That raises the question of what procedure the Tribunal should now follow. Schedule 8, Part I, paragraph 3(2) of the Act provides:

> "(2) The tribunal may confirm or set aside the decision which is the subject of the appeal, or any part of it, and may –
>
> (a) remit the matter to the Director"

Schedule 8, part II, paragraph 9(1)(f) provides that:

> "9(1) Rules may make provision –...
>
> (f) for enabling the tribunal to refer a matter back to the Director if it appears to the tribunal that the matter has not been adequately investigated."

188. Rule 17 of the Tribunal Rules provides:

> "(1) The tribunal may at any time, on the request of a party or of its own motion, at the pre-hearing review or otherwise, give such directions as are provided for in paragraph (2) below or such other directions as it thinks fit to secure the just, expeditious and economical conduct of the proceedings.
>
> (2) The tribunal may give directions –
>
> ...
>
> (j) to enable a disputed decision to be referred back (or in Scotland, remitted) to the person by whom it was taken."

189. In the circumstances we have explained we feel we have no alternative but to set aside the Decision under paragraph 3(2) of Schedule 8 of the Act on the grounds that the treatment in the Decision of the relevant product market is inadequate. Although, strictly speaking, that applies only to paragraphs 16 to 31 of the Decision, those paragraphs constitute the foundation upon which the rest of the Decision is based. In our view it follows that the Decision as a whole falls to be set aside.

190. However, paragraph 3(2)(a) of Schedule 8 of the Act gives the Tribunal power to remit the matter back to the Director. A further such power is to be found in paragraph 9(1)(f) of Schedule 8, and Rule 17(2)(j) of the Tribunal Rules, but we do not for present purposes need to explore the precise relationship between these provisions. The power to remit is clearly established under the Act. In that respect, it seems to us that there is a "relevant difference", for the purposes of section 60 of the Act, between our powers and those of the Court of Justice and Court of First Instance where there is no power to remit: see Cases T-305/94 etc *Limburgse Vinyl Maatschappij v Commission* [1999] ECR II-931, at paragraph 96. Nor are we aware of any overriding principle of domestic law, including the Human Rights Act 1998, that would preclude the Director from reconsidering the matter and arriving at a further decision.



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191. Notwithstanding that these are "criminal" proceedings for the purposes of Article 6(1) of the ECHR the various statutory provisions governing the circumstances in which, following a criminal appeal, the relevant appellate court in Scotland, England & Wales or Northern Ireland (in this case Scotland) may authorise a new criminal prosecution, or order a retrial in a criminal case, do not apply to proceedings by the Director under the Act (see the Tribunal's judgment in *Napp*, cited above, at paragraph 95 and *Han v Commissioners of Customs & Excise* [2001] 4 All ER 687 CA). However, it seems to us that, in infringement proceedings potentially involving a penalty under section 36 of the Act, we should not exercise the power to remit with a view to the matter being further considered by the Director unless we are satisfied that the proceedings should continue in the interests of justice.

192. In this case we are so satisfied. There is an important public interest in seeing that the Chapter II prohibition is respected. As it turns out, the issues canvassed in this judgment turn largely on matters of due process. The main purpose of remitting to the Director is to ensure that due process is respected at the administrative stage rather than left to the appeal stage. At this early point in the operation of the Act (this is only the second decision imposing a penalty) the parties had no prior guidance from the Tribunal on the extent to which relevant matters should be put during the administrative procedure, or the extent to which the Tribunal would itself be prepared to admit further evidence. That procedural issue having been clarified, we see no basis for preventing the Director from reconsidering the matter.

193. From Aberdeen Journals' point of view, the documents in question are already in existence, emanate from Aberdeen Journals itself and appear to be material to the issues. We see no unfairness or oppression if the proceedings continue against Aberdeen Journals. Moreover it is in the general interests of the newspaper industry, including the Northcliffe Group, that the ambit of the Chapter II prohibition in circumstances such as these should be fully explored. The interests of the complainant, Aberdeen Independent, go in the same direction. In the light, notably, of its wider ramifications for the newspaper industry, and for the issue of predatory pricing under the Act, we do not think that the present case can be regarded as in any way insignificant, albeit that the penalty relates to an infringement of only one month in the Aberdeen area. On the contrary, in our view this case raises a number of serious issues upon which an authoritative adjudication – whatever that may ultimately be – remains highly desirable.

194. The matter, namely the issue of the definition of the relevant product market, in particular, which newspapers constitute the relevant product market, will therefore be remitted to the Director for further consideration. We direct that any further Rule 14 Notice that the Director

considers appropriate be issued at most within two months of the notification of this judgment, and that any further decision be issued at most within two months from the completion of the procedure envisaged by that Rule.

195. If, the Director having adopted a further decision, there is then an appeal to this Tribunal, it seems to us that the efforts that have already been made in this appeal should not be allowed to go to waste. As at present advised, the Tribunal would see scope, within the wide flexibility accorded by the Tribunal Rules, for dealing with any new appeal in a way that allowed the existing record to stand, or be consolidated with, any new appeal, so as to minimise duplication in any future proceedings.

196. In those circumstances our present view, subject to any further submissions that may be made, is that the question of costs should be reserved for the time being until it is known what further course the Director proposes to take.

197. We wish to emphasise that this judgment does not imply any finding by the Tribunal as to whether Aberdeen Journals has, or has not, a dominant position in any relevant market, and still less whether any such dominant position has been abused. Our position simply is that we regard the treatment of the relevant product market in the present Decision as unsatisfactory and that the appropriate course is to remit the matter to the Director.

## VI ORDERS MADE

198. On these grounds the Tribunal unanimously orders:

(1) Decision no. CA 98/5/2001 entitled "Predation by Aberdeen Journals Ltd" adopted by the Director General of Fair Trading on 16 July 2001 is set aside

(2) The matter set out at paragraph 194 above is remitted to the Director

(3) Any further notice pursuant to Rule 14 of The Competition Act 1998 (Director's rules) Order 2000 is to be issued within two months of the notification of this judgment. Any further decision the Director decides to take shall be adopted no later than two months from the completion of the procedure pursuant to that Rule.

(4) The costs are reserved for further argument

(5) The parties have liberty to apply to the Tribunal for any further necessary directions

Christopher Bellamy | Andrew Bain | Patricia Quigley

Delivered in open court | 19 March 2002

Charles Dhanowa
Registrar



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222 F.3d 390
2000-2 Trade Cases P 72,977, 21 Communications Reg. (P&F) 937
**(Cite as: 222 F.3d 390)**

United States Court of Appeals,
Seventh Circuit.

Richard GOLDWASSER, et al., individually and on behalf of all others similarly situated, Plaintiffs-Appellants,
v.
AMERITECH CORPORATION, Defendant-Appellee.

**No. 98-1439.**

Argued March 30, 1999
Decided July 25, 2000

Before RIPPLE, DIANE P. WOOD, and EVANS, Circuit Judges.

DIANE P. WOOD, Circuit Judge.

The Telecommunications Act of 1996, Pub.L. 104-104, 110 Stat. 56 (1996), codified at 47 U.S.C. § 151 *et seq.*, represents a comprehensive effort by Congress to bring the benefits of deregulation and competition to all aspects of the telecommunications market in the United States, including especially local markets. But progress and change in such a complex industry do not occur overnight, and Congress accordingly entrusted the Federal Communications Commission (FCC) and the state public utility commissions with the task of overseeing the transition from the former regulatory regime to the Promised Land where competition reigns, consumers have a wide array of choice, and prices are low.

The antitrust laws for more than 110 years have served much the same purpose for the entire economy. The question that confronts us here is how and where these two competition-friendly regimes intersect. Consumers in most of the states served by Ameritech Corporation brought this suit under the monopolization provision of the Sherman Act, 15 U.S.C. § 2 (1994), claiming that Ameritech has been violating both the antitrust laws, as it has moved through the deregulation process mandated by the Telecommunications Act (which we will usually call "the 1996 Act" for short), and the 1996 Act itself. The district court dismissed their case, never reaching their effort to bring it as a class action, on the ground that they lacked standing to complain about Ameritech's alleged footdragging and obstructive behavior. We have concluded that the district court was correct to dismiss the plaintiffs' suit. Our reasons, however, differ in important respects ***392** from those on which it relied, as we explain below.

I

Plaintiffs-appellants Richard Goldwasser, Michael Cohn, Eric Carter, and Richard Lozon are citizens of Illinois, Wisconsin, Indiana, and Michigan, respectively. Those states, plus Ohio (for which there mysteriously was no named class representative) are the five states in which defendant Ameritech provides local telephone service. The Goldwasser plaintiffs (which is what we will call them here) are consumers of local telephone services in Ameritech's area. When the 1996 Act was passed, they, like millions of other telephone customers throughout the country, looked forward to the same kind of development of competitive local services that had occurred several decades earlier in the telephone equipment, long distance, and enhanced services markets. When this did not occur as speedily as they had hoped, they concluded that the fault lay with Ameritech. Under the 1996 Act, Ameritech has special responsibilities as the incumbent local exchange carrier, or ILEC, to cooperate with potential entrants as they seek to break into the local services markets. Believing that Ameritech was flouting its obligations under the 1996 Act and unlawfully monopolizing under Section 2 of the Sherman Act, they filed the present suit as a class action on September 26, 1997.

A.

Before turning to the specifics of the Goldwasser complaint, it is helpful to review what the 1996 Act was designed to do and how it went about that task.

Voice telephone itself was born with the famous summons Alexander Graham Bell sent to his assistant Thomas A. Watson, on March 10, 1876: "Mr. Watson, come here; I want you." George P. Oslin, The Story of Telecommunications 219 (1992). Just a few days earlier, on March 7, 1876, Bell became the owner of the first patent for a

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recognizable telephone, Patent No. 174,465. After a considerable amount of litigation, certain patents for improvements to Bell's original invention were upheld by the Supreme Court. See *United States v.* American Bell Telephone Co., 167 U.S. 224, 17 S.Ct. 809, 42 L.Ed. 144 (1897). Bell and his backers proved to be even more astute as businesspeople than they had been as inventors. They incorporated, and by 1886, a mere decade after the issuance of Bell's patent, the treelike shape of the world-famous Bell Telephone company was beginning to be recognizable, with the American Telephone and Telegraph Company (AT&T) at its trunk. Oslin at 230.

Although the Bell company reigned supreme during the life of the basic patents, when the patents expired there was a burst of competition from many independent telephone companies around the country. This was, however, temporary: mergers and acquisitions led to re-consolidation, and by the time the Communications Act of 1934, ch. 652, 48 Stat. 1064 (1934) (codified as amended in scattered sections of 47 U.S.C.) (the 1934 Act), was passed, it was an article of faith that telephone service, like services furnished by other public utilities, was a natural monopoly. Consumer protection wasto be achieved by regulation, which, insofar as it affected local service, took place at the state level. The FCC had responsibility for regulating interstate telephone companies and services.

By 1934, the Bell System included operating companies, long distance services, equipment manufacturing, and research facilities. AT&T owned 80% of all the local telephone lines and services in the United States, and it had a monopoly lock on long distance service. There matters stood for some four decades. But, even if the regulatory picture was static, technology and markets were not. The natural monopoly assumption came under increasing attack, especially as it pertained to long distance services and equipment manufacturing.

In 1974, the United States, through the Antitrust Division of the U.S. Department of Justice, sent shock waves through the nation when it instituted a massive antitrust case against AT&T. The complaint alleged that AT&T and its affiliates Western Electric Co. and Bell Telephone Laboratories had maintained an unlawful combination for many years among themselves and with the 22 Bell Operating Companies, or BOCs in telecom jargon; that they had restricted competition from other telecommunications systems and carriers, and from other manufacturers; and that they had engaged in a host of monopolistic practices. See [1970-1979 U.S. Antitrust Cases Transfer Binder] Trade Reg. Rep. (CCH) ¶ 45,074. Rather early in the litigation, the district judge who handled the proceedings from the date of filing until the case was wrapped up after the passage of the 1996 Act, the Honorable Harold Greene, rejected the defendants' argument that the matters raised in the complaint fell within the exclusive jurisdiction of the FCC and were thus immune from antitrust scrutiny. See *United States v. American Tel. & Tel. Co.*, 461 F.Supp. 1314, 1326-28 (D.D.C.1978) (*AT&T I*). In that opinion, Judge Greene considered the question whether the communications statutes conferred an implied immunity from antitrust regulation on the defendants, and his answer was no. Both his decision in that case, and the eventual Modified Final Judgment (MFJ) that reflected the consent decree reached among the parties, rested on the simple notion that, despite the existence of a substantial network of regulation in the field, there was still plenty of room for competition. See *United States v. American Tel. & Tel. Co.*, 552 F.Supp. 131 (D.D.C.1982) (*AT&T II*), aff'd. sub nom. *Maryland v. United States*, 460 U.S. 1001, 103 S.Ct. 1240, 75 L.Ed.2d 472 (1983). Where competition was possible, the defendants had no right to use their monopoly power to squelch it.

From the time when the consent decree was approved until the 1996 Act took effect, the process of opening up telecommunications markets to competition took place under the supervision of the district court, which had the task of administering the MFJ. Apart from its provisions requiring the break-up of the old Bell System, which was perhaps the most newsworthy consequence of the antitrust suit, the MFJ contained behavioral restrictions on the newly independent regional BOCs (including Ameritech) and on AT&T itself. See *AT&T II*, 552 F.Supp. at 226-28. These restrictions, which pertained to questions like the provision of long distance services outside local access and transport areas, the furnishing of wireless telephone, and the development of enhanced services, were designed to ensure that the former system (under which competition was distorted by leverage and cross-subsidization between protected, regulated markets and unregulated markets) did not reappear.

Long before the 1996 Act was passed, however, it had become clear that comprehensive regulation of the rapidly advancing telecommunications markets was not a task well suited to the federal courts. Thus, one of the first things Congress did in the 1996 Act was to shift the remaining authority the district

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court was exercising under the MFJ over to the FCC. The 1996 Act itself was designed to "promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies." Preamble to Telecommunications Act of 1996. As the Supreme Court acknowledged in *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 371, 119 S.Ct. 721, 142 L.Ed.2d 835 (1999), and as we have already noted, the eventual hope is to transform the telecommunications market from a monopolistic, regulated one to a vibrant, competitive one.

Two sections of the 1996 Act are of central importance here: §§ 251 and 252. They are both contained in Part II of the statute, which is entitled "Development of Competitive Markets." Section 251 sets out detailed rules that implement the general duty of telecommunications carriers (as established in the statute) to interconnect with one another's facilities and equipment. Each local exchange carrier, or LEC, has the duty to resell on reasonable and nondiscriminatory terms, to provide number portability to the extent technically feasible, to provide dialing parity to competing providers, to afford access to rights-of-way, and to establish reciprocal compensation arrangements for the transport and termination of telecommunications. 47 U.S.C. § 251(b).

Incumbent LECs, or ILECs, have additional duties under the statute, which are spelled out in § 251(c): they must negotiate in good faith to create the agreements necessary for fulfilling the subpart (b) duties; they must provide for "requesting telecommunications carriers" appropriate interconnections; they must provide unbundled access to network elements at any technically feasible point on just, reasonable and nondiscriminatory terms; they must offer to aspiring competitors at wholesale rates any services that they sell at retail; and they must give reasonable public notice of changes in their services that would affect others.

The 1996 Act contains specific language about its relation to the federal antitrust laws. Section 601(b)(1), found at 47 U.S.C.A. § 152 Historical and Statutory Notes, provides that "... nothing in this Act or the amendments made by this Act shall be construed to modify, impair, or supersede the applicability of any of the antitrust laws." To similar effect, § 601(c)(1) states that "[t]his Act and the amendments made by this Act shall not be construed to modify, impair, or supersede Federal, State, or local law unless expressly so provided in such Act or amendments."

B.

This is the background against which the Goldwasser plaintiffs filed their class action complaint. The complaint focuses tightly on the ILECs' § 251 duties. It alleges that Ameritech controls more than 90% of the markets for local telephone service in the geographic territories it covers (basically, the five state-area) and that it has erected substantial barriers to entry into those markets. It also alleges that Ameritech controls a number of so-called essential facilities, including its telephone lines, equipment, transmission, and interconnection stations in the relevant markets. Ameritech's competitors (*i.e.* the companies from whom the plaintiff customers would like to purchase) are unable to duplicate those facilities. Ameritech, by engaging in a host of exclusionary practices made possible by its monopoly power, is preventing those competitors from entering the market.

The complaint specifies 20 specific exclusionary or monopolistic practices Ameritech has engaged in or continues to commit. We detail them here, because the nature of the complaint sheds significant light on the extent to which it implicates pure antitrust theory, the extent to which it focuses on local markets, and the extent to which it rests on the 1996 Act:

(1) Ameritech is not providing the same quality of service to its competitors as it provides to itself, in violation of § 251.

(2) Again in violation of § 251, Ameritech has not given its competitors nondiscriminatory access to its operational support systems, nor has it given them access to unbundled elements of its system on terms equivalent to those Ameritech enjoys.

(3) Ameritech has failed to provide "dark fiber" as an unbundled network element, in violation of the 1996 Act.

(4) Ameritech has failed to provide its competitors access to poles, ducts, conduits, and rights-of-way on a nondiscriminatory basis, in violation of §§ 251 and 271.

(5) Ameritech has failed fully to unbundle its network elements, including local loops, local transport, and local switching, in violation of § 251(c)(3).

(6) Ameritech's competitors have experienced undue delays (presumably caused by Ameritech) in acquiring unbundled elements, and those delays have precluded them from offering services as attractive as Ameritech's.

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(7) The competitors have also experienced delays and discrimination as they have sought to gain access to unbundled loops, in violation of § 251(c)(3).
(8) Ameritech has failed to provide unbundled access to local transport interoffice transmission facilities on a nondiscriminatory basis, in violation of § 251(c)(3).
(9) Ameritech has failed to provide local switching to competitors, in violation of § 271(c)(2)(B)(vi).
(10) Ameritech discriminates against competitors by requiring competitive LECs and competitors to pay originating and terminating access charges, when it cannot collect interstate access charges.
(11) Ameritech has failed to offer or provide customized routing, which is required to be provided as part of unbundled local switching.
(12) Ameritech has not provided dialing parity to competitors for services such as operator assistance ("0"), directory assistance ("411"), and repairs ("611"), in violation of § 271(c)(2)(B)(xii).
(13) Ameritech has failed to provide access to its own 911 and emergency services on a nondiscriminatory basis, in violation of § 271(c)(2)(B)(vii)(I).
(14) Ameritech has continued to bill customers of competitors who have converted from Ameritech's services, and hence some customers are being double- billed, thereby harming the competitors' good will.
(15) Ameritech has failed to provide interconnection between its network and those of competitors that is equal to the interconnections it gives itself, in violation of §§ 251(c)(2) and 271(c)(2)(B)(i).
(16) Ameritech has not complied with § 272(b)(3) of the 1996 Act, which requires a BOC and its interLATA affiliates to have separate officers, directors, and employees.
(17) Ameritech has failed publicly to disclose all transactions with § 272 affiliates, in violation of § 272(b)(5).
(18) Ameritech has refused to sell to its competitors, on just, reasonable, and nondiscriminatory terms, access to components of its network on an unbundled or individual basis.
(19) Ameritech has refused to sell to its competitors local telephone services at wholesale prices that are just, reasonable, and nondiscriminatory, which prevents the competitors in turn from offering attractive resale prices to consumers.
(20) Ameritech has refused to allow its competitors to connect with its local telephone network on just, reasonable, and nondiscriminatory terms.

All of these practices, the complaint alleges, violate both § 2 of the Sherman Act, 15 U.S.C. § 2, and the 1996 Act itself. The plaintiffs sought treble damages for the antitrust violations, as well as declaratory and injunctive relief.

C.

The district court dismissed the entire case under Rule 12(b)(6) for failure to state a claim. It found first that the filed rate doctrine, as developed in the line of cases beginning with *Keogh v. Chicago & N.W. Ry. Co.*, 260 U.S. 156, 43 S.Ct. 47, 67 L.Ed. 183 (1922), barred the claims for damages under either the antitrust laws or the 1996 Act. The remainder of its discussion therefore pertained only to the plaintiffs' requests for injunctive relief. As to that, the court found that the plaintiffs lacked standing to sue under the antitrust laws, under the Supreme Court's decision in *Block v. Community Nutrition Institute*, 467 U.S. 340, 351-52, 104 S.Ct. 2450, 81 L.Ed.2d 270 (1984) (no standing where a suit would severely disrupt a complex regulatory scheme). Last, it found that consumer plaintiffs were not entitled to sue to enforce the duties on ILECs created by the 1996 Act.

**II**

A.

We consider first the propriety of dismissing the Goldwasser plaintiffs' antitrust claims on a Rule 12(b)(6) motion. The plaintiffs see this as a straightforward application of Section 2: Ameritech is a monopolist; Ameritech is engaging in conduct designed to maintain its monopoly power, through a variety of exclusionary practices; and plaintiffs as consumers are harmed. See generally *United States v. Grinnell Corp.*, 384 U.S. 563, 570- 71, 86 S.Ct. 1698, 16 L.Ed.2d 778 (1966). As consumers and direct purchasers from Ameritech, they argue, they clearly have standing to bring this suit under decisions such as *Associated General Contractors of California, Inc. v. California State Council of Carpenters*, 459 U.S. 519, 539-41, 103 S.Ct. 897, 74 L.Ed.2d 723 (1983) (general definition of "person injured" within the meaning of Clayton Act § 4, 15 U.S.C. § 15) and *Illinois Brick Co. v. Illinois*, 431 U.S. 720, 97 S.Ct. 2061, 52 L.Ed.2d 707 (1977) (barring suits by indirect purchasers). The 1996 Act contains an antitrust savings provision, and that is the end of the matter as far as they are concerned. Neither the filed rate doctrine nor the fact that the 1996 Act contains specific rules regulating Ameritech should stand in their way of treble damages and injunctive relief, on behalf of themselves and the class they seek to represent.

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We agree with the plaintiffs part of the way: there is nothing in the rules of antitrust standing that prevents them from suing. But, as we will show, this case cannot survive as a pure antitrust suit against Ameritech, freed from the specific regulatory requirements Congress imposed in the 1996 Act. Only if Section 2 somehow incorporates the more particularized statutory duties the 1996 Act has imposed on ILECs like Ameritech would Ameritech's alleged failure to comply with the 1996 Act be, in itself, also an antitrust violation. In considering whether this is so, we necessarily make an inquiry similar to the one in *Silver v. New York Stock Exchange,* 373 U.S. 341, 83 S.Ct. 1246, 10 L.Ed.2d 389 (1963), about the extent to which antitrust rules apply in this industry and the extent to which a different federal statute--the 1996 Act--provides the governing rules of law. If that inquiry reveals a conflict between the antitrust laws and the 1996 Act, we would need to reach the question of implied immunity; if it shows instead that the two laws are reconcilable, immunity is beside the point. (This, we believe, is what the district court was getting at too, when it turned to *Block* to justify its dismissal of the case; its misstep was to use the rhetoric of standing.)

We begin this part of our inquiry with a brief review of Sherman Act § 2, which is the statute that makes it unlawful to monopolize, to attempt to monopolize, or to conspire to monopolize. The Supreme Court has had a number of occasions on which to address the elements of a Section 2 monopolization case, most recently in *Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451, 112 S.Ct. 2072, 119 L.Ed.2d 265 (1992). There, quoting from *Grinnell, supra*, the Court reviewed what it takes to prove monopolization:

> The offense of monopoly under § 2 of the Sherman Act has two elements: (1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development ***397** as a consequence of a superior product, business acumen, or historic accident.

504 U.S. at 481, 112 S.Ct. 2072, quoting *Grinnell*, 384 U.S. at 570-71, 86 S.Ct. 1698.

Few would say that the first element is easily proved: it is exceedingly difficult to prove market power, or monopoly power, directly, and the conventional way of proving power by showing a given share of a properly defined relevant market can present vexing problems as well. But the first element is a snap compared to the second. To demonstrate unlawful acquisition of monopoly power may not be terribly difficult, especially if it was born from an unlawful merger or acquisition, fraud on the Patent Office, or some other visible misdeed. Proof of unlawful maintenance of monopoly power, in contrast, requires courts to make the most subtle of economic judgments about particular business practices. As the Supreme Court noted in *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 104 S.Ct. 2731, 81 L.Ed.2d 628 (1984), unilateral conduct must be approached with the utmost caution, lest the law forbid desirable, robust competition:

> It is not enough that a single firm appears to "restrain trade" unreasonably, for even a vigorous competitor may leave that impression. For instance, an efficient firm may capture unsatisfied customers from an inefficient rival, whose own ability to compete may suffer as a result. This is the rule of the marketplace and is precisely the sort of competition that promotes the consumer interests that the Sherman Act aims to foster. In part because it is sometimes difficult to distinguish robust competition from conduct with long- run anticompetitive effects, Congress authorized Sherman Act scrutiny of single firms only when they pose a danger of monopolization. Judging unilateral conduct in this manner reduces the risk that the antitrust laws will dampen the competitive zeal of a single aggressive competitor.

*Id.* at 767-68, 104 S.Ct. 2731 (footnote omitted).

[1] Thus, it is clear that merely being a monopolist does not violate Section 2. *United States v. Aluminum Co. of America,* 148 F.2d 416, 429 (2d Cir.1945) ("size alone does not determine guilt; ... there must be some 'exclusion' of competitors; ... the growth must be something else than 'natural' or 'normal;' ... there must be a 'wrongful intent,' or some other specific intent; or ... some 'unduly' coercive means must be used"). See also *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 275 (2d Cir.1979); *United States v. New York Great Atlantic & Pacific Tea Co.*, 173 F.2d 79, 87 (7th Cir.1949). It follows from this, as our court and others have pointed out from time to time, that even a monopolist is entitled to compete; it need not lie down and play dead, as it watches the quality of its products deteriorate and its customers become disaffected. See, *e.g.*, *Olympia Equipment Leasing Co. v. Western Union Telegraph Co.*, 797 F.2d 370, 375 (7th Cir.1986); *Telex Corp. v. IBM,* 510 F.2d 894, 927-28 (10th Cir.1975).

Part of competing like everyone else is the ability to make decisions about with whom and on what terms one will deal. When we are considering distribution

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chains, or vertical relationships, the doctrine of *United States v. Colgate & Co.*, 250 U.S. 300, 39 S.Ct. 465, 63 L.Ed. 992 (1919), comes into play, under which the Court said (somewhat tautologically, unfortunately), "[i]n the absence of any purpose to create or maintain a monopoly, the [Sherman] act does not restrict the long recognized right of trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal." Id. at 307, 39 S.Ct. 465. Tautologies or no, the Colgate right has received consistent support from the Supreme Court even for large firms, as one can seefrom more recent decisions such as *NYNEX Corp. v. Discon, Inc.*, 525 U.S. 128, 119 S.Ct. 493, 142 L.Ed.2d 510 (1998), in which the Court rejected the application of the *per se* rule against group boycotts to the decision of one buyer to favor one supplier over another, even if the decision was not for a legitimate business reason. See also *Monsanto Co. v. Spray- Rite Service Corp.*, 465 U.S. 752, 761, 104 S.Ct. 1464, 79 L.Ed.2d 775 (1984) (reaffirming *Colgate* in terms).

In general, then, even a firm with significant market power has no duty to deal with certain suppliers or distributors, unless it can be shown that its decisions are part of a broader effort to maintain its monopoly power. What about duties to deal with competitors, either affirmatively or by refraining from actions that will exclude them from the market either by preventing entry or by forcing incumbents out? The Supreme Court encountered a competitor case in *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 105 S.Ct. 2847, 86 L.Ed.2d 467 (1985). Although the Court ultimately found that the decision of Ski Company (a firm with monopoly power) actually to forgo cash revenues and efficient methods of doing business for the sole purpose of driving its rival out of the market amounted to a violation of Section 2, it was careful to explain the limits on its holding as well. "Ski Co.," it wrote, "is surely correct in submitting that even a firm with monopoly power has no general duty to engage in a joint marketing program with a competitor." 472 U.S. at 600, 105 S.Ct. 2847. "The absence of a duty to transact business with another firm is, in some respects, merely the counterpart of the independent businessman's cherished right to select his customers and his associates." *Id.* at 601, 105 S.Ct. 2847.

This court's decision in *Olympia Equipment Leasing* is consistent with the recognition in Aspen Skiing that monopolists normally do not need affirmatively to help their competitors. Monopolists are just as entitled as other firms to choose efficient methods of doing business (which is not, recall, what the Ski Company was doing, and that was why the Court and the jury were able to spot its conduct for the exclusionary practice it was). See *Olympia Equipment Leasing*, 797 F.2d at 375; *Abcor Corp. v. AM Int'l, Inc.*, 916 F.2d 924, 929 (4th Cir.1990); *United States Football League v. National Football League*, 842 F.2d 1335, 1360-61 (2d Cir.1988).

[2] With these principles in mind, we turn to the question whether the Goldwasser plaintiffs had standing under the antitrust laws to bring their suit. We conclude that the answer is yes, no matter which branch of antitrust standing doctrine one considers. First, as we noted above, the plaintiffs were direct purchasers from Ameritech, and their complaint asserts that a variety of practices in which Ameritech has engaged and is engaging in have led prices for those services to be anticompetitively high, in violation of Section 2. As direct purchasers, they have no *Illinois Brick* problem. As people forced to pay an alleged monopolistic overcharge, they have described the kind of injury the antitrust laws are designed to redress, which is to say they have satisfied the "antitrust injury" requirement of *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S.477, 97 S.Ct. 690, 50 L.Ed.2d 701 (1977). They are consumers, not shareholders, or unions, or others whose injury is too remote to satisfy Clayton Act § 4; thus, they have standing as the term is defined in *Associated General Contractors, supra.*

Finally, we think Ameritech is wrong to claim that the plaintiffs lack standing because they are attempting to raise third-party rights--the rights of the competitors. It is true that the reason the plaintiffs have been injured (allegedly, of course) implicates the rights of the competitors not to be excluded from the local markets through anticompetitive actions of Ameritech, but that does not make this a *jus tertii* case. These plaintiffs want lower prices and more choice, and they claim that Ameritech (a monopolist) is doing things to prevent that from happening. Their theory is a classic exclusionary acts theory, and in all such cases, the monopolist's alleged sin is the exclusion of other competitors from the market. One assumes that those other competitors are grateful for the help from the consumer litigation, but that is incidental. The Goldwasser plaintiffs do not care in principle which competitors enter their markets; they just want a competitively structured local telephone market that will prevent Ameritech from inflicting antitrust injury on them. We are satisfied that they are asserting their own rights, and thus that they have standing.

*Block*, on which the district court relied, does not

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require a contrary conclusion. Indeed, *Block* did not even involve antitrust standing. The question there was instead whether ultimate consumers of dairy products were entitled to obtain judicial review of milk market orders issued by the Secretary of Agriculture under the Agricultural Marketing Agreement Act of 1937, 7 U.S.C. § 601 *et seq.* The consumer plaintiffs brought their suit under the Administrative Procedure Act, 5 U.S.C. § 701 *et seq.*, but the Court found that Congress had created a different scheme for judicial review of marketing orders in the agricultural marketing legislation, which excluded the kind of consumer suit the plaintiffs wanted to bring.

*Block* may offer useful insight into the Goldwasser plaintiffs' case insofar as they are trying to assert rights directly under the 1996 Act, but we do not find it helpful for their antitrust case. Their problem in the antitrust case is not standing. It is the more fundamental question whether they have stated a Section 2 claim at all against Ameritech when they accuse it of failing to comply with its myriad duties under §§ 251, 252, and 271 of the telecommunications law.

[3] The fundamental fallacy in the plaintiffs' theory is that the duties the 1996 Act imposes on ILECs are coterminous with the duty of a monopolist to refrain from exclusionary practices. They are not. It would have been possible for Congress to have passed a statute that simply lifted the regulatory prohibitions found in sources such as the Telecommunications Act of 1934, the MFJ, and other sources, that barred companies in different parts of the telecommunications market (*i.e.* long distance and local markets, generally speaking) from entering one another's domains. Anyone who wanted to compete with an ILEC would have had the burden of duplicating its physical infrastructure or of persuading the ILEC to contract with it on mutually satisfactory terms, but this is the normal way in which competitive markets work. It obviously takes much longer to enter a market that requires huge sunk cost investments before business is possible, but the success of the companies that challenged AT&T's hegemony over long distance shows that it can be done. We might think of this hypothetical legislative approach as one involving passive restrictions on the ILECs, under which they would have been permitted to compete, but they would have been prohibited from engaging in affirmatively exclusionary acts like the efforts of the Ski Company in *Aspen Skiing*, or the newspaper company in *Lorain Journal Co. v. United States*, 342 U.S. 143, 72 S.Ct. 181, 96 L.Ed. 162 (1951), or the shoe company in both *United Shoe Machinery Corp. v. United States*, 258 U.S. 451, 42 S.Ct. 363, 66 L.Ed. 708 (1922), and *United States v. United Shoe Machinery Corp.*, 110 F.Supp. 295 (D.Mass.1953), *aff'd. per curiam*, 347 U.S. 521, 74 S.Ct. 699, 98 L.Ed. 910 (1954).

In other words, Congress could have chosen a simple antitrust solution to the problem of restricted competition in local telephone markets. It did not. Instead, in an effort to jump-start the development of competitive local markets, it imposed a host of special duties on the ILECs; it entrusted supervision of those duties to the FCC and the state public utility commissions; and it created a system of negotiated agreements through which this would be accomplished. These are precisely the kinds of affirmative duties to help one's competitors that we have already noted do not exist under the unadorned antitrust laws. See *Olympia Equipment Leasing Co.*, 797 F.2d at 375; *MCI Communications Corp. v. AT&T*, 708 F.2d 1081, 1149 (7th Cir.1983); *United States Football League*, 842 F.2d at 1360-61; *Catlin v. Washington Energy Co.*, 791 F.2d 1343, 1348-49 (9th Cir.1986).

It is not our task to assess the wisdom of the particular measures Congress thought would be helpful in that process. We have only to recognize that the duties to which plaintiffs refer in paragraphs (1) through (20) of their complaint, which we have set out earlier, go well beyond anything the antitrust laws would mandate on their own. A complaint like this one, which takes the form "X is a monopolist; X didn't help its competitors enter the market so that they could challenge its monopoly; the prices I must pay X are therefore still too high" does not state a claim under Section 2. The reason is because the antitrust laws do not impose that kind of affirmative duty, even on monopolists.

To the extent such a duty exists, as the complaint itself makes clear, it comes from the 1996 Act. We think it both illogical and undesirable to equate a failure to comply with the 1996 Act with a failure to comply with the antitrust laws. It is illogical because there are countless laws that a firm with market power might violate that have little or nothing to do with its position in the market: an agricultural firm might fail to comply with safety or cleanliness standards applicable to food processing; a computer processor firm might violate employment discrimination laws; a pharmaceutical firm might run afoul of the Food and Drug Administration's rules for approval of new drugs. Even if, in some indirect way, those defalcations helped the firm to maintain its

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monopoly, the link is too indirect to support an antitrust claim. Those other statutory regimes contain their own penalty structures, and that is the proper way to address any violations.

That leads to our other point, which is that it would be undesirable here to assume that a violation of a 1996 Act requirement automatically counts as exclusionary behavior for purposes of Sherman Act § 2. The 1996 Act in fact has an elaborate enforcement structure that Congress created for purposes of managing the transition from the former regulated world to the hoped-for competitive markets of the future. Questions concerning the duties of the ILECs, the state commissions, and competitors have been coming before the courts with regularity. See, *e.g.*, *MCI Telecommunications Corp. v. U.S. West Communications*, 204 F.3d 1262 (9th Cir.2000) (review of arbitrated agreement, including topics such as unbundling, co-location of remote switching units, and cost arrangements); *AT&T Communications Systems v. Pacific Bell*, 203 F.3d 1183 (9th Cir.2000) (reviewing arbitrated agreement under which competitor sought entry into ILEC market); *Alenco Communications, Inc. v. FCC*, 201 F.3d 608 (5th Cir.2000) (denying a host of petitions from local exchange carriers challenging FCC universal service obligation rules); *GTE South, Inc. v. Morrison*, 199 F.3d 733 (4th Cir.1999) (upholding FCC's rules under the 1996 Act for setting prices for unbundled network elements and state commission's decision in an arbitration); *Puerto Rico Telephone Co. v. Telecommunications Regulatory Board of Puerto Rico*, 189 F.3d 1, 12-13 (1st Cir.1999) (deciding among other things that review of state commission's actions under state law relating to interconnection was not possible under the 1996 Act); *Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393 (5th Cir.1999) (evaluating claims pertaining to the universal service obligation that exists under the 1996 Act, upholding some parts of the FCC's orders and striking down others); *BellSouth Corp. v. FCC*, 162 F.3d 678 (D.C.Cir.1998) (upholding 1996 Act restrictions on the BOCs' ability immediately to provide in-region long distance service); *SBC Communications, Inc. v. FCC*, 154 F.3d 226 (5th Cir.1998) (upholding thespecial provisions of the 1996 Act directed toward the BOCs, relating to in-region long distance service, equipment manufacturing, and electronic publishing); and *BellSouth Corp. v. FCC*, 144 F.3d 58 (D.C.Cir.1998) (upholding provisions of 1996 Act that limit the ability of the BOCs to provide electronic publishing services). The antitrust laws would add nothing to the oversight already available under the 1996 law.

Our principal holding is thus not that the 1996 Act confers implied immunity on behavior that would otherwise violate the antitrust law. Such a conclusion would be troublesome at best given the antitrust savings clause in the statute. It is that the 1996 Act imposes duties on the ILECs that are not found in the antitrust laws. Those duties do not conflict with the antitrust laws either; they are simply more specific and far-reaching obligations that Congress believed would accelerate the development of competitive markets, consistently with universal service (which, we note, competitive markets would not necessarily assure).

[4] The only question that remains under the antitrust part of the case is whether anything the plaintiffs have alleged can be divorced from its 1996 Act context such that it states a freestanding antitrust claim for Rule 12(b)(6) purposes. The plaintiffs have argued that they have such claims: they point to their allegations that Ameritech (a monopolist) controlled certain essential facilities and refused unreasonably to provide access for others to those facilities. They refer to the antitrust theory that began with *United States v. Terminal Railroad Ass'n*, 224 U.S. 383, 32 S.Ct. 507, 56 L.Ed. 810 (1912), and that the Supreme Court developed further in *Associated Press v. United States*, 326 U.S. 1, 65 S.Ct. 1416, 89 L.Ed. 2013 (1945).

[5] It is true that paragraph 37 of the complaint asserts that Ameritech "dominates and controls an essential facility, which consists of its telephone lines, equipment, and transmission and interconnection stations in the relevant market," and paragraph 38 asserts that Ameritech's competitors are practically and reasonably unable to duplicate those essential facilities. The complaint also alleges that Ameritech has refused to deal with its competitors on just, reasonable, and nondiscriminatory terms. Nevertheless, when one reads the complaint as a whole these allegations appear to be inextricably linked to the claims under the 1996 Act. Even if they were not, such a conclusion would then force us to confront the question whether the procedures established under the 1996 Act for achieving competitive markets are compatible with the procedures that would be used to accomplish the same result under the antitrust laws. In our view, they are not. The elaborate system of negotiated agreements and enforcement established by the 1996 Act could be brushed aside by any unsatisfied party with the simple act of filing an antitrust action. Court orders in those cases could easily conflict with the obligations the state commissions or the FCC

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imposes under the sec. 252 agreements. The 1996 Act is, in short, more specific legislation that must take precedence over the general antitrust laws, where the two are covering precisely the same field.

This is not the kind of question that requires further development of a factual record, either on summary judgment or at a trial. We therefore agree with the district court that it was proper for resolution under Rule 12(b)(6). There are many markets within the telecommunications industry that are already open to competition and that are not subject to the detailed regulatory regime we have been discussing; as to those, the antitrust savings clause makes it clear that antitrust suits may be brought today. At some appropriate point down the road, the FCC will undoubtedly find that local markets have also become sufficiently competitive that the transitional regulatory regime can be dismantled and the background antitrust laws can move to the fore. Our holding here is simply that this is not what Congress has mandated at this time for the ILEC duties that are the subject of the Goldwasser complaint. The district court thus correctly rejected the plaintiffs' antitrust theory.

B.

Plaintiffs still have another arrow in their quiver, which is their claim under the 1996 Act itself. No one ever suggested that they lacked standing to bring that action, and it obviously does not raise the problems of conflicting statutory schemes that the antitrust theory does. But they face a different problem here. The 1934 Act permits a lawsuit for damages to be brought by "[a]ny person claiming to be damaged by any common carrier subject to the provisions of this chapter," 47 U.S.C. § 207, and it makes carriers liable to such plaintiffs for "the full amount of damages sustained in consequence of any such violation," together with attorney's fees, 47 U.S.C. § 206. As consumers, however, their lawsuit for damages boils down to a claim for overcharges Ameritech has been able to impose upon them, as a result of its failure to carry out its responsibilities under the 1996 Act.

[6] The district court concluded that the filed rate doctrine, which bars courts from reexamining the reasonableness of rates that have been filed with regulatory commissions, precluded this kind of consumer action. In *Keogh, supra*, the Supreme Court explained that the courts' ability to determine the reasonableness of rates is limited; that awarding damages to plaintiffs while leaving less litigious customers paying the filed rates would be discriminatory; and that a damages assessment would necessarily require an independent rate-setting proceeding in which the court would have to guess what lower rate the agency should have chosen. 260 U.S. at 163-64, 43 S.Ct. 47. Although the doctrine had come under some criticism, the Supreme Court reaffirmed it in *Square D Co. v. Niagara Frontier Tariff Bureau, Inc.*, 476 U.S. 409, 424, 106 S.Ct. 1922, 90 L.Ed.2d 413 (1986), and we are bound to follow it.

The Goldwasser plaintiffs argue that Ameritech's rates should not be shielded by the doctrine because, although the state public utility commissions nominally oversee its rate-setting, they rarely exercise their muscle and thus give no meaningful review to the rate structure. The Supreme Court rejected precisely this argument in *Square D*, 476 U.S. at 417 n. 19, 106 S.Ct. 1922, and this court did the same in *In re Wheat Rail Freight Rate Antitrust Litigation*, 759 F.2d 1305, 1313 (7th Cir.1985). We reject it here again, but with the additional comment that the process established in § 252 of the 1996 Act for review of negotiated agreements, both for substance and for implementation, provides an extra safeguard against indolent agencies. Furthermore, the record thus far is one of active use of these review procedures; there would be no basis at all to find that they are illusory.

We thus agree with the district court that the plaintiffs cannot pursue their damages claim under the 1996 Act, because the monopoly claim these plaintiffs are trying to assert necessarily implicates the rates Ameritech is charging. To the extent they are seeking damages under the Sherman Act, the same analysis applies.

**III**

The judgment of the district court is AFFIRMED.

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95 S.Ct. 2598
45 L.Ed.2d 463, Fed. Sec. L. Rep. P 95,215, 1975-1 Trade Cases P 60,367
**(Cite as: 422 U.S. 659, 95 S.Ct. 2598)**

Supreme Court of the United States

Richard A. GORDON et al., Petitioners,
v.
NEW YORK STOCK EXCHANGE, INC., et al.

**No. 74--304.**

Argued March 25 and 26, 1975.
Decided June 26, 1975.

Mr. Justice BLACKMUN delivered the opinion of the Court.

This case presents the problem of reconciliation of the antitrust laws with a federal regulatory scheme in the particular context of the practice of the securities exchanges and their members of using fixed rates of commission. The United States District Court for the Southern District of New York and the United States Court of Appeals for the Second Circuit concluded that fixed commission rates were immunized from antitrust attack because of the Securities and Exchange Commission's authority to approve or disapprove exchange commission rates and its exercise of that power.

I

In early 1971 petitioner Richard A. Gordon, individually and on behalf of an asserted class of small investors, filed this suit against the New York Stock Exchange, Inc. (NYSE), the American Stock Exchange, Inc. (Amex), and two member firms of the Exchanges.[FN1] The complaint challenged a variety of exchange rules and practices and, in particular, claimed that the system of fixed commission rates, utilized by the Exchanges at that time for transactions less than $500,000, violated ss 1 and 2 of the Sherman Act, 26 Stat. 209, as amended 15 U.S.C. ss 1 and 2. Other challenges in the complaint focused on (1) the volume discount on trades of over 1,000 shares, and the presence of negotiated rather than fixed rates for transactions in excess of $500,000;\fs20fs20 [FN2] (2) the rules limiting the number of exchange memberships; and (3) the rules denying discounted commission rates to nonmembers using exchange facilities.[FN3]

FN1. The member firms are Merrill Lynch, Pierce, Fenner & Smith, Inc., and Bache & Company, Inc.

FN2. Petitioner urged that these practices were in violation of the Robinson-Patman Price Discrimination Act, 49 Stat. 1528, 15 U.S.C. s 13a.

FN3. The relief requested included an injunction prohibiting the implementation of certain negotiated commission rates that were to be placed in effect on April 5, 1971, or, alternatively, requiring that negotiated rates be available for transactions of any size. Petitioner also requested treble damages amounting to $1.5 billion and an award of attorneys' fees of $10 million plus interest and costs.

Respondents moved for summary judgment on the ground that the challenged actions were subject to the overriding supervision of the Securities and Exchange Commission (SEC) under s 19(b) of the Securities Exchange Act of 1934, 48 Stat. 898, as amended, 15 U.S.C. s 78s(b), and, therefore, were not subject to the strictures of the antitrust laws. The District Court granted respondents' motion as to all claims. 366 F.Supp. 1261 (1973). Dismissing the exchange membership limitation and the Robinson-Patman Act contentions as without merit,[FN4] the court focused on the relationship between the fixed commission rates and the Sherman Act mandates. It utilized the framework for analysis of antitrust immunity in the regulated securities area that was established a decade ago in Silver v. New York Stock Exchange, 373 U.S. 341, 83 S.Ct. 1246, 10 L.Ed.2d 389 (1963). Since s 19(b)(9) of the Exchange Act authorized the SEC to supervise the Exchanges 'in respect of such matters as . . . the fixing of reasonable rates of commission,' the court held applicable the antitrust immunity reserved in Silver for those cases where 'review of exchange self-regulation (is) provided through a vehicle other than the antitrust laws.' 373 U.S., at 360, 83 S.Ct. at 1258. It further noted that the practice of fixed commission rates had continued without substantial challenge after the enactment of the 1934 Act, and that the SEC had been engaged in detailed study of the rate

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structure for a decade, culminating in the requirement for abolition of fixed rates as of May 1, 1975.

FN4. In short, the District Court concluded that (1) since petitioner had never applied for exchange membership, he was not in a position to complain that he was arbitrarily precluded from membership; (2) the Exchange Act's s 3(a)(3), 15 U.S.C. s 78c(a)(3), by its definition of 'member,' specifically limited access of nonmembers to the Exchanges; and (3) the Robinson-Patman Act did not apply to services or intangibles, but only to commodities or goods, and the latter were not involved in this litigation.

On appeal, the Second Circuit affirmed. 498 F.2d 1303 (1974). Characterizing petitioner's other challenges as frivolous, the appellate court devoted its opinion to the problem of antitrust immunity. It, too, used Silver as a basis for its analysis. Because the SEC, by s 19(b)(9), was given specific review power over the fixing of commission rates, because of the language, legislative history, and policy of the Exchange Act, and because of the SEC's actual exercise of its supervisory power, the Court of Appeals determined that this case differed from Silver, and that antitrust immunity was proper.

By his petition for certiorari, petitioner sought review only of the determination that fixed commission rates are beyond the reach of the antitrust laws. Because of the vital importance of the question, and at the urging of all the parties, we granted certiorari. 419 U.S. 1018, 95 S.Ct. 491, 42 L.Ed.2d 291 (1974).

II

Resolution of the issue of antitrust immunity for fixed commission rates may be made adequately only upon a thorough investigation of the practice in the light of statutory restrictions and decided cases. We begin with a brief review of the history of commission rates in the securities industry.

Commission rates for transactions on the stock exchanges have been set by agreement since the establishment of the first exchange in this country. The New York Stock Exchange was formed with the Buttonwood Tree Agreement of 1792, and from the beginning minimum fees were set and observed by the members. That Agreement itself stated:

"We the Subscribers, Brokers for the Purchase and Sale of Public Stock, do hereby solemnly promise and pledge ourselves to each other, that we will not buy or sell from this day for any person whatsoever, any kind of Public Stock at a less rate than one-quarter per cent. Commission on the Specie value, and that we will give a preference to each other in our Negotiations." F. Eames, The New York Stock Exchange 14 (1968 ed).

See generally, R. Doed, The Monopoly Power of the New York Stock Exchange, reprinted in Hearings on S. 3169 before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 92d Cong., 2d Sess., 405, 412--427 (1972). Successive constitutions of the NYSE have carried forward this basic provision. Similarly, when Amex emerged in 1908--1910, a pattern of fixed commission rates was adopted there.

These fixed rate policies were not unnoticed by responsible congressional bodies. For example, the House Committee on Banking and Currency, in a general review of the stock exchanges undertaken in 1913, reported that the fixed commission rate rules were 'rigidly enforced' in order 'to prevent competition amongst the members.' H.R.Rep. No. 1593, 62d Cong., 3d Sess., 39 (1913).[FN5] [Omitted.]The report, known as the Pujo Report, did not recommend any change in this policy, for the Committee believed

'The present rates to be reasonable, except as to stocks, say, of $25 or less in value, and that the exchange should be protected in this respect by the law under which it shall be incorporated against a kind of competition between members that would lower the service and threaten the responsibility of members. A very low or competitive commission rate would also promote speculation and destroy the value of membership.' Id., at 115--116.

Despite the monopoly power of the few exchanges, exhibited not only in the area of commission rates but in a wide variety of other aspects, the exchanges remained essentially self-regulating and without significant supervision until the adoption of the Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. s 78a et seq. At the lengthy hearings before adoption of that Act, some attention was given to the fixed commission rate practice and to its anticompetitive features. See Hearings on S.Res. 84 (72d Cong.) and S.Res. 56 and 97 (73d Cong.) before the Senate Committee on Banking and Currency, 73d Cong., 1st and 2d Sess., pts. 13, 15,

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and 16, pp. 6075, 6080, 6868, and 7705 (1934) (hereafter Senate Hearings). See also Hearings on S.Res. 84 before the Senate Committee on Banking and Currency, 72d Cong., 1st Sess., pt. 1, p. 85 (1932); Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 320--321, 423 (1934).

Perhaps the most pertinent testimony in the hearings preparatory to enactment of the Exchange Act was proferred by Samuel Untermyer, formerly chief counsel to the committee that drafted the Pujo Report. In commenting on proposed S. 2693, Mr. Untermyer noted that although the bill would provide the federal supervisory commission with

> 'The right to prescribe uniform rates of commission, it does not otherwise authorize the Commission to fix rates, which it seems to me it should do and would do by striking out the word 'uniform.' That would permit the Commission to fix rates.
>
> 'The volume of the business transacted on the exchange has increased manyfold. Great fortunes have been made by brokers through this monopoly. The public has no access to the exchange by way of membership except by buying a seat and paying a very large sum for it. Therefore it is a monopoly. Probably it has to be something of a monopoly. But after all it is essentially a public institution. It is the greatest financial agency in the world, and should be not only controlled by the public but it seems to me its membership and the commissions charged should either be fixed by some governmental authority or be supervised by such authority. As matters now stand, the exchange can charge all that the traffic will bear, and that is a burden upon commerce.' Senate Hearings 7705.

As finally enacted, the Exchange Act apparently reflected the Untermyer suggestion, for it gave the SEC the power to fix and insure 'reasonable' rates. Section 19(b) provided:

> '(b) The Commission is further authorized, if after making appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such exchange has not made the changes so requested, and that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange, by rules or regulations or by order to alter or supplement the rules of such exchange (insofar as necessary or appropriate to effect such changes) in respect of such matters as . . . (9) the fixing of reasonable rates of commission, interest, listing, and other charges.' (Emphasis added.)

[1][2] This provision conformed to the Act's general policy of self- regulation by the exchanges coupled with oversight by the SEC. It is to be noted that the ninth category is one of 12 specifically enumerated. In Merrill Lynch, Pierce, Fenner & Smith v. Ware, 414 U.S. 117, 127--128, 94 S.Ct. 383, 390, 38 L.Ed.2d 348 (1973), we observed:

> 'Two types of regulation are reflected in the Act. Some provisions impose direct requirements and prohibitions. Among these are mandatory exchange registration, restrictions on broker and dealer borrowing, and the prohibition of manipulative or deceptive practices. Other provisions are flexible and rely on the technique of self-regulation to acheive their objectives. . . . Supervised self-regulation, although consonant with the traditional private governance of exchanges, allows the Government to monitor exchange business in the public interest.'

The congressional reports confirm that while the development of rules for the governing of exchanges, as enumerated in s 19(b), was left to the exchanges themselves in the first instance, the SEC could compel adoption of those changes it felt were necessary to insure fair dealing and protection of the public. See H.R.Rep. No. 1383, 73d Cong., 2d Sess., 15 (1934); S.Rep. No. 792, 73d Cong., 2d Sess., 13 (1934). The latter report, id., at 15, noted that registered exchanges were required to provide the SEC with 'complete information' regarding its rules.

III

With this legislative history in mind, we turn to the actual post-1934 experience of commission rates on the NYSE and Amex. After these two Exchanges had registered in 1934 under s 6 of the Exchange Act, 15 U.S.C. s 78f, both proceeded to prescribe minimum commission rates just as they had prior to the Act. App. A42, A216. These rates were changed periodically by the Exchanges, [FN6] after their submission to the SEC pursuant to s 6(a)(4), 15 U.S.C. s 78f(a)(4), and SEC Rule 17a--8 17 CFR s 240.17a--8. Although several rate changes appear to have been effectuated without comment by the SEC, in other instances the SEC thoroughly exercised its supervisory powers. Thus, for example, as early as 1958 a study of the NYSE commission rates to determine whether the rates were 'reasonable and in

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accordance with the standards contemplated by applicable provisions of the Securities Exchange Act of 1934,' was announced by the SEC. SEC Exchange Act Release No. 5678, Apr. 14, 1958, App. A240. This study resulted in an agreement by the NYSE to reduce commission rates in certain transactions, to engage in further study of the rate structure by the NYSE in collaboration with the SEC, and to provide the SEC with greater advance notice of proposed rate changes. SEC Exchange Act Release No. 5889, Feb. 20, 1959, App. A247. The SEC specifically stated that it had undertaken the study 'in view of the responsibilities and duties imposed upon the Commission by Section 19(b) . . . with respect to the rules of national ***669** securities exchanges, including rules relating to the fixing of commission rates.' Ibid.

FN6. Since 1947, rates generally have been based on the value of stock in a round lot, SEC Report of Special Study of Securities Markets, H.R.Doc.No.95, 88th Cong., 1st Sess., pt. 5, p. 103 (1963). There was no volume discount at the time of this SEC report.

Under subsection (d) of s 19 of the Act (which subsection was added in 1961, 75 Stat. 465), the SEC was directed to investigate the adequacy of exchange rules for the protection of investors. Accordingly, the SEC began a detailed study of exchange rules in that year. In 1963 it released its conclusions in a six-volume study. SEC Report of Special Study of Securities Markets, H.R.Doc. No. 95, 88th Cong., 1st Sess. The study, among other things, focused on problems of the structure of commission rates and procedures, and standards for setting and reviewing rate levels. Id., pt. 5, p. 102. The SEC found that the rigid commission rate structure based on value of the round lot was causing a variety of 'questionable consequences,' such as 'give-ups' and the providing of special services for certain large, usually institutional customers. These attempts indirectly to achieve rate alterations made more difficult the administration of the rate structure and clouded the cost data used as the basis for determination of rates. These effects were believed by the SEC to necessitate a complete study of the structure. Moreover, the SEC concluded that methods for determining the reasonableness of rates were in need of overhaul. Not only was there a need for more complete information about the economics of the securities business and commission rates in particular, but also for a determination and articulation of the criteria important in arriving at a reasonable rate structure. Hence, while the study did not produce any major immediate changes in commission rate structure or levels, it did constitute a careful articulation of the problems in the structure and of the need for further studies that would be essential as a basis for future changes.

Meanwhile, the NYSE began an investigation of its own into the particular aspect of volume discounts from the fixed commission rates. App. A219--A220. This study determined that a volume discount and various other changes were needed, and so recommended to the SEC. The Commission responded in basic agreement. Letter dated Dec. 22, 1965, from SEC Chairman Cohen to NYSE President Funston, App. A249. The NYSE study continued over the next few years and final conclusions were presented to the SEC in early 1968. Id., at A253. [FN7]

FN7. The basic NYSE proposal included some volume discounts, continuation of limited give-ups if directed by the customers, termination of 'rebative' reciprocal practices, discounts for certain nonmembers, and limitation of membership and discounts to 'bona fide broker-dealers.' App. A255.

In 1968, the SEC, while continuing the study started earlier in the decade, began to submit a series of specific proposals for change and to require their implementation by the exchanges. Through its Exchange Act Release No. 8324, May 28, 1968, App. A286, the SEC requested the NYSE to revise its commission rate schedule, including a reduction of rates for orders for round lots in excess of 400 shares or, alternatively, the elimination of minimum rate requirements for orders in excess of $50,000. These changes were viewed by the SEC as interim measures, pending further consideration 'in the context of the Commission's responsibilities to consider the national policies embodied both in the securities laws and in the antitrust laws.' Letter dated May 28, 1968, from SEC Chairman Cohen to NYSE President Haack, App. A285. In response to these communications, the NYSE (and Amex) eventually adopted a volume discount for orders exceeding 1,000 shares, as well as other alterations in rates, all approved by the SEC. See, e.g., letter of Aug. 30, 1968, from Chairman Cohen to President Haack, App. A310; memorandum dated Sept. 20, 1968, Amex Subcommittee on Commission Structure, App. A104.

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Members of the securities exchanges faced substantial declines in profits in the late 1960's and early 1970. These were attributed by the NYSE to be due, at least in part, to the fact that general commission rates had not been increased since 1958. Statement of Feb. 13, 1970, by President Haack to the SEC, App. A313. The NYSE determined that a service charge of at least the lesser of $15 or 50% of the required minimum commission on orders of fewer than 1,000 shares should be imposed as an interim measure to restore financial health by bringing rates in line with costs. NYSE Proposed Rule 383, App. A331. See also letter dated Mar. 19, 1970, from President Haack to members of the NYSE, App. A327. This proposal, submitted to the SEC pursuant to its Rule 17a--8, was permitted by the SEC to be placed into operation on a 90-day interim basis. Letter dated Apr. 2, 1970, from SEC Chairman Budge to President Haack, App. A333. Continuation of the interim measure was thereafter permitted pending further rate structure hearings undertaken by the SEC. SEC Exchange Act Release No. 8923, July 2, 1970, App. A336. The interim rates remained in effect until the rate structure change of March 1972.

In 1971 the SEC concluded its hearings begun in 1968. Finding that 'minimum commissions on institutional size orders are neither necessary nor appropriate,' the SEC announced that it would not object to competitive rates on portions of orders above a stated level. Letter dated Feb. 3, 1971, from SEC Commissioner Smith to President Haack, App. A353. See also SEC Exchange Act Release No. 9007, Oct. 22, 1970, App. A348. Although at first supporting a $100,000 order as the cutoff below which fixed rates would be allowed, ibid., the SEC later decided to permit use of $500,000 as the breakpoint. After a year's use of this figure, the SEC required the exchanges to reduce the cutoff point to $300,000 in April 1972. Statement of the SEC on the Future Structure of the Securities Markets, Feb. 2, 1972, App. A369, A387, A388 (Policy Study).

The 1972 Policy Study emphasized the problems of the securities markets, and attributed as a major cause of those problems the prevailing commission rate structure. The Policy Study noted:

> 'Our concern with the fixed minimum commission . . . is not only with the level of the rate structure but with its side effects as well. Of these, perhaps the most important are the following:
> '(a) Dispersion of trading in listed securities.
> '(b) Reciprocal practices of various kinds.
> '(c) Increasing pressure for exchange membership by institutions.' Id., at A385.

Since commission rates had been fixed for a long period of time, however, and since it was possible that revenue would decline if hasty changes were made, the SEC believed that there should be no rush to impose competitive rates. Rather, the effect of switching to competition should be gauged on a step-by- step basis, and changes should be made 'at a measured, deliberate pace.' Id., at A387. The result of the introduction of competitive rates for orders exceeding $500,000 was found to be a substantial reduction in commissions, with the rate depending on the size of the order. In view of this result, the SEC determined to institute competition in the $300,000--$500,000 range as well.

Further reduction followed relatively quickly. By March 29, 1973, the SEC was considering requiring the reduction of the breakpoint on competitive rates to orders in excess of $100,000. SEC Policy Statement on the Structure of a Central Market System 3. In June, the SEC began hearings on the rate schedules, stimulated in part by a request by the NYSE to permit an increase of 15% of the current rate on all orders from $5,000 to $300,000, and to permit a minimum commission on small orders (below $5,000) as well. SEC Exchange Act Release No. 10206, June 6, 1973, Documentary Appendix to Brief for SEC as Amicus Curiae 24 (Doc.App.). Three months later, after completion of the hearings, the SEC determined that it would allow the increases. SEC Exchange Act Release No. 10383, Sept. 11, 1973,[FN8] Doc.App. 27. The SEC also announced, however, that '(i)t will act promptly to terminate the fixing of commission rates by stock exchanges after April 30, 1975, if the stock exchanges do not adopt rule changes achieving that result.' Id., at 28.

> FN8. The increases were permitted through March 31, 1974, without restriction. Such increases could continue from April 1, 1974, through April 30, 1975, if the NYSE permitted its members to charge in excess of the old rate and also permitted reductions in brokerage services in return for discounts from the rate.

Elaboration of the SEC's rationale for this phasing out of fixed commission rates was soon forthcoming. In December 1973, SEC Chairman Garrett noted that the temporary increase in fixed rates (through April 1975) was permitted because of the inflation in the cost of operating the Exchanges, the decline in the volume of transactions on the exchanges, and the

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consequently severe financial losses for the members. SEC Exchange Act Release No. 10560, Dec. 14, 1973, Doc.App. 29. Indeed, without the rate increase, 'the continued deterioration in the capital positions of many member firms was foreseeable, with significant capital impairment and indirect, but consequential, harm to investors the likely result.' Id., at 36. The rate increase also would forestall the possibility that the industry would be impaired during transition to competitive rates and other requirements. This view conformed to the suggestion of Senator Williams, Chairman of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs. See statement dated July 27, 1973, of Senator Williams submitted to the SEC, cited in Exchange Act Release No. 10560 n. 12, Doc.App. 37. Although not purporting to elucidate fully its reasons for abolishing fixed rates, the SEC did suggest several considerations basic to its decision: the heterogeneous nature of the brokerage industry; the desirability of insuring trading on, rather than off, the Exchanges; doubt that small investors are subsidized by large institutional investors under the fixed rate system; and doubt that small firms would be forced out of business if competitive rates were required.

In response to a request by the NYSE, the SEC permitted amendment to allow competitive rates on nonmember orders below $2,000. SEC Exchange Act Release No. 10670, Mar. 7, 1974, Doc.App. 42. Hearings on intramember commission rates were announced in April 1974. SEC Exchange Act Release No. 10751, Apr. 23, 1974, Doc.App. 45. The SEC concluded that intramember rates should not be fixed beyond April 30, 1975. SEC Exchange Act Release No. 11019, Sept. 19, 1974, Doc.App. 60. At this time the SEC stated:

> '(I)t presently appears to the Commission that it is necessary and appropriate (1) for the protection of investors, (2) to insure fair dealing in securities traded in upon national securities exchanges, and (3) to insure the fair administration of such exchanges, that the rules and practices of such exchanges that require, or have the effect of requiring, exchange members to charge any person fixed minimum rates of commission, should be eliminated.' Id., at 63.

The SEC formally requested the exchanges to make the appropriate changes in their rules. When negative responses were received from the NYSE and others, the SEC released for public comment proposed Securities Exchange Act Rules 19b--3 and 10b--22. Proposed Rule 19b--3, applicable to intramember and nonmember rates effective May 1, 1975, would prohibit the exchanges from using or compelling their members to use fixed rates of commission. It also would require the exchanges to provide explicitly in their rules that nothing therein require or permit arrangements or agreements to fix rates. Proposed Rule 10b-- 22 would prohibit agreements with respect to the fixing of commission rates by brokers, dealers, or members of the exchanges. See SEC Exchange Act Release No. 11073, Oct. 24, 1974, Doc.App. 65.

Upon the conclusion of hearings on the proposed rules, the SEC determined to adopt Rule 19b--3, but not Rule 10b--22. SEC Exchange Act Release No. 11203, Jan. 23, 1975, Doc.App. 109. Effective May 1, 1975, competitive rates were to be utilized by exchange members in transactions of all sizes for persons other than members of the exchanges. Effective May 1, 1976, competitives rates were to be mandatory in transactions for members as well, i.e., floor brokerage rates. Competition in floor brokerage rates was so deferred until 1976 in order to permit an orderly transition.[FN9] The required transition to competitive rates was based on the SEC's conclusion that competition, rather than fixed rates, would be in the best interests of the securities industry and markets, as well as in the best interests of the investing public and the national economy. Ibid. This determination was not based on a simplistic notion in favor of competition, but rather on demonstrated deficiencies of the fixed commission rate structure. Specifically mentioned by the SEC were factors such as the rigidity and delay inherent in the fixed rate system, the potential for distortion, evasion, and conflicts of interest, and fragmentation of markets caused by the fixed rate system. Acknowledging that the fixed rate system perhaps was not all bad in all periods of its use, the SEC explicitly declined to commit itself to permanent abolition of fixed rates in all cases: in the future circumstances might arise that would indicate that reinstitution of fixed rates in certain areas would be appropriate.

FN9. It was also believed that members of the exchanges had not expected that floor brokerage rates would be included among those required to be made competitive, and that extra time for planning and adjustment would be needed. The SEC noted, additionally, that the impact of floor brokerage rates on public investors was significantly less than the impact of public rates, i.e., the rates on transactions for nonmembers. SEC Exchange Act Release

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No. 11203, Jan. 23, 1975, Doc.App. 109, 110.

The SEC dismissed the arguments against competitive rates that had been raised by various proponents of the status quo. First, the SEC deemed the possibility of destructive competition to be slim, because of the nature of the cost curve in the industry.[FN10] Second, there was substantial doubt whether maintenance of fixed rates, in fact, provided various subsidies that would be beneficial to the operation of the securities markets. For example, it was unlikely that small investors reaped a subsidy from higher rates charged larger investors, because of separation of the business between large and small investors. Nor did the SEC believe that regional brokers were substantially benefited by maintenance of fixed rates. Third, the possibility of an exodus from membership on the exchanges was unlikely, and should be dealt with only as it occurred. In any event, inasmuch as the SEC anticipated that there would be detailed studies of the operation of the competitive rates effectuated by its orders, any problems that arose could be effectively resolved upon further consideration.

FN10. In order for destructive competition to occur on a large scale, fixed costs must be a high percentage of total costs, and there must be economies of scale in a wide range of production. Neither of these factors was found to be present in the brokerage industry. Id., at 138--139.

During this period of concentrated study and action by the SEC, lasting more than a decade, various congressional committees undertook their own consideration of the matter of commission rates. Early in 1972, the Senate Subcommittee on Securities concluded that fixed commission rates must be eliminated on institution-size transactions, and that lower fees should be permitted for small transactions with 'unbundled' services than for those having the full range of brokerage services. Senate Committee on Banking, Housing and Urban Affairs, 92d Cong., 2d Sess., Securities Industry Study (For the Period Ended Feb. 4, 1972), 4 (1972) (containing a report of the Subcommittee on Securities). The Subcommittee objected particularly to the failure of the fixed rate system to produce 'fair and economic' rates, id., at 59, and to distortion in the rate structure in favor of the institutionally oriented firms.

The Subcommittee was perturbed at the SEC's actions regarding fixed commission rates for several reasons. First, the Subcommittee noted that in litigation the SEC had taken the position that it had not approved NYSE rate changes in 1971, but had merely failed to object to the introduction of the new rates, id., at 58, referring to the SEC position in Independent Investor Protective League v. SEC (SDNY No. 71--1924), dismissed without opinion (CA2 1971). This posture precluded review of the SEC action in the Court of Appeals.[FN11] Second, the Subcommittee was displeased with the length of time the SEC took in arriving at its decisions regarding commission rate structure and level. Third, the Subcommittee feared that statements of the SEC lacked clarity and perpetuated uncertainty as to the status of fixed rates on transactions exceeding $100,000. Therefore, the Subcommittee report stressed:

FN11. This view has been rejected by the United States Court of Appeals for the District of Columbia Circuit. Independent Broker- Dealers' Trade Assn. v. SEC, 142 U.S.App.D.C. 384, 442 F.2d 132, cert. denied, 404 U.S. 828, 92 S.Ct. 63, 30 L.Ed.2d 57 (1971). The SEC appears no longer to take this position. See Brief for SEC as Amicus Curiae 38--39, n. 45.

'(I)t is essential that fixed commission rates be phased out in an orderly and systematic manner, and that a date certain be set promptly for elimination of fixed commissions on institutional-size transactions, which have resulted in the most serious distortions. Based on the SEC's conclusions and on testimony submitted to the SEC and to this Subcommittee, this could best be achieved by eliminating fixed rates on orders in excess of $100,000.' Securities Industry Study, supra, at 60.

The House Committee on Interstate and Foreign Commerce, in a report issued only six months after the Senate Report, supra, concluded that fixed rates of commission were not in the public interest and should be replaced by competitively determined rates for transactions of all sizes. Such action should occur 'without excessive delay.' H.R.Rep. No. 92--1519, pp. xiv, 141, 144--145, 146 (1972). Although prodding the SEC to take quick measures to introduce competitive rates for transactions of all sizes, the House Committee determined to defer enacting legislation so long as reasonable progress was being made. These conclusions resulted from a detailed study, by the Subcommittee, of asserted costs and benefits of competitive versus fixed rates,

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and reflected information gained through lengthy hearings. Id., at 131--146, and related Study of the Securities Industry, Hearings before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 92d Cong., 1st and 2d Sess., serials 92--37 to 92--37h (1971--1972). Similarly, after lengthy analysis, the Senate Subcommittee on Securities concluded both that competitive rates must be introduced at all transaction levels, and that legislation was not required at that time in view of the progress made by the SEC. Securities Industry Study Report of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, S.Doc. No. 93--13, pp. 5--7, 43--63 (1973), and Hearings on S. 3169 before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 92d Cong., 2d Sess. (1972).

In 1975 both Houses of Congress did in fact enact legislation dealing directly with commission rates. Although the bills initially passed by each chamber differed somewhat, the Conference Committee compromised the differences. Compare H.R. 4111, s 6(p), as discussed in H.R.Rep. No. 94--123, pp. 51--53, 67--68 (1975), with S. 249, s 6(e), as discussed in S.Rep. No. 94--75, pp. 71-- 72, 98 (1975), U.S.Code Cong. & Admin.News 1975, p. 613. The measure, as so compromised, was signed by the President on June 4, 1975, 89 Stat. 97.

The new legislation amends s 19(b) of the Securities Exchange Act to substitute for the heretofore existing provision a scheme for SEC review of proposed rules and rule changes of the various self-regulatory organizations. Reference to commission rates is now found in the newly amended s 6(e), generally providing that after the date of enactment 'no national securities exchange may impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members.' 89 Stat. 107. An exception is made for floor brokerage rates which may be fixed by the exchanges until May 1, 1976. Further exceptions from the ban against fixed commissions are provided if approved by the SEC after certain findings: prior to and including November 1, 1976, the Commission may allow the exchanges to fix commissions if it finds this to be 'in the public interest,' s 6(e)(1)(A); after November 1, 1976, the exchanges may be permitted by the SEC to fix rates of commission if the SEC finds (1) the rates are reasonable in relation to costs of service (to be determined pursuant to standards of reasonableness published by the SEC), and (2) if the rates 'do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title, taking into consideration the competitive effects of permitting such schedule or fixed rates weighed against the competitive effects of other lawful actions which the Commission is authorized to take under this title.' s 6(e)(1) (B)(ii). The statute specifically provides that even if the SEC does permit the fixing of rates pursuant to one of these exceptions, the SEC by rule may abrogate such practice if it finds that the fixed rates 'are no longer reasonable, in the public interest, or necessary to accomplish the purposes of this title.' s 6(e)(2).

The new section also provides a detailed procedure which the SEC must follow in arriving at its decision to permit fixed commission rates. s 6(e)(4). This procedure was described in the Conference Report as 'comparable to that provided for in Section 18 of the Federal Trade Commission Act, 15 U.S.C. (s) 58, which is more formal than normal notice and comment rulemaking under Section 553 of title 5 U.S.C. but less formal than 'on the record' procedure under Section(s) 556 and 557 of title 5 U.S.C.' H.R.Conf.Rep. No. 94-229, p. 108 (1975), U.S. Code Cong. & Admin.News 1975, p. 773. Finally, the amendments require the SEC to file regularly until December 31, 1976, with both branches of Congress, reports concerning the effect of competitive rates on the public interest, investors, and the securities markets. s 6(e)(3).[FN12]

FN12. One further change in the 1975 amendments should be noted. The 1934 Act defined the term 'member' of an exchange as any person who, among other things, is permitted 'to make use of the facilities of an exchange for transactions thereon . . . with the payment of a commission or fee which is less than that charged the general public.' s 3(a)(3), 48 Stat. 883. This implied a likelihood of fixed rates for the general public, for otherwise it would have been difficult to determine that a member, in fact, was given lower rates. This definition was deleted in the 1975 amendments and has been replaced with a general definition of a member of an exchange. s 3(a)(3)(A), 89 Stat. 97.

As of May 1, 1975, pursuant to order of the SEC, fixed commission rates were eliminated and competitive rates effectuated. Although it is still to soon to determine the total effect of this alteration, there have been no reports of disastrous effects for

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the public, investors, the industry, or the markets.

This lengthy history can be summarized briefly: In enacting the Securities Exchange Act of 1934, the Congress gave clear authority to the SEC to supervise exchange self-regulation with respect to the 'fixing of reasonable rates of commission.' Upon SEC determination that exchange rules or practices regarding commission rates required change in order to protect investors or to insure fair dealing, the SEC was authorized to require adoption of such changes as were deemed necessary or appropriate. This legislative permission for the fixing of commission rates under the supervision of the SEC occurred seven years after this Court's decision in United States v. Trenton Potteries Co., 273 U.S. 392, 47 S.Ct. 377, 71 L.Ed. 700 (1927), to the effect that price fixing was a per se violation of the Sherman Act. Since the Exchange Act's adoption, and primarily in the last 15 years, the SEC has been engaged in thorough review of exchange commission rate practices. The committees of the Congress, while recently expressing some dissatisfaction with the progress of the SEC in implementing competitive rates, have generally been content to allow the SEC to proceed without new legislation. As of May 1, 1975, the SEC, by order, has abolished fixed rates. And new legislation, enacted into law June 5, 1975, codifies this result, although still permitting the SEC some discretion to reimpose fixed rates if warranted.

IV

[3][4] This Court has considered the issue of implied repeal of the antitrust laws in the context of a variety of regulatory schemes and procedures. Certain axioms of construction are now clearly established. Repeal of the antitrust laws by implication is not favored and not casually to be allowed. Only where there is a 'plain repugnancy between the antitrust and regulatory provisions' will repeal be implied. United States v. Philadelphia National Bank, 374 U.S. 321, 350--351, 83 S.Ct. 1715, 1734--1735, 10 L.Ed.2d 915 (1963). See also Merrill Lynch, Pierce, Fenner & Smith v. Ware, 414 U.S., at 126, 94 S.Ct., at 389; Hughes Tool Co. v. Trans World Airlines, Inc., 409 U.S. 363, 385--389, 93 S.Ct. 647, 659--662, 34 L.Ed.2d 577 (1973); Carnation Co. v. Pacific Conference, 383 U.S. 213, 217--218, 86 S.Ct. 781, 784--785, 15 L.Ed.2d 709 (1966); Silver v. New York Stock Exchange, 373 U.S., at 357--358, 83 S.Ct. at 1257--1258; United States v. Borden Co., 308 U.S. 188, 198--199, 60 S.Ct. 182, 188--189, 84 L.Ed. 181 (1939). See United States v. National Assn. of Securities Dealers, 422 U.S. 694, at 719--720, 729--730, 95 S.Ct. 2427, 2443, 2447--2448, 45 L.Ed.2d 486.

The starting point for our consideration of the particular issue presented by this case, viz., whether the antitrust laws are impliedly repealed or replaced as a result of the statutory provisions and administrative and congressional experience concerning fixed commission rates, of course, is our decision in Silver. There the Court considered the relationship between the antitrust laws and the Securities Exchange Act, and did so specifically with respect to the action of an exchange in ordering its members to remove private direct telephone connections with the offices of nonmembers. Such action, absent any immunity derived from the regulatory laws, would be a per se violation of s 1 of the Sherman Act. 373 U.S., at 347, 83 S.Ct. at 1251. Concluding that the proper approach to the problem was to reconcile the operation of the antitrust laws with a regulatory scheme, the Court established a 'guiding principle' for the achievement of this reconciliation. Under this principle, '(r)epeal is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary.' Id., at 357, 83 S.Ct. at 1257.

In Silver, the Court concluded that there was no implied repeal of the antitrust laws in that factual context because the Exchange Act did not provide for SEC jurisdiction or review of particular applications of rules enacted by the exchanges. It noted:

> 'Although the Act gives to the Securities and Exchange Commission the power to request exchanges to make changes in their rules, s 19(b), 15 U.S.C. s 78s(b), and impliedly, therefore, to disapprove any rules adopted by an exchange, see also s 6(a)(4), 15 U.S.C. s 78f(a)(4), it does not give the Commission jurisdiction to review particular instances of enforcement of exchange rules.' Ibid.

At the time Silver was decided, both the rules and constitution of the NYSE provided that the Exchange could require discontinuance of wire service between the office of a member and a nonmember at any time. There was no provision for notice or statement of reasons. While these rules were permissible under the general power of the exchanges to adopt rules regulating relationships between members and nonmembers, and the SEC could disapprove the rules, the SEC could not forbid or regulate any particular application of the rules. Hence, the regulatory agency could not prevent application of the rules that would have undesirable anticompetitive effects; there was no governmental oversight of the

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exchange's self-regulatory action, and no method of insuring that some attention at least was given to the public interest in competition.

The Court, therefore, concluded that the absence in Silver of regulatory supervision over the application of the exchange rules prevented any conflict arising between the regulatory scheme and the antitrust laws. See also Georgia v. Pennsylvania R. Co., 324 U.S. 439, 455--457, 65 S.Ct. 716, 89 L.Ed. 1051 (1945), where the Court found no conflict because the regulatory agency, (the Interstate Commerce Commission) had no jurisdiction over the rate- fixing combination involved. The Court in Silver cautioned, however, that '(s)hould review of exchange self-regulation be provided through a vehicle other than the antitrust laws, a different case as to antitrust exemption would be presented.' 373 U.S., at 360, 83 S.Ct. at 1258. It amplified this statement in a footnote:

> 'Were there Commission jurisdiction and ensuing judicial review for scrutiny of a particular exchange ruling . . . a different case would arise concerning exemption from the operation of laws designed to prevent anticompetitive activity, an issue we do not decide today.' Id., at 358, n. 12, 83 S.Ct. at 1257.

It is patent that the case presently at bar is, indeed, that 'different case' to which the Court in Silver referred. In contrast to the circumstances of Silver, s 19(b) gave the SEC direct regulatory power over exchange rules and practices with respect to 'the fixing of reasonable rates of commission.' Not only was the SEC authorized to disapprove rules and practices concerning commission rates, but the agency also was permitted to require alteration or supplementation of the rules and practices when 'necessary or appropriate for the protection of investors or to insure fair dealings in securities traded in upon such exchange.' Since 1934 all rate changes have been brought to the attention of the SEC, and it has taken an active role in review of proposed rate changes during the last 15 years. Thus, rather than presenting a case of SEC impotence to affect application of exchange rules in particular circumstances, this case involves explicit statutory authorization for SEC review of all exchange rules and practices dealing with rates of commission and resultant SEC continuing activity.

Having determined that this case is, in fact, the 'different case,' we must then make inquiry as to the proper reconciliation of the regulatory and antitrust statutes involved here, keeping in mind the principle that repeal of the antitrust laws will be 'implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary.' 373 U.S., at 357, 83 S.Ct., at 1257. We hold that these requirements for implied repeal are clearly satisfied here. To permit operation of the antitrust laws with respect to commission rates, as urged by petitioner Gordon and the United States as amicus curiae, would unduly interfere, in our view, with the operation of the Securities Exchange Act.

[5] As a threshold matter, we believe that the determination of whether implied repeal of the antitrust laws is necessary to make the Exchange Act provisions work is a matter for the courts, and in particular, for the courts in which the antitrust claims are raised. Silver exemplifies this responsibility. In some cases, however, the courts may defer to the regulatory agency involved, in order to take advantage of its special expertise. The decision in the end, however, is for the courts. Ricci v. Chicago Mercantile Exchange, 409 U.S. 289, 306--308, 93 S.Ct. 573, 582--584, 34 L.Ed.2d 525 (1973).

[6][7] The United States, as amicus curiae, suggests not only that the immunity issue is ultimately for the courts to decide, but also that the courts may reach the decision only on a full record. A summary record, as compiled in this case on motions for summary judgment, though voluminous, is said to be an inadequate basis for resolution of the question. We disagree. In this case nothing is to be gained from any further factual development that might be possible with a trial on the merits. We have before us the detailed experience of the SEC regulatory activities, and we have the debates in the Congress culminating in the 1975 legislation. This information is sufficient to permit an informed decision as to the existence of an implied repeal.

Our disposition of this case differs from that of the Seventh Circuit in Thill Securities Corp. v. New York Stock Exchange, 433 F.2d 264 (1970), cert. denied, 401 U.S. 994, 91 S.Ct. 1232, 28 L.Ed.2d 532 (1971), where antitrust immunity for the NYSE's antirebate rule was claimed and denied. The Court of Appeals reversed a grant of summary judgment in favor of the NYSE, and remanded for further evidence regarding the effects of the antirebate rule on competition, the degree of actual review by the SEC, and the extent to which the rule was necessary to make the Exchange Act work. 433 F.2d, at 270. This ruling is persuasively distinguishable on at least two grounds from the case at bar: First, there was no evidence presented regarding the extent of SEC review of the challenged rule. Second, the antirebate practice differs from fixed commission rates in that

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(1) it was not among the items specifically listed in s 19(b), although the practice might reasonably be thought to be related to the fixing of commission rates, and (2) it does not necessarily apply uniformly, and may be applied in a discriminatory manner. We do not believe it necessary, in the circumstances of this case, to take further evidence concerning the competitive effects of fixed rates, or the necessity of fixed rates as a keystone of the operation of exchanges under the Exchange Act. To the extent that the Court of Appeals in Thill viewed the question of implied repeal as a question of fact, concerning whether the particular rule itself is necessary to make the Act work, we decline to follow that lead.

We also regard our specific disposition in Ricci v. Chicago Mercantile Exchange, supra, as inapposite for this case. In Ricci, an antitrust complaint charged that the Chicago Mercantile Exchange arbitrarily transferred a membership, in violation of both the Commodity Exchange Act, 42 Stat. 998, as amended, 7 U.S.C. s 1 et seq., and the exchange rules. We held that consideration of the antitrust claims should be stayed pending determination by the Commodity Exchange Commission as to whether the actions taken were in violation of the Act or the rules. Although we noted that the Act did not confer a general antitrust immunity, we stated that if the actions complained of were in conformity with the Act and exchange rules, a substantial question would be presented concerning whether the actions were insulated from antitrust attack. It is manifest, then, that Ricci involved a deference to the expertise of a regulatory agency in determining if the activities violated the Act or rules, and did not represent a decision on antitrust immunity where the conduct charged was clearly encompassed by the legislation or rules and where there was no factual dispute.

We believe that the United States, as amicus, has confused two questions. On the one hand, there is a factual question as to whether fixed commission rates are actually necessary to the operation of the exchanges as contemplated under the Securities Exchange Act. On the other hand, there is a legal question as to whether allowance of an antitrust suit would conflict with the operation of the regulatory scheme which specifically authorizes the SEC to oversee the fixing of commission rates. The factual question is not before us in this case. Rather, we are concerned with whether antitrust immunity, as a matter of law, must be implied in order to permit the Exchange Act to function as envisioned by the Congress. The issue of the wisdom of fixed rates becomes relevant only when it is determined that there is no antitrust immunity.

The United States appears to suggest that only if there is a pervasive regulatory scheme, as in the public utility area, can it be concluded that the regulatory scheme ousts the antitrust laws. Brief for United States, as Amicus Curiae 16, 35. It is true that in some prior cases we have been concerned with the question of the pervasiveness of the regulatory scheme as a factor in determining whether there is an implied repeal of the antitrust laws. See, e.g., Otter Tail Power Co. v. United States, 410 U.S. 366, 373--375, 93 S.Ct. 1022, 1027--1028, 35 L.Ed.2d 359 (1973). In the present case, however, respondents do not claim that repeal should be implied because of a pervasive regulatory scheme, but because of the specific provision of s 19(b)(9) and the regulatory action thereunder. Brief for Respondents 35. Hence, whether the Exchange Act amounts to pervasive legislation ousting the antitrust acts is not a question before us.

[8][9][10] We agree with the District Court and the Court of Appeals, and with respondents, that to deny antitrust immunity with respect to commission rates would be to subject the exchanges and their members to conflicting standards. It is clear from our discussion in Part III, supra, that the commission rate practices of the exchanges have been subjected to the scrutiny and approval of the SEC.[FN13] If antitrust courts were to impose different standards or requirements, the exchanges might find themselves unable to proceed without violation of the mandate of the courts or of the SEC. Such different standards are likely to result because the sole aim of antitrust legislation is to protect competition, whereas the SEC must consider, in addition, the economic health of the investors, the exchanges, and the securities industry.[FN14] Given the expertise of the SEC, the confidence the Congress has placed in the agency, and the active roles the SEC and the Congress have taken, permitting courts throughout the country to conduct their own antitrust proceedings would conflict with the regulatory scheme authorized by Congress rather than supplement that scheme.[FN15]

FN13. We believe that this degree of scrutiny and approval by the SEC is not significantly different for our purposes here than an affirmative order to the exchanges to follow fixed rates. The United States, as amicus curiae, agrees that if the SEC 'were to order the exchanges to adhere to a fixed commission rate system of some kind, no antitrust liability could arise.' Brief for

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United States as Amicus Curiae 48. We conclude that immunity should not rest on the existence of a formal order by the SEC, but that the actions taken by the SEC pursuant to s 19(b)(9), as outlined in Part III, supra, are to be viewed as having an effect equivalent to that of a formal order.

FN14. Compare Pan American World Airways v. United States, 371 U.S. 296, 305--310, 83 S.Ct. 476, 482--485, 9 L.Ed.2d 325 (1963), with United States v. Philadelphia National Bank, 374 U.S. 321, 350--352, 83 S.Ct. 1715, 1734--1736, 10 L.Ed.2d 915 (1963). In the latter case two factors pointed against antitrust immunity: (1) congressional intent in the Bank Merger Act not to immunize activities from antitrust legislation, and (2) the lack of conflict between the Bank Merger Act and Clayton Act standards. Also, there was an absence of continuing oversight by the Comptroller General of the Currency. These factors are not present in, and are inapplicable to, the case at bar.

FN15. We note, of course, that judicial review of SEC action is available under the Administrative Procedure Act, 5 U.S.C. ss 702 and 704, or under s 25 of the Securities Exchange Act, 15 U.S.C. s 78y. See also Independent Broker-Dealers' Trade Assn. v. SEC, 142 U.S.App.D.C. 384, 442 F.2d 132, cert. denied, 404 U.S. 828, 92 S.Ct. 63, 30 L.Ed.2d 57 (1971).

In Part III, supra, we outlined the legislative and regulatory agency concern with the fixing of commission rates. Beginning with the enactment of the Securities Exchange Act in 1934, the Congress persistently has provided for SEC authority to regulate commission rates. Although SEC action in the early years appears to have been minimal, it is clear that since 1959 the SEC has been engaged in deep and serious study of the commission rate practices of the exchanges and of their members, and has required major changes in those practices. The ultimate result of this long-term study has been a regulatory decree requiring abolition of the practice of fixed rates of commission as of May 1, 1975, and the institution of full and complete competition. Significantly, in the new legislation enacted subsequent to the SEC's abolition of commision rate fixing, the Congress has indicated its continued approval of SEC review of the commission rate structure. Although legislatively enacting the SEC regulatory provision banning fixed rates, the Congress has explicitly provided that the SEC, under certain circumstances and upon the making of specified findings, may allow reintroduction of fixed rates.

[11][12] In sum, the statutory provision authorizing regulation, s 19(b)(9), the long regulatory practice, and the continued congressional approval illustrated by the new legislation, point to one, and only one, conclusion. The Securities Exchange Act was intended by the Congress to leave the supervision of the fixing of reasonable rates of commission to the SEC. Interposition of the antitrust laws, which would bar fixed commission rates as per se violations of the Sherman Act, in the face of positive SEC action, would preclude and prevent the operation of the Exchange Act as intended by Congress and as effecutated through SEC regulatory activity. Implied repeal of the antitrust laws is, in fact, necessary to make the Exchange Act work as it was intended; failure to imply repeal would render nugatory the legislative provision for regulatory agency supervision of exchange commission rates.

Affirmed.

Mr. Justice DOUGLAS, concurring.

The Court relies upon three factors--statutory authorization for regulation by the Securities and Exchange Commission (SEC), a long history of actual SEC oversight and approval, and continued congressional affirmation of the SEC's role--in holding that the system of fixed commission rates employed on the securities exchanges is immune from antitrust attack. While I join that opinion, I write separately to emphasize the single factor which, for me, is of prime importance.

The mere existence of a statutory power of review by the SEC over fixed commission rates cannot justify immunizing ***692** those rates from antitrust challenges. The antitrust laws are designed to safeguard a strong public interest in free and open competition, and immunity from those laws should properly be implied only when some equivalent mechanism is functioning to protect that public interest. Only if the SEC is actively and aggressively exercising its powers of review and approval can we be sure that fixed commission rates are being

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monitored in the manner which Congress intended. Cf. Hughes Tool Co. v. Trans World Airlines, Inc., 409 U.S. 363, 387--389, 93 S.Ct. 647, 660--662, 34 L.Ed.2d 577 (1973).

The Court reviews at length the history of the SEC's involvement with fixed commission rates. In light of that history, I am satisfied to join the opinion of the Court and affirm the judgment below.

Mr. Justice STEWART, with whom Mr. Justice BRENNAN, joins, concurring.

While joining the opinion of the Court, I add a brief word. The Court has never held, and does not hold today, that the antitrust laws are inapplicable to anticompetitive conduct simply because a federal agency has jurisdiction over the activities of one or more of the defendants. An implied repeal of the antitrust laws may be found only if there exists a 'plain repugnancy between the antitrust and regulatory provisions.' United States v. Philadelphia Nat. Bank, 374 U.S. 321, 351, 83 S.Ct. 1715, 1735, 10 L.Ed.2d 915.

The mere existence of the Commission's reserve power of oversight with respect to rules initially adopted by the exchanges, therefore, does not necessarily immunize those rules from antitrust attack. Rather, 'exchange self-regulation is to be regarded as justified in response to antitrust charges only to the extent necessary to protect the achievement of the aims of the Securities Exchange Act.' Silver v. New York Stock Exchange, 373 U.S. 341, 361, 83 S.Ct. 1246, 1259, 10 L.Ed.2d 389. The question presented by the present case, therefore, is whether exchange rules fixing minimum commission rates are 'necessary to make the Securities Exchange Act work.' Id., at 357, 83 S.Ct. at 1257.

As the Court's opinion explains, see ante, at 2602--2604, when Congress enacted the Securities Exchange Act of 1934, it was fully aware of the well-established exchange practice of fixing commission rates, which had existed continuously since 1792. Nevertheless, Congress chose not to prohibit that practice. Instead, in s 19(b)(9) of the 1934 Act Congress specifically empowered the Commission to exercise direct supervisory authority over exchange rules respecting 'the fixing of reasonable rates of commission.' Congress thereby unmistakably determined that, until such time as the Commission ruled to the contrary, exchange rules fixing minimum commission rates would further the policies of the 1934 Act. Accordingly, although the Act contains no express exemption from the antitrust laws for exchange rules establishing fixed commission rates, under Silver that particular instance of exchange self-regulation is immune from antitrust attack.

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106 S.Ct. 1922
90 L.Ed.2d 413, 54 USLW 4520, 1986-1 Trade Cases P 67,105
**(Cite as: 476 U.S. 409, 106 S.Ct. 1922)**

Supreme Court of the United States

SQUARE D COMPANY and Big D Building Supply Corp., Petitioners
v.
NIAGARA FRONTIER TARIFF BUREAU, INC., et al.

**No. 85-21.**

Argued March 3, 1986.
Decided May 27, 1986.

STEVENS, J., delivered the opinion of the Court, in which BURGER, C.J., and BRENNAN, WHITE, BLACKMUN, POWELL, REHNQUIST, and O'CONNOR, JJ., joined. MARSHALL, J., filed a dissenting opinion, *post,* p. ---.

Justice STEVENS delivered the opinion for the Court.

Petitioners have alleged that rates filed with the Interstate Commerce Commission by respondent motor carriers during the years 1966 through 1981 were fixed pursuant to an agreement forbidden by the Sherman Act, 26 Stat. 209, as amended, 15 U.S.C. § 1 *et seq.* The question presented is whether the carriers are subject to treble-damages liability in a private antitrust action if the allegation is true.

The question requires us to give careful consideration to the way in which Congress has accommodated the sometimes conflicting policies of the antitrust laws and the Interstate Commerce Act, 49 U.S.C. § 10101 *et seq.* (1982 ed. and Supp. II). Our analysis of the question will include three components: (1) the sufficiency of the complaint allegations in light of the bare language of the relevant statutes; (2) the impact of the Court's decision of an analogous question in 1922 in *Keogh v. Chicago & Northwestern R. Co.,* 260 U.S. 156, 43 S.Ct. 47, 67 L.Ed. 183; and (3) the extent to which the rule of the *Keogh* case remains part of our law today.

I

Two class-action complaints making parallel allegations against the same six defendants were filed in the United States District Court for the District of Columbia and then transferred to Buffalo, New York, where a similar action brought by the United States was pending. The Government case was ultimately settled by the entry of a consent decree;[FN1] after the two private actions had been consolidated, the District Court granted a motion to dismiss the complaints. We therefore take the well-pleaded facts as true.[FN2]

FN1. The consent decree enjoins respondents from "harassing, discouraging, coercing, or threatening in any way any motor carrier to withdraw, forbear from filing, or modify in any way said carrier's planned or actual independent rates," and from discussing rates except "within an authorized ratemaking body of a rate bureau with a rate agreement." *United States v. Niagara Frontier Tariff Bureau, Inc.,* 1984-2 Trade Cases ¶ 66,167, pp. 66,533-66,535 (WDNY 1984).

FN2. See *Hishon v. King & Spalding,* 467 U.S. 69, 73, 104 S.Ct. 2229, 2233, 81 L.Ed.2d 59 (1984); *McClain v. Real Estate Bd. of New Orleans,* 444 U.S. 232, 246, 100 S.Ct. 502, 511, 62 L.Ed.2d 441 (1980); *Hospital Building Co. v. Trustees of Rex Hospital,* 425 U.S. 738, 746, 96 S.Ct. 1848, 1853, 48 L.Ed.2d 338 (1976); *Scheuer v. Rhodes,* 416U.S. 232, 236, 94 S.Ct. 1683, 1686, 40 L.Ed.2d 90 (1974); *Conley v. Gibson,* 355 U.S. 41, 45-46, 78 S.Ct. 99, 101-102, 2 L.Ed.2d 80 (1957).

Five of the respondents are Canadian motor carriers engaged in the transportation of freight between the United States and Canada. They are subject to regulation by the Ontario Highway Transport Board, and by the Interstate Commerce Commission (ICC). They are all members of the Niagara Frontier Tariff Bureau, Inc. (NFTB), which is also a defendant. NFTB is a nonprofit corporation organized to engage in collective ratemaking activities pursuant to an agreement filed with and approved by the ICC. [FN3]

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FN3. See *Niagara Frontier Tariff Bureau, Inc.--Agreement,* 297 I.C.C. 494 (1955).

Petitioners are corporations that have utilized respondents' services to ship goods between the United States and Canada for many years. In their complaints, they allege that, at least as early as 1966 and continuing at least into 1981, respondents engaged in a conspiracy "to fix, raise and maintain prices and to inhibit or eliminate competition for the transportation of freight by motor carrier between the United States and the Province of Ontario, Canada without complying with the terms of the NFTB agreement and by otherwise engaging in conduct that either was not or could not be approved by the ICC." [FN4]

FN4. Square D complaint, ¶ 22, App. 11; Big D complaint, ¶ 19, App. 24.

The complaints allege five specific actions in furtherance of this conspiracy. First, senior management officials of the NFTB used a "Principals Committee," which was not authorized by the NFTB agreement, to set rates and to inhibit competition.[FN5] Second, respondents set and controlled NFTB rate levels without complying with the notice, publication, public hearing, and recordkeeping requirements of the NFTB agreement and ICC regulations.[FN6] Third, respondents planned threats, retaliation, and coercion against NFTB members to inhibit independent actions.[FN7] Fourth, respondents actually used pressures, threats, and retaliation to interfere with independent actions.[FN8] Finally, still in furtherance of the conspiracy, respondents filed tariffs with the ICC.[FN9]

FN5. Square D complaint, ¶ 23(a), App. 12; Big D complaint, ¶ 20(a), App. 24.

FN6. Square D complaint, ¶ 23(b), App. 12; Big D complaint, ¶ 20(b), App. 24.

FN7. Square D complaint, ¶ 23(c), App. 12; Big D complaint, ¶ 20(c), App. 24.

FN8. Square D complaint, ¶ 23(d), App. 12; Big D complaint, ¶ 20(d), App. 25.

FN9. Square D complaint, ¶ 23(e), App. 12; Big D complaint, ¶ 20(e), App. 25.

Because of respondents' unlawful conduct, the complaints continue, petitioners and the members of the large class of shippers that they represent have paid higher rates for motor carrier freight transport than they would have paid in a freely competitive market.[FN10] They seek treble damages measured by that difference, as well as declaratory and injunctive relief.

FN10. Square D complaint, ¶¶ 24(a)-(d), App. 12-13; Big D complaint, ¶ ¶ 21(a)-(c), App. 25.

The legal theory of the complaint is that the respondents' conspiracy is not exempted from a private antitrust, treble-damages action even though the rates that respondents charged were filed with the ICC, as required by law. The complaints note that the ICC requires motor carriers to file tariffs containing all their rates, to make the tariffs available for public inspection, and to give advance notice of any changes in the filed rates.[FN11] Although the ICC has the power to determine those rates, the rates are set by the carriers, not the ICC, in the first instance.[FN12] The Reed-Bulwinkle Act, enacted in 1948, expressly authorizes the ICC to grant approval to agreements establishing rate bureaus for the purpose of setting rates collectively. [FN13] The joint setting of rates pursuant to such agreements is exempted from the antitrust laws, but the statute strictly limits the exemption to actions that conform to the terms of the agreement approved by the ICC. [FN14] In this case, according to the theory of the complaints, the activities of the respondents were not authorized by the NFTB agreement; hence the alleged conspiracy was not exempt from the antitrust laws, and, indeed, blatantly violated those laws.

FN11. Square D complaint, ¶ 16, Joint App. 9 (citing 49 U.S.C. § 10762); Big D complaint, ¶ 13, App. 22 (same).

FN12. Square D complaint, ¶ 16, App. 9 (citing 49 U.S.C. § 10704); Big D complaint, ¶ 13, App. 22 (same).

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FN13. Square D complaint, ¶ 17, App. 10 (citing 49 U.S.C. § 5b, now codified at 49 U.S.C. § 10706(b)(2)); Big D complaint, ¶ 14, App. 22 (same).

FN14. Under the Reed-Bulwinkle Act, as currently codified, "[i]f the [Interstate Commerce] Commission approves the agreement, it may be made and carried out under its terms and under the conditions required by the Commission, and the antitrust laws, as defined in the first section of the Clayton Act ( 15 U.S.C. 12), do not apply to parties and other persons with respect to making or carrying out the agreement." 49 U.S.C. § 10706(b)(2).

Under the plain language of the relevant statutes, it would appear that petitioners have alleged a valid antitrust action. The stated activities are clearly within the generally applicable language of the antitrust laws; [FN15] nothing in the language of the Interstate Commerce Act, moreover, necessarily precludes a private antitrust treble-damages remedy for actions that are not specifically immunized within the terms of the Reed-Bulwinkle Act. [FN16]

FN15. See, *e.g.*, 15 U.S.C. § 1 ("Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal").

FN16. See n. 14, *supra.*

The District Court nevertheless dismissed the complaints on the authority of the *Keogh* case. 596 F.Supp. 153 (WDNY 1984). The Court of Appeals for the Second Circuit affirmed insofar as the District Court's judgment dismissed the claims for treble damages based on respondents' filed rates, but remanded for a further hearing to determine whether petitioners are entitled to injunctive relief and to give them an opportunity to amend their complaints to state possible claims for damages not arising from the filed tariffs. 760 F.2d 1347 (1985). We granted certiorari to consider whether the rule of the *Keogh* case was correctly applied in barring a treble-damages action based on the filed tariffs, and, if so, whether that case should be overruled. 474 U.S. 815, 106 S.Ct. 57, 88 L.Ed.2d 47 (1985).

II

[1] In *Keogh,* as in this case, a shipper's complaint alleged that rates filed with the ICC by the defendants had been fixed pursuant to an agreement prohibited by the Sherman Act. The rates had been set by an agreement among executives of railroad companies "which would otherwise be competing carriers," 260 U.S., at 160, 43 S.Ct. at 48. They were "higher than the rates would have been if competition had not been thus eliminated." *Ibid.* The shipper claimed treble damages measured by the difference between the rates set pursuant to agreement and those that had previously been in effect.

In their special plea, defendants averred that every rate complained of had been filed with the ICC and that, after hearings in which Keogh had participated, the rates had been approved by the Commission. That approval established that the fixed rates were "reasonable and non-discriminatory," *id.,* at 161, 43 S.Ct. at 49, but it did not foreclose the possibility that slightly lower rates would also have been within the zone of reasonableness that the Commission would also have found lawful under the Interstate Commerce Act. Nor did the ICC's approval require rejection of Keogh's contention that the combination among the railroads violated the Sherman Act.[FN17] The Court nevertheless held that Keogh, a private shipper, could not "recover damages under § 7 because he lost the benefit of rates still lower, which, but for the conspiracy, he would have enjoyed." *Id.,* at 162, 43 S.Ct. at 49.

FN17. "All the rates fixed were reasonable and non-discriminatory. That was settled by the proceedings before the Commission. *Los Angeles Switching Case,* 234 U.S. 294, 34 S.Ct. 814, 58 L.Ed. 1319. But under the Anti-Trust Act, a combination of carriers to fix reasonable and non- discriminatory rates may be illegal; and if so, the Government may have redress by criminal proceedings under § 3, by injunction under § 4, and by forfeiture under § 6. That was settled by *United States v. Trans- Missouri Freight Association,* 166 U.S. 290, 17 S.Ct. 540, 41 L.Ed. 1007, and *United States v. Joint Traffic Association,* 171 U.S. 505, 19 S.Ct. 25, 43 L.Ed.2d 259. The fact that these rates had been approved by the Commission would not, it seems, bar proceedings by the Government." 260 U.S., at 161-162, 43 S.Ct.

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at 49.

The Court reasoned that the ICC's approval had, in effect, established the lawfulness of the defendant's rates,[FN18] and that the legal right of the shippers against the carrier had to be measured by the published tariff. It therefore concluded that the shipper could not have been "injured in his business or property" within the meaning of § 7 of the Sherman Act by paying the carrier the rate that had been approved by the ICC. Justice Brandeis explained:

> FN18. "A rate is not necessarily illegal because it is the result of a conspiracy in restraint of trade in violation of the Anti-Trust Act. What rates are legal is determined by the Act to Regulate Commerce. Under § 8 of the latter act the exaction of any illegal rate makes the carrier liable to the 'person injured thereby for the full amount of damages sustained in consequence of any such violation' together with a reasonable attorney's fee. Sections 9 and 16 provide for the recovery of such damages either by complaint before the Commission or by an action in a federal court. If the conspiracy here complained of had resulted in rates which the Commission found to be illegal because unreasonably high or discriminatory, the full amount of the damages sustained, whatever their nature, would have been recoverable in such proceedings. *Louisville & Nashville R.R. Co. v. Ohio Valley Tie Co.*, 242 U.S. 288, 37 S.Ct. 120, 61 L.Ed. 305. Can it be that Congress intended to provide the shipper, from whom illegal rates have been exacted, with an additional remedy under the Anti-Trust Act? See *Meeker v. Lehigh Valley R.R. Co.*, 162 Fed. 354 (1908). And if no remedy under the Anti-Trust Law is given where the injury results from the fixing of rates which are illegal, because too high or discriminatory, may it be assumed that Congress intended to give such a remedy where, as here, the rates complained of have been found by the Commission to be legal and while in force had to be collected by the carrier?" *Id.*, at 162, 43 S.Ct. at 49.

"Section 7 of the Anti-Trust Act gives a right of action to one who has been 'injured in his business or property.' Injury implies violation of a legal right. The legal rights of shipper as against carrier in respect to a rate are measured by the published tariff. Unless and until suspended or set aside, this rate is made, for all purposes, the legal rate, as between carrier and shipper. The rights as defined by the tariff cannot be varied or enlarged by either contract or tort of the carrier. *Texas & Pacific R.R. Co. v. Mugg*, 202 U.S. 242, 26 S.Ct. 628, 50 L.Ed. 1011; *Louisville & Nashville R.R. Co. v. Maxwell*, 237 U.S. 94, 35 S.Ct. 494, 59 L.Ed. 853; *Atchison, Topeka & Santa Fe Ry. Co. v. Robinson*, 233 U.S. 173, 34 S.Ct. 556, 58 L.Ed. 901; *Dayton Iron Co. v. Cincinnati, New Orleans & Texas Pacific Ry. Co.*, 239 U.S. 446, 36 S.Ct. 137, 60 L.Ed. 375; *Erie R.R. Co. v. Stone*, 244 U.S. 332, 37 S.Ct. 633, 61 L.Ed. 1173. And they are not affected by the tort of a third party. Compare *Pittsburgh, Cincinnati, Chicago & St. Louis Ry. Co. v. Fink*, 250 U.S. 577, 40 S.Ct. 27, 63 L.Ed. 1151. This stringent rule prevails, because otherwise the paramount purpose of Congress--prevention of unjust discrimination--might be defeated." *Id.*, at 163, 43 S.Ct. at 49.

In this case, unlike *Keogh*, the respondents' rates, established in the tariffs that had been filed with the ICC, were not challenged in a formal ICC hearing before they were allowed to go into effect. They were, however, duly submitted, lawful rates under the Interstate Commerce Act in the same sense that the rates filed in *Keogh* were lawful. Under the Court's holding in that case, it therefore follows that petitioners may not bring a treble-damages antitrust action.[FN19] The question, then, is whether we should continue to respect the rule of *Keogh*.

> FN19. In their brief, petitioners argue that, even under *Keogh*, their treble-damages action should not have been dismissed because there was no ICC hearing in this case and because *Keogh* did not involve allegations of the type of covert legal violations at issue here. Brief for Petitioners, 10-11. The Court of Appeals, however, properly concluded that *Keogh* was not susceptible to such a narrow reading: "Rather than limiting its holding to cases where, as in *Keogh*, rates had been investigated and approved by the ICC, the Court said broadly that shippers could not recover treble-damages for overcharges whenever tariffs have been filed." 760 F.2d, at 1351.

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III

Petitioners, supported by the Solicitor General of the United States, ask us to overrule *Keogh*. They submit that *Keogh* was implicitly rejected in the Reed-Bulwinkle Act and in the Motor Carrier Act of 1980, Pub.L. 96-296, 94 Stat. 793; that *Keogh* in effect created an implied immunity from the antitrust laws and that its reasoning is thus inconsistent with later cases, particularly *Carnation Co. v. Pacific Westbound Conference,* 383 U.S. 213, 86 S.Ct. 781, 15 L.Ed.2d 709 (1966); and that the rationales of the *Keogh* decision are no longer valid.

[2] Petitioners argue that the Reed-Bulwinkle Act, by delineating an antitrust immunity for specific ratemaking activities,[FN20] repudiated *Keogh* 's holding that shippers may not bring treble-damages actions in connection with ICC-filed tariffs. In our view, however, it is not proper to read that statute as supplanting the *Keogh* rule with a narrow, express exemption from the antitrust laws.

FN20. See ch. 491, 62 Stat. 472, now codified at 49 U.S.C. § 10706(b).

The legislative history of Reed-Bulwinkle explains that it was enacted, at least in part, in response to this Court's decision in *Georgia v. Pennsylvania R. Co.,* 324 U.S. 439, 65 S.Ct. 716, 89 L.Ed. 1051 (1945). [FN21] In that case, after restating the holding in *Keogh,* the Court held that, although Georgia could not maintain a suit under the antitrust laws to obtain damages, it could obtain injunctive relief against the collective ratemaking procedures employed by the railroads.[FN22] The Reed-Bulwinkle Act thus created an absolute immunity from the antitrust laws for approved collective ratemaking activities.

FN21. See, *e.g.,* H.R.Rep. No. 1100, 80th Cong., 1st Sess., 4 (1947) (citing "[t]he Georgia suit" and other cases, and emphasizing, "These developments have caused grave concern among all those having direct interest in transportation, who see in the situation a threat to long- standing practices in the transportation industry that were developed in cooperation with the shippers and have proved their worth"). See also 760 F.2d, at 1356-1360 (reviewing legislative history of Reed-Bulwinkle Act).

FN22. "We think it is clear from the *Keogh* case alone that Georgia may not recover damages even if the conspiracy alleged were shown to exist. That was a suit for damages under § 7 of the Sherman Act. 26 Stat. 210. The Court recognized that although the rates fixed had been found reasonable and non-discriminatory by the Commission, the United States was not barred from enforcing the remedies of the Sherman Act. 260 U.S. pp. 161-162, 43 S.Ct. p. 49. It held, however, that for purposes of a suit for damages a rate was not necessarily illegal because it was the result of a conspiracy in restraint of trade. The legal rights of a shipper against a carrier in respect to a rate are to be measured by the published tariff. That rate until suspended or set aside was for all purposes the legal rate as between shipper and carrier and may not be varied or enlarged either by the contract or tort of the carrier.... The reasoning and precedent of that case apply with full force here. But it does not dispose of the main prayer of the bill, stressed at the argument, which asks for relief by way of injunction." 324 U.S., at 453, 65 S.Ct. at 724.

Nothing in the Act or in its legislative history, however, indicates that Congress intended to change or supplant the *Keogh* rule that other tariff- related claims, while subject to governmental and injunctive antitrust actions, did not give rise to treble-damages antitrust actions. On the contrary, the House Report expressly stated that, except for creating the new exemption, the bill left the antitrust laws applicable to carriers unchanged "so far as they are now applicable." [FN23] Particularly because the legislative history reveals clear congressional awareness of *Keogh,*[FN24] far from supporting petitioners' position, the fact that Congress specifically addressed this area and left *Keogh* undisturbed lends powerful support to *Keogh* 's continued viability.

FN23. "The bill here reported leaves the antitrust laws to apply with full force and effect to carriers, *so far as they are now applicable,* except as to such joint agreements or arrangements between them as may have been submitted to the Interstate Commerce Commission and approved by that body upon a finding that, by reason of furtherance of the national transportation policy as declared in the Interstate

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Commerce Act, relief from the antitrust laws should be granted." H.R.Rep. No. 1100, 80th Cong.2d Sess., 5 (1947) (emphasis added).

FN24. See 760 F.2d, at 1359-1360 (reviewing attention to *Keogh* in the congressional consideration of the Reed-Bulwinkle Act).

[3] Similarly, petitioners and the Solicitor General argue that private treble-damages actions would further the congressional policy of promoting competition in the transportation industry reflected in the Motor Carrier Act of 1980.[FN25] We may assume that this is the case--indeed, we may assume that petitioners are correct in arguing that the *Keogh* decision was unwise as a matter of policy--but it nevertheless remains true that Congress must be presumed to have been fully cognizant of this interpretation of the statutory scheme,[FN26] which had been a significant part of our settled law for over half a century, and that Congress did not see fit to change it when Congress carefully reexamined this area of the law in 1980. Petitioners have pointed to no specific statutory provision or legislative history indicating a specific congressional intention to overturn the longstanding *Keogh* construction; [FN27] harmony with the general legislative purpose is inadequate for that formidable task.

FN25. As we recently pointed out, the "legislative history of the Act is clear that, beyond the bounds of immunity granted in § 10706(b)(3), Congress wanted the forces of competition to determine motor-carrier tariffs." *ICC v. American Trucking Assns., Inc.*, 467 U.S. 354, 367, 104 S.Ct. 2458, 2465, 81 L.Ed.2d 282 (1984). See also H.R.Rep. No. 96-1069, pp. 27-28 (1980), U.S.Code Cong. & Admin.News 1980 p. 2283. 126 Cong.Rec. 7777 (1980) (statement of Sen. Cannon).

FN26. See *Cannon v. University of Chicago*, 441 U.S. 677, 696-697, 99 S.Ct. 1946, 1957-1958, 60 L.Ed.2d 560 (1979) ("It is always appropriate to assume that our elected representatives, like other citizens, know the law"). See also *Director, OWCP v. Perini North River Associates*, 459 U.S. 297, 319, 103 S.Ct. 634, 648, 74 L.Ed.2d 465 (1983); *Merrill Lynch, Pierce, Fenner & Smith v.Curran*, 456 U.S. 353, 379, 102 S.Ct. 1825, 1839, 72 L.Ed.2d 182 (1982); *Albernaz v. United States*, 450 U.S. 333, 341, 101 S.Ct. 1137, 1143, 67 L.Ed.2d 275 (1981).

FN27. The Motor Carrier Act did change the terms of the Reed- Bulwinkle Act in significant respects, see *ICC v. American Trucking Assns., Inc.*, 467 U.S., at 356-357, 104 S.Ct., at 2460, but it did not address the *Keogh* rule. For the same reasons that the creation of the Reed-Bulwinkle exemption did not affect *Keogh*, the reworking of that exemption in the Motor Carrier Act also did not affect the rule of that case.

[4] Petitioners' reliance on *Carnation Co. v. Pacific Westbound Conference*, 383 U.S. 213, 86 S.Ct. 781, 15 L.Ed.2d 709 (1966), is also unavailing. In *Carnation*, a shipper of evaporated milk brought an antitrust treble-damages action against an association of shipping companies that had established higher rates for transportation between the west coast of the United States and the Philippine Islands. The defendants contended that the Shipping Act of 1916 had repealed all antitrust regulation of rate-making activities in the shipping industry. Section 15 of the Shipping Act did create an express exemption for collective ratemaking pursuant to agreements that had been approved by the Federal Maritime Commission, but the defendants had not obtained any such approval. They nevertheless contended that the structure of the entire Shipping Act, read against its legislative history, demonstrated an intent to free the ratemaking activities of the shipping industry from the antitrust laws. The Court unanimously rejected the argument, explaining:

"We recently said: 'Repeals of the antitrust laws by implication from a regulatory statute are strongly disfavored, and have only been found in cases of plain repugnancy between the antitrust and regulatory provisions.' *United States v. Philadelphia National Bank*, 374 U.S. 321, 350-351 [83 S.Ct. 1715, 1734-1735, 10 L.Ed.2d 915]. We have long recognized that the antitrust laws represent a fundamental national economic policy and have therefore concluded that we cannot lightly assume that the enactment of a special regulatory scheme for particular aspects of an industry was intended to render the more general provisions of the antitrust laws wholly inapplicable to that industry. We have, therefore, declined to construe special industry regulations as an implied repeal of the antitrust laws even when the regulatory statute did not contain an accommodation provision such as the exemption

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provisions of the Shipping and Agricultural Acts. See, *e.g., United States v. Philadelphia National Bank, supra.*" *Id.,* at 217-218, 86 S.Ct. at 874.

Petitioners correctly point out that cases like *Carnation* make it clear that collective ratemaking activities are not immunized from antitrust scrutiny simply because they occur in a regulated industry, and that exemptions from the antitrust laws are strictly construed and strongly disfavored. Nevertheless, even if we agreed that *Keogh* should be viewed as an "antitrust immunity" case, we would not conclude that later cases emphasizing the necessity to strictly construe such immunity rendered *Keogh* invalid. For *Keogh* represents a longstanding statutory construction that Congress has consistently refused to disturb, even when revisiting this specific area of law.

We disagree, however, with petitioners' view that the issue in *Keogh* and in this case is properly characterized as an "immunity" question. The alleged collective activities of the defendants in both cases were subject to scrutiny under the antitrust laws by the Government and to possible criminal sanctions or equitable relief. *Keogh* simply held that an award of treble damages is not an available remedy for a private shipper claiming that the rate submitted to, and approved by, the ICC was the product of an antitrust violation. Such a holding is far different from the creation of an antitrust immunity, [FN28] and makes the challenge to *Keogh*'s role in the settled law of this area still more doubtful.[FN29]

FN28. In so characterizing the issue, we do not minimize the powerful role of the private treble-damages action in the structure of the Nation's antitrust laws. See, *e.g.,* Mitsubishi Motors Corp. v. Soler Chrysler- Plymouth, Inc., 473 U.S. 614, 635, 105 S.Ct. 3346, 3358, 87 L.Ed.2d 444 (1985) ("The treble-damages provision wielded by the private litigant is a chief tool in the antitrust enforcement scheme, posing a crucial deterrent to potential violators"). Granting this role its due respect, however, a critical distinction remains between an absolute immunity from all antitrust scrutiny and a far more limited nonavailability of the private treble-damages remedy. The consent decree in this case, n. 1, *supra,* as well as the unchallenged Court of Appeals decision to remand on the question of injunctive and declaratory relief for antitrust violations highlight this distinction: respondents' conduct has consistently been within the reach of the generally applicable antitrust laws.

FN29. The specific *Keogh* holding, moreover, was not even implicated in *Carnation Co. v. Pacific Westbound Conference,* 383 U.S. 213, 86 S.Ct. 781, 15 L.Ed.2d 709 (1966), because the ratemaking agreements challenged in that case had not been approved by, or filed with, the Federal Maritime Commission. *Id.,* at 215, 86 S.Ct., at ---. Indeed, the Shipping Act gives the Federal Maritime Commission far more limited authority over rates than the Interstate Commerce Act gives the ICC. See 760 F.2d, at 1363 ("Although the [Federal Maritime Commission] can and does take effects on competition into account in approving conference agreements under 46 U.S.C. § 814, ... the Shipping Act does not give the Commission any mandate to regulate *rate* competition and, indeed, the statutory scheme was designed to minimize the role of the FMC in this regard").

Finally, petitioners point to various developments, discussed by the Court of Appeals, that seem to undermine some of the reasoning in Justice Brandeis' *Keogh* opinion--the development of class actions, which might alleviate the expressed concern about unfair rebates; [FN30] the emergence of precedents permitting treble-damages remedies even when there is a regulatory remedy available; [FN31] the greater sophistication in evaluating damages, which might mitigate the expressed fears about the speculative nature of such damages; [FN32] and the development of procedures in which judicial proceedings can be stayed pending regulatory proceedings.[FN33] Even if it is true that these developments cast Justice Brandeis' reasons in a different light, however, it is also true that the *Keogh* rule has been an established guidepost at the intersection of the antitrust and interstate commerce statutory regimes for some 6 1/2 decades. The emergence of subsequent procedural and judicial developments does not minimize *Keogh*'s role as an essential element of the settled legal context in which Congress has repeatedly acted in this area.

FN30. See *id.,* at 1352 (discussing development of class actions in view of the *Keogh* concern about antitrust litigation

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operating as a discriminatory rebate).

FN31. See *id.*, at 1354 (noting that "[t]he Court has subsequently found that activity could be challenged under the antitrust laws despite the existence of an administrative agency with authority to regulate the activity").

FN32. See *id.*, at 1353 ("The Supreme Court has ... rejected the argument that a plaintiff cannot recover damages it was able to pass on to its customers in the antitrust context").

FN33. See *ibid.* (referring to "the many later cases in which the Supreme Court has directed the suspension of judicial proceedings pending the referral of similar issues to the ICC" in view of the *Keogh* concern about the need for the ICC to determine the propriety of a lower rate).

IV

The Court of Appeals, in Judge Friendly's characteristically thoughtful and incisive opinion, suggested that, in view of subsequent developments, this Court might be prepared to overrule *Keogh.* We conclude, however, that the developments in the six decades since *Keogh* was decided are insufficient to overcome the strong presumption of continued validity that adheres in the judicial interpretation of a statute.[FN34] As Justice Brandeis himself observed, a decade after his *Keogh* decision, in commenting on the presumption of stability in statutory interpretation: "*Stare decisis* is usually the wise policy because in most matters, it is more important that the applicable rule of law be settled than that it be settled right.... This is commonly true, even where the error is a matter of serious concern, provided correction can be had by legislation." [FN35] We are especially reluctant to reject this presumption in an area that has seen careful, intense, and sustained congressional attention. If there is to be an overruling of the *Keogh* rule, it must come from Congress, rather than from this Court.

FN34. See, *e.g.*, *NLRB v. Longshoremen,* 473 U.S. 61, 84, 105 S.Ct. 3045, 3058, 87 L.Ed.2d 47 (1985) ("[W]e should follow the normal presumption of *stare decisis* in cases of statutory interpretation"); *Illinois Brick Co. v. Illinois,* 431 U.S. 720, 736, 97 S.Ct 2061, 2069, 52 L.Ed.2d 707 (1977) ("[W]e must bear in mind that considerations of *stare decisis* weigh heavily in the area of statutory construction, where Congress is free to change this Court's interpretation of its legislation"). See also Levi, An Introduction to Legal Reasoning, 15 U.Chi.L.Rev. 501, 540 (1948) ("The doctrine of finality for prior decisions setting the course for the interpretation of a statute is not always followed.... Nevertheless, the doctrine remains as more than descriptive. More than any other doctrine in the field of precedent, it has served to limit the freedom of the court. It marks an essential difference between statutory interpretation on the one hand and case law and constitutional interpretation on the other").

FN35. *Burnet v. Coronado Oil & Gas Co.,* 285 U.S. 393, 406, 52 S.Ct. 443, 447, 76 L.Ed. 815 (1932) (dissenting).

The judgment of the Court of Appeals is affirmed.

*It is so ordered.*

Justice MARSHALL, dissenting.

In his opinion for the Court of Appeals, Judge Friendly cogently and comprehensively explained why the reasoning of *Keogh v. Chicago & Northwestern R. Co.,* 260 U.S. 156, 43 S.Ct. 47, 67 L.Ed. 183 (1922), has been rendered obsolete by subsequent developments in the law. He demonstrated that *Keogh* should be overruled, and I am persuaded by his analysis. I therefore dissent.

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## Article 81 of the EC Treaty (ex Article 85)

1. The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which:

   (a) directly or indirectly fix purchase or selling prices or any other trading conditions;

   (b) limit or control production, markets, technical development, or investment;

   (c) share markets or sources of supply;

   (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

   (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

2. Any agreements or decisions prohibited pursuant to this Article shall be automatically void.

3. The provisions of paragraph 1 may, however, be declared inapplicable in the case of:

   - any agreement or category of agreements between undertakings;

   - any decision or category of decisions by associations of undertakings;

   - any concerted practice or category of concerted practices,

   which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:

   (a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;

   (b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

38 S.Ct. 242
62 L.Ed. 683, Am.Ann.Cas. 1918D,1207
**(Cite as: 246 U.S. 231, 38 S.Ct. 242)**

Supreme Court of the United States

BOARD OF TRADE OF CITY OF CHICAGO et al.
v.
UNITED STATES.

**No. 98.**

Argued Dec. 18 and 19, 1917.
Decided March 4, 1918.

Mr. Justice BRANDEIS delivered the opinion of the Court.

Chicago is the leading grain market in the world. Its Board of Trade is the commercial center through which most of the trading in grain is done. The character of the organization is described in Board of Trade v. Christie Grain & Stock Co., 198 U. S. 236, 25 Sup. Ct. 637, 49 L. Ed. 1031. Its 1600 members include brokers, commission merchants, dealers, millers, maltsters, manufacturers of corn products and proprietors of elevators. Grains there dealt in are graded according to kind and quality and are sold usually 'Chicago weight, inspection and delivery.' The standard forms of trading are: (a) Spot sales; that is, sales of grain already in Chicago in railroad cars or elevators for immediate delivery by order on carrier or transfer of warehouse receipt. (b) Future sales; that is, agreements for delivery later in the current or in some future month. (c) Sales 'to arrive'; thatis, agreements to deliver on arrival grain which is already in transit to Chicago or is to be shipped there within a time specified. On every business day sessions of the Board are held at which all bids and sales are publicly made. Spot sales and future sales are made at the regular sessions of the Board from 9:30 a. m. to 1:15 p. m., except on Saturdays, when the session closes at 12 m. Special sessions, termed the 'call,' are held immediately after the close of the regular session, at which sales 'to arrive' are made. These sessions are not limited as to duration, but last usually about half an hour. At all these sessions transactions are between members only; but they may trade either for themselves or on behalf of others. Members may also trade privately with one another at any place, either during the sessions or after, and they may trade with nonmembers at any time except on the premises occupied by the Board. [FN1]

Purchases of grain 'to arrive' are made largely from country dealers and farmers throughout the whole territory tributary to Chicago, which includes besides Illinois and Iowa, Indiana, Ohio, Wisconsin, Minnesota, Missouri, Kansas, Nebraska, and even South and North Dakota. The purchases are sometimes the result of bids to individual country dealers made by telegraph or telephone either during the sessions or after; but most purchases are made by the sending out from Chicago by the afternoon mails to hundreds of country dealers, offers to buy at the prices named, any number of carloads, subject to acceptance before 9:30 a. m. on the next business day.

In 1906 the Board adopted what is known as the 'call' rule. By it members were prohibited from purchasing or offering to purchase, during the period between the close of the call and the opening of the session on the next business day, any wheat, corn, oats or rye 'to arrive' at a price other than the closing bid at the call. The call was over, with rare exceptions, by 2 o'clock. The change effected was this: Before the adoption of the rule, members fixed their bids throughout the day at such prices as they respectively saw fit; after the adoption of the rule, the bids had to be fixed at the day's closing bid on the call until the opening of the next session.

In 1913 the United States filed in the District Court for the Northern District of Illinois, this suit against the Board and its executive officers and directors, to enjoin the enforcement of the call rule, alleging it to be in violation of the Anti-Trust Law of July 2, 1890, c. 647, 26 Stat. 209. The defendants admitted the adoption and enforcement of the call rule, and averred that its purpose was not to prevent competition or to control prices, but to promote the convenience of members by restricting their hours of business and to break up a monopoly in that branch of the grain trade acquired by four or five warehousemen in Chicago. On motion of the government the allegations concerning the purpose of establishing the regulation were stricken from the record. The case was then heard upon evidence; and a decree was entered which declared that defendants became parties to a combination or conspiracy to restrain interstate and foreign trade and commerce 'by adopting, acting upon and enforcing' the 'call' rule; and enjoined them from acting upon the same or from adopting or acting upon any similar rule.

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No opinion was delivered by the District Judge. The government proved the existence of the rule and described its application and the change in business practice involved. It made no attempt to show that the rule was designed to or that it had the effect of limiting the amount of grain shipped to Chicago; or of retarding or accelerating shipment; or if raising or depressing prices; or of discriminating against any part of the public; or that it resulted in hardship to any one. The case was rested upon the bald proposition, that a rule or agreement by which men occupying positions of strength in any branch of trade, fixed prices at which they would buy or sell during an important part of the business day, is an illegal restraint of trade under the Anti-Trust Law. But the legality of an agreement or regulation cannot be determined by so simple a test, as whether it restrains competition. Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts. This is not because a good intention will save an otherwise objectionable regulation or the reverse; but because knowledge of intent may help the court to interpret facts and to predict consequences. The District Court erred, therefore, in striking from the answer allegations concerning the history and purpose of the call rule and in later excluding evidence on that subject. But the evidence admitted makes it clear that the rule was a reasonable regulation of business consistent with the provisions of the Anti-Trust Law.

First. The nature of the rule: The restriction was upon the period of price- making. It required members to desist from further price-making after the close of the call until 9:30 a. m. the next business day; but there was no restriction upon the sending out of bids after close of the call. Thus it required members who desired to buy grain 'to arrive' to make up their minds before the close of the call how much they were willing to pay during the interval before the next session of the Board. The rule made it to their interest to attend the call; and if they did not fill their wants by purchases there, to make the final bid high enough to enable them to purchase from country dealers.

Second. The scope of the rule: It is restricted in operation to grain 'to arrive.' It applies only to a small part of the grain shipped from day to day to Chicago, and to an even smaller part of the day's sales; members were left free to purchase grain already in Chicago from any one at any price throughout the day. It applies only during a small part of the business day; members were left free to purchase during the sessions of the Board grain 'to arrive,' at any price, from members anywhere and from nonmembers anywhere except on the premises of the Board. It applied only to grain shipped to Chicago; members were left free to purchase at any price throughout the day from either members or non-members, grain 'to arrive' at any other market. Country dealers and farmers had available in practically every part of the territory called tributary to Chicago some other market for grain 'to arrive.' Thus Missouri, Kansas, Nebraska and parts of Illinois are also tributary to St. Louis; Nebraska and Iowa, to Omaha; Minnesota, Iowa, South and North Dakota, to Minneapolis or Duluth; Wisconsin and parts of Iowa and of Illinois, to Milwaukee; Ohio, Indiana and parts of Illinois, to Cincinnati; Indiana and parts of Illinois, to Louisville.

Third. The effects of the rule: As it applies to only a small part of the grain shipped to Chicago and to that only during a part of the business day and does not apply at all to grain shipped to other markets, the rule had no appreciable effect on general market prices; nor did it materially affect the total volume of grain coming to Chicago. But within the narrow limits of its operation the rule helped to improve market conditions thus:

(a) It created a public market for grain 'to arrive.' Before its adoption, bids were made privately. Men had to buy and sell without adequate knowledge of actual market conditions. This was disadvantageous to all concerned, but particularly so to country dealers and farmers.

(b) It brought into the regular market hours of the Board sessions, more of the trading in grain 'to arrive.'

(c) It brought buyers and sellers into more direct relations; because on the call they gathered together for a free and open interchange of bids and offers.

(d) It distributed the business in grain 'to arrive' among a far larger number of Chicago receivers and commission merchants than had been the case there

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before.

(e) It increased the number of country dealers engaging in this branch of the business; supplied them more regularly with bids from Chicago; and also increased the number of bids received by them from competing markets.

(f) It eliminated risks necessarily incident to a private market, and thus enabled country dealers to do business on a smaller margin. In that way the rule made it possible for them to pay more to farmers without raising the price to consumers.

(g) It enabled country dealers to sell some grain to arrive which they would otherwise have been obliged either to ship to Chicago commission merchants or to sell for 'future delivery.'

(h) It enabled those grain merchants of Chicago who sell to millers and exporters, to trade on a smaller margin and by paying more for grain or selling it for less, to make the Chicago market more attractive for both shippers and buyers of grain.

(i) Incidentally it facilitated trading 'to arrive' by enabling those engaged in these transactions to fulfill their contracts by tendering grain arriving at Chicago on any railroad, whereas formerly shipments had to be made over the particular railroad designated by the buyer.

The restraint imposed by the rule is less severe than that sustained in Anderson v. United States, 171 U. S. 604, 19 Sup. Ct. 50, 43 L. Ed. 300. Every Board of Trade and nearly every trade organization imposes some restrainst upon the conduct of business by its members. Those relating to the hours in which business may be done are common; and they make a special appeal where, as here, they tend to shorten the working day or, at least, limit the period of most exacting activity. The decree of the District Court is reversed with directions to dismiss the bill.

Reversed.

Mr. Justice McREYNOLDS took no part in the consideration or decision of this case.

FN1 There is an exception as to future sales not here material.

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97 S.Ct. 2549
53 L.Ed.2d 568, 1977-1 Trade Cases P 61,488
**(Cite as: 433 U.S. 36, 97 S.Ct. 2549)**

Supreme Court of the United States

CONTINENTAL T. V., INC., et al., Petitioners,
v.
GTE SYLVANIA INCORPORATED.

**No. 76-15.**

Argued Feb. 28, 1977.
Decided June 23, 1977.

Mr. Justice POWELL delivered the opinion of the Court.

Franchise agreements between manufacturers and retailers frequently include provisions barring the retailers from selling franchised products from locations other than those specified in the agreements. This case presents important questions concerning the appropriate antitrust analysis of these restrictions under s 1 of the Sherman Act, 26 Stat. 209, as amended, 15 U.S.C. s 1, and the Court's decision in United States v. Arnold, Schwinn & Co., 388 U.S. 365, 87 S.Ct. 1856, 18 L.Ed.2d 1249 (1967).

I

Respondent GTE Sylvania Inc. (Sylvania) manufactures and sells television sets through its Home Entertainment Products Division. Prior to 1962, like most other television manufacturers, Sylvania sold its televisions to independent or company-owned distributors who in turn resold to a large and diverse group of retailers. Prompted by a decline in its market share to a relatively insignificant 1% to 2% of nationaltelevision sales,[FN1] Sylvania conducted an intensive reassessment of its marketing strategy, and in 1962 adopted the franchise plan challenged here. Sylvania phased out its wholesale distributors and began to sell its televisions directly to a smaller and more select group of franchised retailers. An acknowledged purpose of the change was to decrease the number of competing Sylvania retailers in the hope of attracting the more aggressive and competent retailers thought necessary to the improvement of the company's market position.[FN2] To this end, Sylvania limited the number of franchises granted for any given area and required each franchisee to sell his Sylvania products only from the location or locations at which he was franchised.[FN3] A franchise did not constitute an exclusive territory, and Sylvania retained sole discretion to increase the number of retailers in an area in light of the success or failure of existing retailers in developing their market. The revised marketing strategy appears to have been successful during the period at issue here, for by 1965 Sylvania's share of national television sales had increased to approximately 5%, and the company ranked as the Nation's eighth largest manufacturer of color television sets.

FN1. RCA at that time was the dominant firm with as much as 60% to 70% of national television sales in an industry with more than 100 manufacturers.

FN2. The number of retailers selling Sylvania products declined significantly as a result of the change, but in 1965 there were at least two franchised Sylvania retailers in each metropolitan center of more than 100,000 population.

FN3. Sylvania imposed no restrictions on the right of the franchisee to sell the products of competing manufacturers.

This suit is the result of the rupture of a franchiser-franchisee relationship that had previously prospered under the revised Sylvania plan. Dissatisfied with its sales in the city of San Francisco,[FN4] Sylvania decided in the spring of 1965 to franchise Young Brothers, an established San Francisco retailer of televisions, as an additional San Francisco retailer. The proposed location of the new franchise was approximately a mile from a retail outlet operated by petitioner Continental T. V., Inc. (Continental), one of the most successful Sylvania franchisees.[FN5] [Omitted.] Continental protested that the location of the new franchise violated Sylvania's marketing policy, but Sylvania persisted in its plans. Continental then canceled a large Sylvania order and placed a large order with Phillips, one of Sylvania's competitors.

FN4. Sylvania's market share in San

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Francisco was approximately 2.5% half its national and northern California average.

During this same period, Continental expressed a desire to open a store in Sacramento, Cal., a desire Sylvania attributed at least in part to Continental's displeasure over the Young Brothers decision. Sylvania believed that the Sacramento market was adequately served by the existing Sylvania retailers and denied the request.[FN6] In the face of this denial, Continental advised Sylvania in early September 1965, that it was in the process of moving Sylvania merchandise from its San Jose, Cal., warehouse to a new retail location that it had leased in Sacramento. Two weeks later, allegedly for unrelated reasons, Sylvania's credit department reduced Continental' credit line from $300,000 to $50,000.[FN7] In response to the reduction in credit and the generally deteriorating relations with Sylvania, Continental withheld all payments owed to John P. Maguire & Co., Inc. (Maguire), the finance company that handled the credit arrangements between Sylvania and its retailers. Shortly thereafter, Sylvania terminated Continental's franchises, and Maguire filed this diversity action in the United States District Court for the Northern District of California seeking recovery of money owed and of secured merchandise held by Continental.

FN6. Sylvania had achieved exceptional results in Sacramento, where its market share exceeded 15% in 1965.

FN7. In its findings of fact made in conjunction with Continental's plea for injunctive relief, the District Court rejected Sylvania's claim that its actions were prompted by independent concerns over Continental's credit. The jury's verdict is ambiguous on this point. In any event, we do not consider it relevant to the issue before us.

The antitrust issues before us originated in cross-claims brought by Continental against Sylvania and Maguire. Most important for our purposes was the claim that Sylvania had violated s 1 of the Sherman Act by entering into and enforcing franchise agreements that prohibited the sale of Sylvania products other than from specified locations.[FN8] At the close of evidence in the jury trial of Continental's claims, Sylvania requested the District Court to instruct the jury that its location restriction was illegal only if it unreasonably restrained or suppressed competition. App. 5-6, 9-15. Relying on this Court's decision in United States v. Arnold, Schwinn & Co., supra, the District Court rejected the proffered instruction in favor of the following one:

FN8. Although Sylvania contended in the District Court that its policy was unilaterally enforced, it now concedes that its location restriction involved understandings or agreements with the retailers.

"Therefore, if you find by a preponderance of the evidence that Sylvania entered into a contract, combination or conspiracy with one or more of its dealers pursuant to which Sylvania exercised dominion or control over the products sold to the dealer, after having parted with title and risk to the products, you must find any effort thereafter to restrict outlets or store locations from which its dealers resold the merchandise which they had purchased from Sylvania to be a violation of Section 1 of the Sherman Act, regardless of the reasonableness of the location restrictions." App. 492.

In answers to special interrogatories, the jury found that Sylvania had engaged "in a contract, combination or conspiracy in restraint of trade in violation of the antitrust laws with respect to location restrictions alone," and assessed Continental's damages at $591,505, which was trebled pursuant to 15 U.S.C. s 15 to produce an award of.$1,774,515. App. 498, 501.[FN9]

FN9. The jury also found that Maguire had not conspired with Sylvania with respect to this violation. Other claims made by Continental were either rejected by the jury or withdrawn by Continental. Most important was the jury's rejection of the allegation that the location restriction was part of a larger scheme to fix prices. A pendent claim that Sylvania and Maguire had willfully and maliciously caused injury to Continental's business in violation of California law also was rejected by the jury, and a pendent breach-of-contract claim was withdrawn by Continental during the course of the proceedings. The parties eventually stipulated to a judgment for Maguire on its claim against Continental.

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On appeal, the Court of Appeals for the Ninth Circuit, sitting en banc, reversed by a divided vote. 537 F.2d 980 (1976). The court acknowledged that there is language in Schwinn that could be read to support the District Court's instruction but concluded that Schwinn was distinguishable on several grounds. Contrasting the nature of the restrictions, their competitive impact, and the market shares of the franchisers in the two cases, the court concluded that Sylvania's location restriction had less potential for competitive harm than the restrictions invalidated in Schwinn and thus should be judged under the "rule of reason" rather than the per se rule stated in Schwinn. The court found support for its position in the policies of the Sherman Act and in the decisions of other federal courts involving nonprice vertical restrictions. [FN10] [Omitted.]

We granted Continental's petition for certiorari to resolve this important question of antitrust law. 429 U.S. 893, 97 S.Ct. 252, 50 L.Ed.2d 176 (1976). [FN11]

FN11. This Court has never given plenary consideration to the question of the proper antitrust analysis of location restrictions. Before Schwinn such restrictions had been sustained in Boro Hall Corp. v. General Motors Corp., 124 F.2d 822 (CA2 1942). Since the decision in Schwinn, location restrictions have been sustained by three Courts of Appeals, including the decision below. Salco Corp. v. General Motors Corp., 517 F.2d 567 (CA10 1975); Kaiser v. General Motors Corp., 396 F.Supp. 33 (ED Pa.1975), affirmance order, 530 F.2d 964 (CA3 1976).

II

A

We turn first to Continental's contention that Sylvania's restriction on retail locations is a per se violation of s 1 of the Sherman Act as interpreted in Schwinn. The restrictions at issue in Schwinn were part of a three-tier distribution system comprising, in addition to Arnold, Schwinn & Co. (Schwinn), 22 intermediate distributors and a network of franchised retailers. Each distributor had a defined geographic area in which it had the exclusive right to supply franchised retailers. Sales to the public were made only through franchised retailers, who were authorized to sell Schwinn bicycles only from specified locations. In support of this limitation, Schwinn prohibited both distributors and retailers from selling Schwinn bicycles to nonfranchised retailers. At the retail level, therefore, Schwinn was able to control the number of retailers of its bicycles in any given area according to its view of the needs of that market.

As of 1967 approximately 75% of Schwinn's total sales were made under the "Schwinn Plan." Acting essentially as a manufacturer's representative or sales agent, a distributor participating in this plan forwarded orders from retailers to the factory. Schwinn then shipped the ordered bicycles directly to the retailer, billed the retailer, bore the credit risk, and paid the distributor a commission on the sale. Under the Schwinn Plan, the distributor never had title to or possession of the bicycles. The remainder of the bicycles moved to the retailers through the hands of the distributors. For the most part, the distributors functioned as traditional wholesalers with respect to these sales, stocking an inventory of bicycles owned by them to supply retailers with emergency and "fill-in" requirements. A smaller part of the bicycles that were physically distributed by the distributors were covered by consignment and agency arrangements that had been developed to deal with particular problems of certain distributors. Distributors acquired title only to those bicycles that they purchased as wholesalers; retailers, of course, acquired title to all of the bicycles ordered by them.

In the District Court, the United States charged a continuing conspiracy by Schwinn and other alleged co-conspirators to fix prices, allocate exclusive territories to distributors, and confine Schwinn bicycles to franchised retailers. Relying on United States v. Bausch & Lomb Co., 321 U.S. 707, 64 S.Ct. 805, 88 L.Ed. 1024 (1944), the Government argued that the nonprice restrictions were per se illegal as part of a scheme for fixing the retail prices of Schwinn bicycles. The District Court rejected the price-fixing allegation because of a failure of proof and held that Schwinn's limitation of retail bicycle sales to franchised retailers was permissible under s 1. The court found a s 1 violation, however, in "a conspiracy to divide certain borderline or overlapping counties in the territories served by four Midwestern cycle distributors." 237 F.Supp. 323, 342 (ND Ill.1965). The court described the violation as a "division of territory by agreement between the distributors . . . horizontal in nature," and held that Schwinn's participation did not change that basic characteristic. Ibid. The District Court limited its injunction to apply only to the territorial restrictions on the resale of bicycles purchased by the distributors in their roles as wholesalers. Ibid.

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Schwinn came to this Court on appeal by the United States from the District Court's decision. Abandoning its per se theories, the Government argued that Schwinn's prohibition against distributors' and retailers' selling Schwinn bicycles to nonfranchised retailers was unreasonable under s 1 and that the District Court's injunction against exclusive distributor territories should extend to all such restrictions regardless of the form of the transaction. The Government did not challenge the District Court's decision on price fixing, and Schwinn did not challenge the decision on exclusive distributor territories.

The Court acknowledged the Government's abandonment of its per se theories and stated that the resolution of the case would require an examination of "the specifics of the challenged practices and their impact upon the marketplace in order to make a judgment as to whether the restraint is or is not 'reasonable' in the special sense in which s 1 of the Sherman Act must be read for purposes of this type of inquiry." 388 U.S., at 374, 87 S.Ct., at 1863. Despite this description of its task, the Court proceeded to articulate the following "bright line" per se rule of illegality for vertical restrictions: "Under the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it." Id., at 379, 87 S.Ct., at 1865. But the Court expressly stated that the rule of reason governs when "the manufacturer retains title, dominion, and risk with respect to the product and the position and function of the dealer in question are, in fact, indistinguishable from those of an agent or salesman of the manufacturer." Id., at 380, 87 S.Ct., at 1866.

Application of these principles to the facts of Schwinn produced sharply contrasting results depending upon the role played by the distributor in the distribution system. With respect to that portion of Schwinn's sales for which the distributors acted as ordinary wholesalers, buying and reselling Schwinn bicycles, the Court held that the territorial and customer restrictions challenged by the Government were per se illegal. But, with respect to that larger portion of Schwinn's sales in which the distributors functioned under the Schwinn Plan and under the less common consignment and agency arrangements, the Court held that the same restrictions should be judged under the rule of reason. The only retail restriction challenged by the Government prevented franchised retailers from supplying nonfranchised retailers. Id., at 377, 87 S.Ct., at 1864. The Court apparently perceived no material distinction between the restrictions on distributors and retailers, for it held:

> "The principle is, of course, equally applicable to sales to retailers, and the decree should similarly enjoin the making of any sales to retailers upon any condition, agreement or understanding limiting the retailer's freedom as to where and to whom it will resell the products." Id., at 378, 87 S.Ct., at 1865.

Applying the rule of reason to the restrictions that were not imposed in conjunction with the sale of bicycles, the Court had little difficulty finding them all reasonable in light of the competitive situation in "the product market as a whole." Id., at 382, 87 S.Ct., at 1867.

B

In the present case, it is undisputed that title to the television sets passed from Sylvania to Continental. Thus, the Schwinn per se rule applies unless Sylvania's restriction on locations falls outside Schwinn's prohibition against a manufacturer's attempting to restrict a "retailer's freedom as to where and to whom it will resell the products." Id., at 378, 87 S.Ct., at 1865. As the Court of Appeals conceded, the language of Schwinn is clearly broad enough to apply to the present case. Unlike the Court of Appeals, however, we are unable to find a principled basis for distinguishing Schwinn from the case now before'us.

Both Schwinn and Sylvania sought to reduce but not to eliminate competition among their respective retailers through the adoption of a franchise system. Although it was not one of the issues addressed by the District Court or presented on appeal by the Government, the Schwinn franchise plan included a location restriction similar to the one challenged here. These restrictions allowed Schwinn and Sylvania to regulate the amount of competition among their retailers by preventing a franchisee from selling franchised products from outlets other than the one covered by the franchise agreement. To exactly the same end, the Schwinn franchise plan included a companion restriction, apparently not found in the Sylvania plan, that prohibited franchised retailers from selling Schwinn products to nonfranchised retailers. In Schwinn the Court expressly held that this restriction was impermissible under the broad principle stated there. In intent and competitive impact, the retail-customer restriction n Schwinn is indistinguishable from the location restriction in the present case. In both cases the restrictions limited the freedom of the retailer to dispose of the purchased

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products as he desired. The fact that one restriction was addressed to territory and the other to customers is irrelevant to functional anti-trust analysis, and indeed, to the language and broad thrust of the opinion in Schwinn.[FN12] [Omitted.] As Mr. Chief Justice Hughesstated in Appalachian Coals, Inc. v. United States, 288 U.S. 344, 360, 377, 53 S.Ct. 471, 474, 480, 77 L.Ed. 825 (1933): "Realities must dominate the judgment. . . . The Anti-Trust Act aims at substance."

III

Sylvania argues that if Schwinn cannot be distinguished, it should be reconsidered. Although Schwinn is supported by the principle of stare decisis, Illinois Brick Co. v. Illinois, 431 U.S. 720, 736, 97 S.Ct. 2061, 2070, 52 L.Ed.2d 707 (1977), we are convinced that the need for clarification of the law in this area justifies reconsideration. Schwinn itself was an abrupt and largely unexplained departure from White Motor Co. v. United States, 372 U.S. 253, 83 S.Ct. 696, 9 L.Ed.2d 738 (1963), where only four years earlier the Court had refused to endorse a per se rule for vertical restrictions. Since its announcement, Schwinn has been the subject of continuing controversy and confusion, both in the scholarly journals and in the federal courts. The great weight of scholarly opinion has been critical of the decision,[FN13] and a number of the federal courts confronted with analogous vertical restrictions have sought to limit its reach.[FN14] In our view, the experience of the past 10 years should be brought to bear on this subject of considerable commercial importance.

FN13. A former Assistant Attorney General in charge of the Antitrust Division has described Schwinn as "an exercise in barren formalism" that is "artificial and unresponsive to the competitive needs of the real world." Baker, Vertical Restraints in Times of Change: From White to Schwinn to Where?, 44 Antitrust L.J. 537 (1975). See, e. g., Handler, The Twentieth Annual Antitrust Review 1967, 53 Va.L.Rev. 1667 (1967); McLaren, Territorial and Customer Restrictions, Consignments, Suggested Retail Prices and Refusals to Deal, 37 Antitrust L.J. 137 (1968); Pollock, Alternative Distribution Methods After Schwinn, 63 Nw.U.L.Rev. 595 (1968); Posner, Antitrust Policy and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions, 75 Colum.L.Rev. 282 (1975); Robinson, Recent Antitrust Developments: 1974, 75 Colum.L.Rev. 243 (1975); Note, Vertical Territorial and Customer Restrictions in the Franchising Industry, 10 Colum.J.L. & Soc.Prob. 497 (1974); Note, Territorial and Customer Restrictions: A Trend Toward a Broader Rule of Reason?, 40 Geo.Wash.L.Rev. 123 (1971); Note, Territorial Restrictions and Per Se Rules A Re-evaluation of the Schwinn and Sealy Doctrines, 70 Mich.L.Rev. 616 (1972). But see Louis, Vertical Distributional Restraints Under Schwinn and Sylvania : An Argument for the Continuing Use of a Partial Per Se neApproach, 75 Mich.L.Rev. 275 (1976); Zimmerman, Distribution Restrictions After Sealy and Schwinn, 12 Antitrust Bull. 1181 (1967). For a more inclusive list of articles and comments, see 537 F.2d, at 988 n. 13.

FN14. Indeed, as one commentator has observed, many courts "have struggled to distinguish or limit Schwinn in ways that are a tribute to judicial ingenuity." Robinson, supra, n. 13, at 272. Thus, the statement in Schwinn at post-sale vertical restrictions as to customers or territories are "unreasonable without more," 388 U.S., at 379, 87 S.Ct., at 1865, has been interpreted to allow an exception to the per se rule where the manufacturer proves "more" by showing that the restraints will protect consumers against injury and the manufacturer against product liability claims. See, e. g., Tripoli Co. v. Wella Corp., 425 F.2d 932, 936-938 (CA3 1970) (en banc). Similarly, the statement that Schwinn's enforcement of its restrictions had been " 'firm and resolute,' " 388 U.S., at 372, 87 S.Ct., at 1862, has been relied upon to distinguish cases lacking that element. See, e. g., Janel Sales Corp. v. Lanvin Parfums, Inc., 396 F.2d 398, 406 (CA2 1968). Other factual distinctions have been drawn to justify upholding territorial restrictions that would seem to fall within the scope of the Schwinn per se rule. See, e. g., Carter-Wallace, Inc. v. United States, 449 F.2d 1374, 1379-1380, 196 Ct.Cl. 35, 44-46 (1971) (per se rule inapplicable when purchaser can avoid restraints by electing to buy product at higher price); Colorado

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Pump & Supply Co. v. Febco, Inc., 472 F.2d 637 (CA10 1973) (apparent territorial restriction characterized as primary responsibility clause). One Court of Appeals has expressly urged us to consider the need in this area for greater flexibility. Adolph Coors Co. v. FTC, 497 F.2d 1178, 1187 (CA10 1974). The decision in Schwinn and the developments in the lower courts have been exhaustively surveyed in ABA Antitrust Section, Monograph No. 2, Vertical Restrictions Limiting Intrabrand Competition (1977) (ABA Monograph No. 2).

The traditional framework of analysis under s 1 of the Sherman Act is familiar and does not require extended discussion. Section 1 prohibits "(e) very contract, combination . . ., or conspiracy, in restraint of trade or commerce." Since the early years of this century a judicial gloss on this statutory language has established the "rule of reason" as the prevailing standard of analysis. Standard Oil Co. v. United States, 221 U.S. 1, 31 S.Ct. 502, 55 L.Ed. 619 (1911). Under this rule, the factfinder weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition.[FN15] Per se rules of illegality are appropriate only when they relate to conduct that is manifestly anticompetitive. As the Court explained in Northern Pac. R. Co. v. United States, 356 U.S. 1, 5, 78 S.Ct. 514, 518, 2 L.Ed.2d 545 (1958), "there are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use." [FN16]

FN15. One of the most frequently cited statements of the rule of reason is that of Mr. Justice Brandeis in Chicago Board of Trade v. United States, 246 U.S. 231, 238, 38 S.Ct. 242, 244, 62 L.Ed. 683 (1918). . . .

FN16. Per se rules thus require the Court to make broad generalizations about the social utility of particular commercial practices. The probability that anticompetitive consequences will result from a practice and the severity of those consequences must be balanced against its pro-competitive consequences. Cases that do not fit the generalization may arise, but a per se rule reflects the judgment that such cases are not sufficiently common or important to justify the time and expense necessary to identify them. Once established, per se rules tend to provide guidance to the business community and to minimize the burdens on litigants and the judicial system of the more complex rule-of-reason trials, see Northern Pac. R. Co. v. United States, 356 U.S., at 5, 78 S.Ct., at 518; United States v. Topco Associates, Inc., 405 U.S. 596, 609-610, 92 S.Ct. 1126, 1134, 31 L.Ed.2d 515 (1972), but those advantages are not sufficient in themselves to justify the creation of per se rules. If it were otherwise, all of antitrust law would be reduced to per se rules, thus introducing an unintended and undesirable rigidity in the law.

In essence, the issue before us is whether Schwinn 's per se rule can be justified under the demanding standards of Northern Pac. R. Co. The Court's refusal to endorse a per se rule in White Motor Co. was based on its uncertainty as to whether vertical restrictions satisfied those standards. Addressing this question for the first time, the Court stated:

> "We need to know more than we do about the actual impact of these arrangements on competition to decide whether they have such a 'pernicious effect on competition and lack . . . any redeeming virtue' (Northern Pac. R. Co. v. United States, supra, 356 U.S. p. 5, 78 S.Ct. 514) and therefore should be classified as per se violations of the Sherman Act." 372 U.S., at 263, 83 S.Ct., at 702.

Only four years later the Court in Schwinn announced its sweeping per se rule without even a reference to Northern Pac. R. Co. and with no explanation of its sudden change in position.[FN17] [Omitted.] We turn now to consider Schwinn in light of Northern Pac. R. Co.

The market impact of vertical restrictions [FN18] is complex because of their potential for a simultaneous reduction of intrabrand competition and stimulation of interbrand competition. [FN19] Significantly, the Court in Schwinn did not distinguish among the challenged restrictions on the basis of their individual potential for intrabrand harm or interbrand benefit. Restrictions that completely eliminated intrabrand competition among Schwinn distributors were analyzed no differently from those that merely moderated intrabrand competition among retailers.

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The pivotal factor was the passage of title: All restrictions were held to be per se illegal where title had passed, and all were evaluated and sustained under the rule of reason where it had not. The location restriction at issue here would be subject to the same pattern of analysis under Schwinn.

FN18. As in Schwinn, we are concerned here only with nonprice vertical restrictions. The per se illegality of price restrictions has been established firmly for many years and involves significantly different questions of analysis and policy. As Mr. Justice White notes, post, at 2568, some commentators have argued that the manufacturer's motivation for imposing vertical price restrictions may be the same as for nonprice restrictions. There are, however, significant differences that could easily justify different treatment. In his concurring opinion in White Motor Co. v. United States, Mr. Justice Brennan noted that, unlike nonprice restrictions, "(r)esale price maintenance is not only designed to, but almost invariably does in fact, reduce price competition not only among sellers of the affected product, but quite as much between that product and competing brands." 372 U.S., at 268, 83 S.Ct., at 704. Professor Posner also recognized that "industry-wide resale price maintenance might facilitate cartelizing." Posner, supra, n. 13, at 294 (footnote omitted); see R. Posner, Antitrust: Cases, Economic Notes and Other Materials 134 (1974); E. Gellhorn, Antitrust Law and Economics 252 (1976); Note, 10 Colum.J.L. & Soc.Prob., supra, n. 13, at 498n. 12. Furthermore, Congress recently has expressed its approval of a per se analysis of vertical price restrictions by repealing those provisions of the Miller-Tydings and McGuire Acts allowing fair trade pricing at the option of the individual States. Consumer Goods Pricing Act of 1975, 89 Stat. 801, amending 15 U.S.C. ss 1, 45(a). No similar expression of congressional intent exists for nonprice restrictions.

FN19. Interbrand competition is the competition among the manufacturers of the same generic product television sets in this case and is the primary concern of antitrust law. The extreme example of a deficiency of interbrand competition is monopoly, where there is only one manufacturer. In contrast, intrabrand competition is the competition between the distributors wholesale or retail of the product of a particular manufacturer. The degree of intrabrand competition is wholly independent of the level of interbrand competition confronting the manufacturer. Thus, there may be fierce intrabrand competition among the distributors of a product produced by a monopolist and no intrabrand competition among the distributors of a product produced by a firm in a highly competitive industry. But when interbrand competition exists, as it does among television manufacturers, it provides a significant check on the exploitation of intrabrand market power because of the ability of consumers to substitute a different brand of the same product.

It appears that this distinction between sale and nonsale transactions resulted from the Court's effort to accommodate the perceived intrabrand harm and interbrand benefit of vertical restrictions. The per se rule for sale transactions reflected the view that vertical restrictions are "so obviously destructive" of intrabrand competition [FN20] that their use would "open the door to exclusivity of outlets and limitation of territoryfurther than prudence permits." 388 U.S., at 379-380, 87 S.Ct., at 1865-1866.[FN21] Conversely, the continued adherence to the traditional rule of reason for nonsale transactions reflected the view that the restrictions have too great a potential for the promotion of interbrand competition to justify complete prohibition.[FN22] The Court's opinion provides no analytical support for these contrasting positions. Nor is there even an assertion in the opinion that the competitive impact of vertical restrictions issignificantly affected by the form of the transaction. Non-sale transactions appear to be excluded from the per se rule, not because of a greater danger of intrabrand harm or a greater promise of interbrand benefit, but rather because of the Court's unexplained belief that a complete per se prohibition would be too "inflexibl(e)." Id., at 379, 87 S.Ct., at 1865.

FN20. The Court did not specifically refer to intrabrand competition, but this meaning is clear from the context.

FN21. The Court also stated that to impose

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vertical restrictions in sale transactions would "violate the ancient rule against restraints on alienation." 388 U.S., at 380, 87 S.Ct., at 1866. The isolated reference has provoked sharp criticism from virtually all of the commentators on the decision, most of whom have regarded the Court's apparent reliance on the "ancient rule" as both a misreading of legal history and a perversion of antitrust analysis. See, e. g., Handler, supra, n. 13, at 1684-1686; Posner, supra, n. 13, at 295-296; Robinson, supra, n. 13, at 270-271; but see Louis, supra, n. 13 at 276 n. 6. We quite agree with Mr. Justice Stewart's dissenting comment in Schwinn that "the state of the common law 400 or even 100 years ago is irrelevant to the issue before us: the effect of the antitrust laws upon vertical distributional restraints in the American economy today." 388 U.S., at 392, 87 S.Ct., at 1872.

We are similarly unable to accept Judge Browning's interpretation of Schwinn. In this dissent below he argued that the decision reflects the view that the Sherman Act was intended to prohibit restrictions on the autonomy of independent businessmen even though they have no impact on "price, quality, and quantity of goods and services," 537 F.2d, at 1019. This view is certainly not explicit in Schwinn, which purports to be based on an examination of the "impact (of the restrictions) upon the marketplace." 388 U.S., at 374, 87 S.Ct., at 1863. Competitive economies have social and political as well as economic advantages, see e. g., Northern Pac. R. Co. v. United States, 356 U.S., at 4, 78 S.Ct., at 517, but an antitrust policy divorced from market considerations would lack any objective benchmarks. As Mr. Justice Brandeis reminded us: "Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence." Chicago Board of Trade v. United States, 246 U.S., at 238, 38 S.Ct., at 244. Although Mr. Justice White's opinion endorses Judge Browning's interpretation, post, at 2566-2567, it purports to distinguish Schwinn on grounds inconsistent with that interpretation, post, at 2569.

FN22. In that regard, the Court specifically stated that a more complete prohibition "might severely hamper smaller enterprises resorting to reasonable methods of meeting the competition of giants and of merchandising through independent dealers." 388 U.S., at 380, 87 S.Ct., at 1866. The Court also broadly hinted that it would recognize additional exceptions to the per se rule for new entrants in an industry and for failing firms, both of which were mentioned in White Motor as candidates for such exceptions. 388 U.S., at 374, 87 S.Ct., at 1863. The Court might have limited the exceptions to the per se rule to these situations, which present the strongest arguments for the sacrifice of intrabrand competition for interbrand competition. Significantly, it chose instead to create the more extensive exception for nonsale transactions which is available to all businesses, regardless of their size, financial health, or market share. This broader exception demonstrates even more clearly the Court's awareness of the "redeeming virtues" of vertical restrictions.

Vertical restrictions reduce intrabrand competition by limiting the number of sellers of a particular product competing for the business of a given group of buyers. Location restrictions have this effect because of practical constraints on the effective marketing area of retail outlets. Although intrabrand competition may be reduced, the ability of retailers to exploit the resulting market may be limited both by the ability of consumers to travel to other franchised locations and, perhaps more importantly, to purchase the competing products of other manufacturers. None of these key variables, however, is affected by the form of the transaction by which a manufacturer conveys his products to the retailers.

Vertical restrictions promote interbrand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products. These "redeeming virtues" are implicit in every decision sustaining vertical restrictions under the rule of reason. Economists have identified a number of ways in which manufacturers can use such restrictions to compete more effectively against other manufacturers. See, e.g., Preston, Restrictive Distribution Arrangements: Economic Analysis and Public Policy Standards, 30 Law & Contemp.Prob. 506, 511 (1965).[FN23] For example, new manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labor that is often

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required in the distribution of products unknown to the consumer. Established manufacturers can use them to induce retailers to engage in promotional activities or to provide service and repair facilities necessary to the efficient marketing of their products. Service and repair are vital for many products, such as automobiles and major household appliances. The availability and quality of such services affect a manufacturer's goodwill and the competitiveness of his product. Because of market imperfections such as the so-called "free rider" effect, these services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the services than if none did. Posner, supra, n. 13, at 285; cf. P. Samuelson, Economics 506-507 (10th ed. 1976).

FN23. Marketing efficiency is not the only legitimate reason for a manufacturer's desire to exert control over the manner in which his products are sold and serviced. As a result of statutory and common-law developments, society increasingly demands that manufacturers assume direct responsibility for the safety and quality of their products. For example, at the federal level, apart from more specialized requirements, manufacturers of consumer products have safety responsibilities under the Consumer Product Safety Act, 15 U.S.C. s 2051 et seq. (1970 ed., Supp. V), and obligations for warranties under the Consumer Product Warranties Act, 15 U.S.C. s 2301 et seq. (1970 ed., Supp. V). Similar obligations are imposed by state law. See, e. g., Cal.Civ.Code Ann. s 1790 et seq. (West 1973). The legitimacy of these concerns has been recognized in cases involving vertical restrictions. See, e. g., Tripoli Co. v. Wella Corp., 425 F.2d 932 (CA3 1970).

Economists also have argued that manufacturers have an economic interest in maintaining as much intrabrand competition as is consistent with the efficient distribution of their products. Bork, The Rule of Reason and the Per Se Concept: Price Fixing and the Market Division (II), 75 Yale L.J. 373, 403 (1966); Posner, supra, n. 13, at 283, 287-288.[FN24] Although the view that the manufacturer's interest necessarily corresponds with that of the public is not universally shared, even the leading critic of vertical restrictions concedes that Schwinn 's distinction between sale and nonsale transactions is essentially unrelated to any relevant economic impact. Comanor, Vertical Territorial and Customer Restrictions: White Motor and Its Aftermath, 81 Harv.L.Rev. 1419, 1422 (1968).[FN25] Indeed, to the extent that the form of the transaction is related to interbrand benefits, the Court's distinction is inconsistent with its articulated concern for the ability of smaller firms to compete effectively with larger ones. Capital requirements and administrative expenses may prevent smaller firms from using the exception for nonsale transactions. See, e. g., Baker, supra, n. 13, at 538; Phillips, Schwinn Rules and the "New Economics" of Vertical Relation, 44 Antitrust L.J. 573, 576 (1975); Pollock, supra, n. 13, at 610.[FN26]

FN24. "Generally a manufacturer would prefer the lowest retail price possible, once its price to dealers has been set, because a lower retail price means increased sales and higher manufacturer revenues." Note, 88 Harv.L.Rev. 636, 641 (1975). In this context, a manufacturer is likely to view the difference between the price at which it sells to its retailers and their price to the consumer as his "cost of distribution," which it would prefer to minimize. Posner, supra, n. 13, at 283.

FN25. Professor Comanor argues that the promotional activities encouraged by vertical restrictions result in product differentiation and, therefore, a decrease in interbrand competition. This argument is flawed by its necessary assumption that a large part of the promotional efforts resulting from vertical restrictions will not convey socially desirable information about product availability, price, quality, and services. Nor is it clear that a per se rule would result in anything more than a shift to less efficient methods of obtaining the same promotional effects.

FN26. We also note that per se rules in this area may work to the ultimate detriment of the small businessmen who operate as franchisees. To the extent that a per se rule prevents a firm from using the franchise system to achieve efficiencies that it perceives as important to its successful operation, the rule creates an incentive for vertical integration into the distribution system, thereby eliminating to that extent

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the role of independent businessmen. See, e. g., Keck, The Schwinn Case, 23 Bus.Law. 669 (1968); Pollock, supra, n. 13, at 608-610.

We conclude that the distinction drawn in Schwinn between sale and nonsale transactions is not sufficient to justify the application of a per se rule in one situation and a rule of reason in the other. The question remains whether the per se rule stated in Schwinn should be expanded to include non-sale transactions or abandoned in favor of a return to the rule of reason. We have found no persuasive support for expanding the per se rule. As noted above, the Schwinn Court recognized the undesirability of "prohibit(ing) all vertical restrictions of territory and all franchising . . .." 388 U.S., at 379-380, 87 S.Ct., at 1866.[FN27] And even Continental does not urge us to hold that all such restrictions are per se illegal.

FN27. Continental's contention that balancing intrabrand and interbrand competitive effects of vertical restrictions is not a "proper part of the judicial function," Brief for Petitioners 52, is refuted by Schwinn itself. United States v. Topco Associates, Inc., 405 U.S., at 608, 92 S.Ct., at 1134, is not to the contrary, for it involved a horizontal restriction among ostensible competitors.

We revert to the standard articulated in Northern Pac. R. Co., and reiterated in White Motor, for determining whether vertical restrictions must be "conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use." 356 U.S., at 5, 78 S.Ct., at 518. Such restrictions, in varying forms, are widely used in our free market economy. As indicated above, there is substantial scholarly and judicial authority supporting their economic utility. There is relatively little authority to the contrary.[FN28] Certainly, there has been no showing in this case, either generally or with respect to Sylvania's agreements, that vertical restrictions have or are likely to have a "pernicious effect on competition" or that they "lack . . . any redeeming virtue." Ibid.n [FN29] Accordingly, we conclude that the per se rule stated in Schwinn must be overruled.[FN30] In so holding we do not foreclose the possibility that particular applications of vertical restrictions might justify per se prohibition under Northern Pac. R. Co. But we do make clear that departure from the rule-of-reason standard must be based upon demonstrable economic effect rather than as in Schwinn upon formalistic line drawing.

FN28. There may be occasional problems in differentiating vertical restrictions from horizontal restrictions originating in agreements among the retailers. There is no doubt that restrictions in the latter category would be illegal per se, see, e. g., United States v. General Motors Corp., 384 U.S. 127, 86 S.Ct. 1321, 16 L.Ed.2d 415 (1966); United States v. Topco Associates, Inc., supra, but we do not regard the problems of proof as sufficiently great to justify a per se rule.

FN29. The location restriction used by Sylvania was neither the least nor the most restrictive provision that it could have used. See ABA Monograph No. 2, pp. 20-25. But we agree with the implicit judgment in Schwinn that a per se rule based on the nature of the restriction is, in general, undesirable. Although distinctions can be drawn among the frequently used restrictions, we are inclined to view them as differences of degree and form. See Robinson, supra, n. 13, at 279-280; Averill, Sealy, Schwinn and Sherman One: An Analysis and Prognosis, 15 N.Y.L.F. 39, 65 (1969). We are unable to perceive significant social gain from channeling transactions into one form or another. Finally, we agree with the Court in Schwinn that the advantages of vertical restrictions should not be limited to the categories of new entrants and failing firms. Sylvania was faltering, if not failing, and we think it would be unduly artificial to deny it the use of valuable competitive tools.

FN30. The importance of stare decisis is, of course, unquestioned, but as Mr. Justice Frankfurter stated in Helvering v. Hallock, 309 U.S. 106, 119, 60 S.Ct. 444, 451, 84 L.Ed. 604 (1940), "stare decisis is a principle of policy and not a mechanical formula of adherence to the latest decision, however recent and questionable, when such adherence involves collision with a prior doctrine more embracing in its scope, intrinsically sounder, and verified by

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experience."

In sum, we conclude that the appropriate decision is to return to the rule of reason that governed vertical restrictions prior to Schwinn. When anticompetitive effects are shown to result from particular vertical restrictions they can be adequately policed under the rule of reason, the standard traditionally applied for the majority of anticompetitive practices challenged under s 1 of the Act. Accordingly, the decision of the Court of Appeals is

Affirmed.

Mr. Justice REHNQUIST took no part in the consideration or decision of this case.

Mr. Justice WHITE, concurring in the judgment.

Although I agree with the majority that the location clause at issue in this case is not a per se violation of the Sherman Act and should be judged under the rule of reason, I cannot agree that this result requires the overruling of United States v. Arnold, Schwinn & Co., 388 U.S. 365, 87 S.Ct. 1856, 18 L.Ed.2d 1249 (1967). . . . I therefore concur in the judgment.

Mr. Justice BRENNAN with whom Mr. Justice MARSHALL joins, dissenting.

I would not overrule the per se rule stated in United States v. Arnold, Schwinn & Co., 388 U.S. 365, 87 S.Ct. 1856, 18 L.Ed.2d 1249 (1967), and would therefore reverse the decision of the Court of Appeals for the Ninth Circuit.

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678 F.2d 742
1982-2 Trade Cases P 64,744
**(Cite as: 678 F.2d 742)**

United States Court of Appeals, Seventh Circuit.

VALLEY LIQUORS, INC., Plaintiff-Appellant,
v.
RENFIELD IMPORTERS, LTD., Defendant-Appellee.

**No. 81-3016.**

Argued April 14, 1982.
Decided May 21, 1982.

Before BAUER, ESCHBACH, and POSNER, Circuit Judges.

POSNER, Circuit Judge.

Valley Liquors, Inc., is a wholesale wine and liquor distributor in northern Illinois, and Renfield Importers, Ltd., is one of its suppliers. Effective November 1, 1981, Renfield terminated Valley as a distributor of Renfield products (which include such popular brands as Gordon's and Martini & Rossi) in two counties, McHenry and Du Page (and part of a third, which we shall ignore to simplify this opinion). Valley sued, charging that Renfield had violated section 1 of the Sherman Act, 15 U.S.C. s 1, which forbids conspiracies or other agreements in restraint of trade. The case is before us on Valley's appeal under 28 U.S.C. s 1292(a)(1) from the denial by the district court of a motion for a preliminary injunction under section 16 of the Clayton Act, 15 U.S.C. s 26.

Until November 1, Renfield generally sold its products to several wholesalers in the same county. But its sales had not been growing as rapidly in Illinois as in the rest of the country, and it decided to adopt a system of restricted distribution whereby it would sell to one, or at most two, wholesalers in each county. (In some instances, however, the plan resulted in an increase in the number of wholesalers from one to two.) Although Valley was Renfield's largest wholesaler in McHenry and Du Page Counties, accounting for some 50 percent of Renfield's total sales there, the new plan terminated Valley and all of Renfield's other distributors in the two counties except Continental and Romano; they were, however, terminated in some other areas. There is unrebutted evidence that Valley had been selling Renfield products at prices five percent below those charged by Renfield's other distributors in McHenry and Du Page Counties and that Valley's termination followed discussions between Renfield and Continental and between Renfield and Romano in which Continental and Romano had expressed unhappiness at Renfield's terminating them in other areas. There is virtually no evidence concerning Renfield's motivation for the adoption of a more restricted distribution system and the concomitant realignment of wholesaler territories, except that it was a reaction to Renfield's disappointing sales in Illinois.

Valley contends that two distinct restraints of trade can be inferred from these facts. The first is a conspiracy among Renfield, Continental, and Romano to increase the wholesale prices of Renfield products in McHenry and Du Page Counties by cutting off Valley-Valley's termination being a concession demanded by Continental and Romano in exchange for consenting to the proposed realignment, under which they lost some of their territories. This is alleged to be a "horizontal" conspiracy, unlawful without more ("per se") under section 1 of the Sherman Act. The second alleged restraint of trade is the exclusion of Valley, pursuant to its distribution agreement with Renfield, from McHenry and Du Page Counties. Valley argues that this "vertical" restriction is unreasonable and hence unlawful under section 1's "Rule of Reason."

The district judge denied a preliminary injunction against Renfield's termination of Valley because he did not think that Valley had demonstrated that it was likely to win the case if tried in full. If the judge was right in his estimation of Valley's chances of success, he was right to deny a preliminary injunction, regardless of other considerations relevant to the exercise of his equitable powers.

If Continental and Romano had agreed to raise the prices of Renfield products in McHenry and Du Page Counties and to that end had persuaded Renfield (perhaps by threatening to discontinue carrying its products if it did not cooperate with them) to terminate Valley, their pesky low-price competitor, then they and their cat's paw Renfield would be guilty of a per se unlawful restraint of trade. Although there was no direct evidence of such a chain of events-in particular no evidence that

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Continental and Romano ever communicated with each other about Valley-we are asked to infer from the fact that Continental and Romano (separately) expressed unhappiness at being terminated in some of their sales areas that they demanded and received, as a quid pro quo, the termination of their major competitor in the two counties, Valley. However, this hypothesis is too speculative to compel a trier of fact to infer conspiracy, at least if Renfield may have had independent reasons for wanting to terminate Valley. We are asked to exclude that possibility because Valley was Renfield's largest and lowest-priced wholesaler in McHenry and Du Page Counties, and therefore its best. We follow the argument until "therefore." If Renfield had been content with a policy of maximizing wholesaler price competition, it would not have changed to a system of exclusive and dual wholesalers; it would have thought that the more competing wholesalers it had the better off it was. The adoption of a restricted distribution system implies a decision to emphasize nonprice competition over price competition, which such a system tends to suppress. This does not make restricted distribution good, or even lawful; we shall get to that question in a moment. Right now we are just concerned with whether Renfield may have had reasons for terminating Valley that were independent of the desires of Continental and Romano to be rid of the competition of a price cutter. It may have. That possibility is enough to rebut an inference of collusion with those distributors based solely on the termination of Valley.

We are mindful that Cernuto, Inc. v. United Cabinet Corp., 595 F.2d 164 (3d Cir. 1979), held that it is unlawful per se for a manufacturer to terminate a distributor at the behest of a competing distributor who wants to reduce price competition. Valley's allegation of a horizontal conspiracy is an effort to invoke Cernuto. It is a clumsy effort, since Cernuto is not a horizontal case: a horizontal conspiracy is one between two or more competing sellers; a conspiracy between a supplier and a wholesaler is one between firms in different stages of distribution. Perhaps, though, this is a pedantic distinction, and the important point is that Cernuto condemns the vertical expression of a horizontal desire. But it is not enough that the distributor, that is Continental or Romano, have this desire; the supplier must have it too. See Alloy Int'l Co. v. Hoover-NSK Bearing Co., 635 F.2d 1222, 1226 n.6 (7th Cir. 1980); Edward J. Sweeney & Sons, Inc. v. Texaco, Inc., 637 F.2d 105, 111 (3d Cir. 1980). If Renfield wanted to restrict the distribution of its products in order to be a more effective competitor, the antitrust laws would not forbid it to do so merely because its distributors went along so that they would have less price competition. It is therefore not enough to show that Continental and Romano, acting separately (for if they acted together that would be horizontal action), wanted to get rid of a competitor; there must also be evidence that in terminating Valley Renfield was acceding to their desire rather than acting to promote an independent conception of its self-interest. There was no such direct evidence and the circumstantial evidence was as we have pointed out too tenuous to require the trier of fact to draw the inference that Valley asked him to draw.

There is, we admit, a certain unreality in the careful parsing of motives that Cernuto seems to require. If a supplier wants his distributors to emphasize nonprice rather than price competition, which as we said is the usual reason why he would restrict his distribution, he will be hostile to price cutters because they will make it harder for his other distributors to recoup the expenditures that he wants them to make on presale services to consumers and on other forms of nonprice competition, and of course the undersold distributors will be equally or more hostile. The motive of supplier and distributors alike could thus be described as wanting to eliminate price cutters yet there would be no per se illegality so long as the supplier was not just knuckling under to the distributors' desire for less competition. It is difficult to see how a court could distinguish empirically between such a case and the pure antipathy to price competition envisaged by Cernuto. But the unraveling of this skein can be left for another occasion. It is enough that in this case the plaintiff did not prove an improper motive by its supplier.

We turn to the vertical aspect of the case. If we accept, as on the state of the record we must, that Valley sold at lower prices than the other distributors in McHenry and Du Page Counties, then the territorial restriction pursuant to which it was terminated in those two counties has reduced price competition among wholesalers of the brands supplied by Renfield ("intrabrand price competition"). Valley contends that this reduction establishes a prima facie case of unreasonable restraint of trade which shifts to Renfield the burden of showing an offsetting increase in competition between brands supplied by Renfield on the one hand and brands supplied by other importers or national distributors of alcoholic beverages on the other hand ("interbrand competition").

We reject the casual equation of intrabrand price competition with interbrand competition. The

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elimination of a price cutter who is taking a free ride on the promotional efforts of competing distributors will tend to stimulate nonprice competition among the distributors at the same time that it dampens price competition among them, so that the net effect on intrabrand competition need not be negative. In any event, the suggestion that proof of a reduction in intrabrand competition creates a presumption of illegality is inconsistent with the test that the courts apply in restricted distribution cases. Building from a suggestive footnote in Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 57 n.27, 97 S.Ct. 2549, 2561 n.27, 53 L.Ed.2d 568 (1976), the courts have held that the effects on intrabrand and on interbrand competition must be balanced in deciding whether a challenged restriction on distribution is unreasonable. See, e.g., Muenster Butane, Inc. v. Stewart Co., 651 F.2d 292, 296 (5th Cir. 1981); Eiberger v. Sony Corp. of America, 622 F.2d 1068, 1076 (2d Cir. 1980). And it is not generally true of balancing tests that the plaintiff, in order to make out a prima facie case, has only to show that if you put something on his side of the empty balance the balance will tilt his way. The plaintiff in a restricted distribution case must show that the restriction he is complaining of was unreasonable because, weighing effects on both intrabrand and interbrand competition, it made consumers worse off.

Admittedly, this test of illegality is easier to state than to apply, the effects to be weighed being so difficult to measure or even estimate by the methods of litigation. The courts have therefore looked for shortcuts. A popular one is to say that the balance tips in the defendant's favor if the plaintiff fails to show that the defendant has significant market power (that is, power to raise prices significantly above the competitive level without losing all of one's business). That is the approach of the Fifth and Ninth Circuits. See, e.g., Muenster Butane, supra, 651 F.2d at 298; Cowley v. Braden Indus., Inc., 613 F.2d 751, 755 (9th Cir. 1980). The Second Circuit seems divided on the question. Compare Oreck Corp. v. Whirlpool Corp., 579 F.2d 126, 130 n.5 (2d Cir. 1978) (en banc), with Eiberger, supra, 622 F.2d at 1081. We agree with the Fifth and Ninth Circuits. A firm that has no market power isunlikely to adopt policies that disserve its consumers; it cannot afford to. And if it blunders and does adopt such a policy, market retribution will be swift. Thus its mistakes do not seriously threaten consumer welfare, which is the objective that we are told should guide us in interpreting the Sherman Act. See, e.g., Reiter v. Sonotone Corp., 442 U.S. 330, 343, 99 S.Ct. 2326, 2333, 60 L.Ed.2d 931 (1979). Even if there is some possibility that the distribution practices of a powerless firm will have a substantial anticompetitive effect, it is too small a possibility to warrant trundling out the great machinery of antitrust enforcement.

Since market power can rarely be measured directly by the methods of litigation, it is normally inferred from possession of a substantial percentage of the sales in a market carefully defined in terms of both product and geography. See, e.g., Red Diamond Supply, Inc. v. Liquid Carbonic Corp., 637 F.2d 1001, 1005 (5th Cir. 1981). In this case no evidence of market share was presented. In fact, no market was defined, either in product or in geographical terms, so that we do not have even a rough idea whether Renfield was a big firm in its market or a small firm. Nor did Valley seek to establish Renfield's market power by some alternative route, not involving proof of relevant market and market share.

On this as on all the other issues in this case our comments on the weight of the evidence have reference only to the evidence introduced in support of and in opposition to Valley's motion for a preliminary injunction. We are not prejudging Valley's right to a permanent injunction at the end of the trial. That right depends on the evidence introduced at trial, which for all we know may cure the deficiencies in Valley's proof that require us to order that the denial of its motion for a preliminary injunction be, and it hereby is,

AFFIRMED.

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216 F.3d 645
2000-1 Trade Cases P 72,944, 54 Fed. R. Evid. Serv. 1290
**(Cite as: 216 F.3d 645)**

United States Court of Appeals,
Seventh Circuit.

UNITED STATES of America, Plaintiff-Appellee/Cross-Appellant,
v.
Michael D. ANDREAS and Terrance S. Wilson, Defendants-Appellants/Cross-Appellees.

**Nos. 99-3078, 99-3097, 99-3098, 99-3106, 99-3107, 99-3279 and 99-3363.**

Argued Feb. 7, 2000
Decided June 26, 2000
Rehearing and Rehearing En Banc Denied July 27, 2000.[FN*]

FN* Judges Flaum and Diane P. Wood did not participate in the consideration of this case.

Before KANNE, ROVNER and EVANS, Circuit Judges.

KANNE, Circuit Judge.

For many years, Archer Daniels Midland Co.'s philosophy of customer relations could be summed up by a quote from former ADM President James Randall: "Our competitors are our friends. Our customers are the enemy." This motto animated the company's business dealings and ultimately led to blatant violations of U.S. antitrust law, a guilty plea and a staggering criminal fine against the company. It also led to the criminal charges against three top ADM executives that are the subject of this appeal. The facts involved in this case reflect an inexplicable lack of business ethics and an atmosphere of general lawlessness that infected the very heart of one of America's leading corporate citizens. Top executives at ADM and its Asian co- conspirators throughout the early 1990s spied on each other, fabricated aliases and front organizations to hide their activities, hired prostitutes to gather information from competitors, lied, cheated, embezzled, extorted and obstructed justice.

After a two-month trial, a jury convicted three ADM officials of conspiring to violate § 1 of the Sherman Antitrust Act, 15 U.S.C. § 1, which prohibits any conspiracy or combination to restrain trade. District Judge Blanche M. Manning sentenced defendants Michael D. Andreas and Terrance S. Wilson to twenty-four months in prison. They now appeal several issues related to their convictions and sentences, and the government counter-appeals one issue related to sentencing. We find no error related to the convictions, but agree with the government that the defendants should have received longer sentences for their leadership roles in the conspiracy.

## I. HISTORY

The defendants in this case, Andreas and Wilson, were executives at Archer Daniels Midland Co., the Decatur, Illinois-based agriculture processing company. Mark E. Whitacre, the third ADM executive named in the indictment, did not join this appeal.[FN1] ADM, the self-professed "supermarket to the world," is a behemoth in its industry with global sales of $14 billion in 1999 and 23,000 employees. Its concerns include nearly every farm commodity, such as corn, soybeans and wheat, but also the processing of commodities into such products as fuel ethanol, high-fructose sweeteners, feed additives and various types of seed oils. ADM has a worldwide sales force and a global transportation network involving thousands of rail lines, barges and trucks. The company is publicly held and listed on the New York Stock Exchange.

FN1. At his insistence, Whitacre was tried in absentia from the prison where he is serving a 108-month sentence for embezzlement. He was represented vigorously by counsel at trial and aided his defense through telephone communication with his lawyer. Kazutoshi Yamada, an employee of Ajinomoto Co. of Japan, was the fourth defendant named in the indictment. He has not been tried and remains a fugitive.

The Andreas family has long controlled ADM. Dwayne Andreas is a director and the former CEO, G. Allen Andreas is the board chairman and president, and various other family members occupy other executive positions. Michael D. Andreas,

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commonly called "Mick," was vice chairman of the board of directors and executive vice president of sales and marketing. Wilson was president of the corn processing division and reported directly to Michael Andreas.

*A. The Lysine Industry*

Lysine is an amino acid used to stimulate an animal's growth. It is produced by a fermentation process in which nutrients, primarily sugar, are fed to microorganisms, which multiply and metabolize. As a product of that process, the microorganisms excrete lysine, which is then harvested and sold to feed manufacturers who add it to animal feed. Feed manufacturers sell the feed to farmers who use it to raise chickens and pigs. The fermentation process tends to be very delicate, and utmost care must be used to keep the fermentation plant sterile.

Until 1991, the lysine market had been dominated by a cartel of three companies in Korea and Japan, with American and European subsidiaries. Ajinomoto Co., Inc. of Japan, was the industry leader, accounting for up to half of all world lysine sales. Ajinomoto had 50 percent interests in two subsidiaries, Eurolysine, based in Paris, and Heartland Lysine, based in Chicago. The other two producers of lysine were Miwon Co., Ltd. (later renamed Sewon Co., Ltd.) of South Korea, and Kyowa Hakko, Ltd. of Japan. Miwon ran a New Jersey-based subsidiary called Sewon America, and Kyowa owned the American subsidiary Biokyowa, Inc., which is based in Missouri.

Lysine is a highly fungible commodity and sold almost entirely on the basis of price. Pricing depended largely on two variables: the price of organic substitutes, such as soy or fish meal, and the price charged by other lysine producers. Together, the three parent companies produced all of the world's lysine until the 1990s, presenting an obvious opportunity for collusive behavior. Indeed the Asian cartel periodically agreed to fix prices, which at times reached as high as $3.00 per pound.

In 1989, ADM announced that it was building what would be the world's largest lysine plant. If goals were met, the Illinois facility could produce two or three times as much lysine as any other plant and could ultimately account for up to half of all the lysine produced globally. Even before the plant became operational, ADM embarked on an ambitious marketing campaign aimed at attracting large American meat companies, such as Tyson Foods, in part by capitalizing on anti-Asia sentiment prevalent at the time. Also around 1990, another South Korean company, Cheil Jedang Co., began producing lysine. Despite some early difficulties with the fermenting process, the ADM plant began producing lysine in 1991 and immediately became a market heavyweight, possibly even the industry leader. The two new producers created chaos in the market, igniting a price war that drove the price of lysine down, eventually to about 70-cents per pound. The Asian companies understandably were greatly concerned by developments in this once profitable field.

*B. Start of the Conspiracy*

Against this background, Kyowa Hakko arranged a meeting with Ajinomoto and ADM in June 1992. Mexico City was chosen as the site in part because the participants did not want to meet within the jurisdiction of American antitrust laws. Ajinomoto was represented by Kanji Mimoto and Hirokazu Ikeda from the Tokyo headquarters, and Alain Crouy from its Eurolysine subsidiary. Masaru Yamamoto represented Kyowa Hakko, and Wilson and Whitacre attended for ADM. Mimoto, Ikeda, Crouy and Yamamoto testified as government witnesses at trial. At this meeting, the three companies first discussed price agreements and allocating sales volumes among the market participants. Wilson, who was senior to Whitacre in the corporate hierarchy, led the discussion on behalf of ADM. The price agreements came easily, and all present agreed to raise the price in two stages by the end of 1992. According to internal Ajinomoto documents prepared after the meeting, the cartel's goal was to raise the price to $1.05 per pound in North America and Europe by October 1992 and up to $1.20 per pound by December, with other price hikes for other regions. The companies agreed to that price schedule and presumed that Ajinomoto and Kyowa would convince Sewon and Cheil to agree as well.

The sales volume allocation, in which the cartel (now including ADM) would decide how much each company would sell, was a matter of strong disagreement. In ADM's view, ADM should have onethird of the market, Ajinomoto and its subsidiaries should have one-third and Kyowa and the Koreans should have the remaining third. Ajinomoto--the historical industry leader-- disagreed vehemently and thought ADM did not deserve an equal portion of the market and could not produce that much lysine in any case. Wilson also suggested each company pick an auditor to whom sales volumes could be reported so that the cartel could keep track of each other's business. The meeting

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ended without a sales volume allocation agreement, but two months later, at the recommendation of Whitacre, the cartel raised prices anyway, and prices rose from $.70 to $1.05 per pound.

Still, the cartel considered a price agreement without allocating sales volume to be an imperfect scheme because each company would have an incentive to cheat on the price to get more sales, so long as its competitors continued to sell at the agreed price. With cheating, the price ultimately would drop, and the agreement would falter. An effort had to be made to get the parties to agree to a volume agreement, and to that end, Whitacre invited Ajinomoto officials to visit ADM's Decatur lysine facility to prove that it could produce the volume ADM claimed. Mimoto, Ikeda and other Ajinomoto officials, including an engineer named Fujiwara, visited the plant in September 1992. At a meeting before the tour, Whitacre and Mimoto confirmed the price schedule to which the parties had agreed in Mexico City.

The cartel met again in October 1992, this time in Paris. All five major lysine producers attended, along with representatives of their subsidiaries. Wilson and Whitacre again represented ADM. To disguise the purpose of the meeting, the parties created a fake agenda, and later a fictitious lysine producers trade association, so they could meet and share information without raising the suspicions of customers or law enforcement agencies. According to the agenda, the group was to discuss such topics as animal rights and the environment. In reality, they discussed something much dearer to their hearts--the price of lysine. According to internal Ajinomoto documents, the "purpose of the meeting" was to "confirm present price level and reaction of the market, and 2, future price schedule."

Shortly after this meeting, under circumstances explained below, Whitacre began cooperating with the FBI in an undercover sting operation aimed at busting the price-fixing conspiracy. As a result, most of the meetings and telephone conversations involving Whitacre and other conspirators after October 1992 were audiotaped or videotaped.

Despite the cartel's efforts to raise prices, the price of lysine dropped in 1993. According to executives of the companies who testified at trial, without a sales volume agreement, each company had an incentive to underbid the agreed price, and consequently each company had to match the lower bids or lose sales to its underbidding competitors. This resulted in the price of lysine falling in the spring of 1993. The group, calling itself "G-5" or "the club," met in Vancouver, Canada, in June 1993 to deal with the disintegrating price agreement. Wilson and Whitacre again represented ADM. At this meeting, the Asian companies presented a sales volume allocation that limited each company to a certain tonnage of lysine per year. ADM, through Wilson, rejected the suggested tonnage assignment because it granted ADM less than one-third of the market. Ajinomoto still considered ADM's demands too high.

That summer's strong commodities market permitted frequent increases in the lysine price, to which each of the companies agreed, despite the absence of a volume allocation. The cartel's continued strong interest in a volume allocation to support the price agreement led to another meeting in Paris in October 1993. The failure to reach a volume schedule in Paris finally led to a call for a meeting between the top management at Ajinomoto and ADM: Kazutoshi Yamada and Mick Andreas.

In October 1993, Andreas and Whitacre met with Yamada and Ikeda in Irvine, California. With Whitacre's assistance, the meeting was secretly videotaped and audiotaped. Andreas threatened Yamada that ADM would flood the market unless a sales volume allocation agreement was reached that would allow ADM to sell more than it had the previous year. The four discussed the dangers of competing in a free market and hammered out a deal on volume allocations, with Andreas accepting less than a one-third share of the market in exchange for a large portion of the market's growth. Specific prices were not discussed, but Andreas acknowledged the price deal that had already been negotiated. Yamada agreed to present ADM's proposal to the other three Asian producers.

A central concern to Andreas was the difficulty he expected the Asian producers to encounter in maintaining their agreed price level. As Andreas explained at some length, the Asian companies had a more decentralized sales system that depended on agents making deals with customers. ADM featured a very centralized system in which agents played a small role in overall sales and had no discretion over price. In such an environment, maintaining control over price was easy; for the Japanese, Andreas feared it would be difficult and suggested that Ajinomoto move to a more ADM-like centralized pricing system. Andreas also expressed concern that customers could "cheat" the producers by bargaining down the price, apparently by claiming to have received lower bids from competing producers. Ikeda and Yamada agreed that customer cheating was

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a problem, and the four briefly discussed a quick-response system that would allow the producers to verify with each other the prices offered to particular customers.

After the Irvine meeting, the cartel met in Tokyo to work out the details of the Andreas-Yamada arrangement. All the companies except for Cheil now agreed to both tonnage maximums and percentage market shares. The group excluded Cheil from this discussion because it considered Cheil's volume demand unreasonable. The cartel, expecting the lysine market to grow in 1994, thought it wise to agree on percentages of the market that each company could have since it was possible that all five producers could sell more than their allotted tonnage. With a total expected market of 245,000 tons for 1994, Ajinomoto was to sell 84,000 tons, ADM would sell 67,000 tons, Kyowa would sell 46,000 tons, Miwon would sell 34,000 tons and Cheil, if it eventually accepted the deal, would get 14,000 tons, according to the deal hammered out by Yamada and Andreas in Irvine.

As they had before the Andreas-Yamada meeting, Wilson and Whitacre attended these Tokyo meetings for ADM. In Tokyo, Wilson suggested, and the members agreed, that each producer report their monthly sales figures by telephone to Mimoto throughout the year, and if one producer exceeded its allocation, it would compensate the others by buying enough from the shorted members to even out the allocation. The producers also agreed on a new price of $1.20 for the United States market. The agreement to buy each other's unsold allocation cemented the deal by eliminating any incentive for a company to underbid the sales price. According to Mimoto: "[S]ince there is an agreement on the quantity allocation, our sales quantity is guaranteed by other manufacturers of the lysine. So by matching the price, to us, lowering the price is very silly. We can just keep the price." With the agreement on prices and quantities in place, the lysine price remained at the agreed level for January and February 1994.

On March 10, 1994, the cartel met in Hawaii. At this meeting, attended by Wilson and Whitacre on behalf of ADM, the producers discussed the progress of the volume allocation agreement, reported their sales figures and agreed on prices. They also considered letting Cheil into the allocation agreement and agreed to grant the company a market share of 17,000 tons. Cheil accepted this arrangement at a meeting later that day, at which Wilson explained that the conspiracy would operate almost identically to the scheme used to fix prices in the citric-acid market. The cartel further agreed on prices for Europe, South America, Asia and the rest of the world, and discussed how the global allocations would work on a regional basis. According to the figures reported to Mimoto through May 1994, prices were maintained, and both ADM and Ajinomoto were on track to meet their sales volume limits.

In the summer of 1994, the producers met in Sapporo, Japan, for a routine cartel meeting. Whitacre represented ADM by himself. At this meeting, Sewon demanded a larger share of the market for 1995. This created a problem for the cartel, which necessitated another meeting between Andreas and Yamada. In October 1994, while on a separate business trip to the United States, Yamada met with Andreas in a private dining room at the Four Seasons Hotel in Chicago. Whitacre, Wilson and Mimoto also attended along with their bosses.

The cartel met in Atlanta in January 1995, using a major poultry exposition as camouflage for the producers being in the same place at the same time. The cartel, without the presence of Sewon, decided to cut Sewon out of the agreement for 1995 because of its unrealistic volume demand. Sewon then joined the meeting and agreed to abide by the set price, if not the volume. The group discussed the year-end sales figures for 1994, comparing them to each company's allocated volume, and discussed the new allotment for 1995. According to the 1994 numbers, each company finished fairly close to its allotted volume. The cartel met once more in Hong Kong before the FBI raided the offices of ADM in Decatur and Heartland Lysine in Chicago. These raids ended the cartel. Heartland Lysine immediately notified its home office in Japan of the search, and Ajinomoto began destroying evidence of the cartel housed in its Tokyo office. Mimoto overlooked documents stored at his home and later turned these over to the FBI. Included in these saved documents were copies of internal Ajinomoto reports of the Mexico and Paris meetings.

*C. The Investigation*

Mark E. Whitacre joined ADM in 1989 as president of its bioproducts division. That year, ADM announced that it would enter the lysine market dominated by Asian producers. Whitacre, who held a Ph.D. in biochemistry from Cornell University and degrees in agricultural science, answered directly to Mick Andreas. Just 32 years old when he joined the company, Whitacre's star clearly was rising fast at ADM, and some industry analysts thought he could

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be the next president of ADM.

In 1992, Whitacre began working with Wilson, and the two attended the first meetings of the lysine producers in Mexico City. Also in 1992, Whitacre began embezzling large sums of money from ADM and eventually stole at least $9 million from the company by submitting to ADM phony invoices for work done by outside companies, who would then funnel the money to Whitacre's personal offshore and Swiss bank accounts. To cover up the embezzlement, Whitacre hatched a scheme in the summer of 1992 to accuse Ajinomoto of planting a saboteur in ADM's Decatur plant. Whitacre would accuse the saboteur of contaminating the delicate bacterial environment needed for the production of lysine, a story made believable because of the many early difficulties the ADM lysine plant encountered.

In accordance with the plot, Whitacre told Mick Andreas that an engineer at Ajinomoto named Fujiwara had contacted him at his home and offered to sell ADM the name of the saboteur in exchange for $10 million. The story was a lie. However, Dwayne Andreas believed it and feared it could jeopardize relations between the United States and Japan. He called the CIA, but the CIA, considering the matter one of federal law enforcement rather than national security, directed the call to the FBI, which sent agents out to ADM to interview Whitacre and other officials about the extortion. Whitacre apparently had not expected this and realized quickly that his lie would be discovered by the FBI, particularly after Special Agent Brian Shepard asked Whitacre if he could tap Whitacre's home telephone to record the next extortion demand. Whitacre knew that when the extortionist failed to call, Shepard would know Whitacre had invented the story. Whitacre confessed the scheme to Shepard, but to save himself, he agreed to become an undercover informant to help the FBI investigate price fixing at ADM. He did not come totally clean with the FBI, however; he failed to mention the millions he embezzled and in fact continued to embezzle after he began working for the government. For the next two-and-a-half years, Whitacre acted as an undercover cooperating witness--legally a government agent--and secretly taped hundreds of hours of conversations and meetings with Wilson, Mick Andreas and the other conspirators. In addition, the FBI secretly videotaped meetings of the lysine producers.

Whitacre made between 120 and 130 tapes for the FBI during the investigation, beginning with a November 9, 1992, conversation with Yamamoto, by using recording equipment, tapes and instruction provided by the government. FBI agents met with Whitacre more than 150 times during the investigation. The tapes were collected and reviewed usually within a day or two of the FBI receiving them, and Department of Justice (DOJ) attorneys regularly participated in reviewing the tapes and monitoring the supervision of Whitacre. However, the FBI's supervision of Whitacre was not flawless. Whitacre was, to say the least, a difficult cooperating witness to handle. Whitacre lied to the FBI during the probe, failed polygraph tests, bragged to his gardener about his role as an FBI mole, all while continuing to embezzle millions of dollars from the company. He even envisioned himself ascending to the ADM presidency as a hero once Andreas, Wilson and Randall [FN2] were taken down in the FBI sting. In short, he was out of control, and the FBI struggled to keep him on track. Nonetheless, the FBI and the DOJ considered him the best opportunity to stop a massive price-fixing scheme.

FN2. Randall was not indicted.

Whitacre exercised much discretion in deciding which conversations to record. He was given a tape recorder that could be hidden in his coat breast pocket and another that could be stowed in his briefcase. Agent Shepard showed him how to use the devices and sometimes affixed a recording device to Whitacre's body. Another recording device was used to tap one of Whitacre's home telephones, but not his cellular telephone. All recordings were done with Whitacre's express, signed consent, and all but one were done after Whitacre confessed that his story about a saboteur was a hoax and he began cooperating.

Whitacre was told to record conversations relevant to the conspiracy, but not to record anything about ADM's legitimate business. In direct contravention of the FBI's recording policy, Whitacre did not record many conversations he had with the alleged conspirators. The record shows Whitacre telephoned Ajinomoto and Kyowa 114 times, but 80 were never recorded or documented by the FBI as required. In addition, many conversations with co-defendants Wilson and Andreas were never recorded or documented.

Whitacre once claimed that Shepard ordered him to destroy tapes bearing exculpatory conversations, but Shepard denied this charge and Whitacre later

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recanted it in a sworn affidavit. Both Whitacre and a friend he entrusted with some of the tapes testified that no tapes were destroyed at Shepard's command. A tape expert testified for the government that none of the tapes exhibited evidence of splicing or alteration and that only a few showed evidence of "bulk erasure" or over-recording. Although that meant that some recordings may have been taped over, the expert expressed an opinion that none of the final recordings had been altered.

Andreas and Wilson moved to suppress the inculpatory tapes before trial and to allow them to introduce evidence that exculpatory tapes had been destroyed. For reasons explained below, the motion was denied although the trial court found that the FBI's supervision of Whitacre and its blatant inability to follow its own internal policies "border on gross negligence."

*D. Barrie Cox*

As part of its investigation into lysine and citric-acid price fixing by ADM, the government sought to interview Barrie R. Cox, a British national and president of ADM's food additives division in Europe. Cox, who reported directly to Wilson from 1991 through June 1995, was believed to have information regarding a conspiracy to fix prices in the citric-acid market. Prosecutors thought he could help them better gauge the value of ADM's cooperation, which was a factor in determining how high the fine should be when ADM eventually pleaded guilty, a plea which was expected to follow within a week. To avoid extradition problems from Great Britain and to procure Cox's cooperation, the San Francisco antitrust office of the DOJ sent Cox a letter dated October 11, 1996, guaranteeing use-immunity for any information provided by Cox during the interview. The letter stated in part:

> This is to confirm, as set forth in my letter to Mr. William W. Taylor, III, ... that in connection with the interview of Archer Daniels Midland Company's ("ADM") employee, Mr. Barrie R. Cox, the United States acknowledges that statements made by Mr. Cox and information provided by Mr. Cox during the interview are covered by Federal Rule of Criminal Procedure 11(e)(6) and also may not be used directly or indirectly against ADM or any of its employees, subsidiaries or affiliates in any criminal prosecution.

When the letter was sent and Cox was interviewed, the government was in the final stages of negotiating ADM's guilty plea agreement. Rule 11(e)(6) of the Federal Rules of Criminal Procedure prohibits the government from using the following against a defendant who made a plea or participated in plea discussions:

> (C) any statement made in the course of any proceedings under this rule regardingeither [a guilty plea that was later withdrawn or a plea of nolo contendere]; or
>
> (D) any statement made in the course of plea discussions with an attorney for the government which do not result in a plea of guilty or which result in a plea of guilty later withdrawn.

Based on this guarantee, Cox submitted to the interview. In the interview and later at trial, Cox provided details of the citric-acid conspiracy that showed it to be closely similar in design and function to the lysine conspiracy. Andreas and Wilson moved to suppress Cox's testimony and argued that the government, by its letter to Cox, intended to immunize them as ADM employees, despite the fact that they had already been notified that the government would seek indictments against them. The district court found this argument unpersuasive and denied the motion to immunize Andreas and Wilson or suppress the testimony.

Cox testified that ADM fixed prices and participated in volume allocations in the citric acid market for at least four years, from 1991 to 1995. Wilson, Cox's superior, was actively involved in the schemes in which citric- acid producers representing about two-thirds of the global market would meet on a regular basis to set prices and agree to sales quotas for each company. Cox testified that before he joined ADM,[FN3] Andreas asked him if it was possible to arrange a meeting of the competitors in the citric-acid market. Later, Wilson and Cox arranged meetings with the major competitors, who agreed to fix prices and establish volume quotas. The quotas were considered necessary to discourage any cartel member from cutting prices. As in the lysine conspiracy, the allocations were determined by each company's historical sales performance. If any company sold too much, it would be required to buy the following year from the company that sold too little. To monitor the progress of the conspiracy, each company reported its sales monthly to a designated cartel member. Additionally, a trade association was formed to help cover up the cartel's actions. Wilson participated in several of the cartel's meetings.

FN3. Until 1990, Cox worked for a company that produced citric acid. In 1990,

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ADM bought the citric-acid operation, and Cox joined ADM at that time.

*E. Closing Arguments*

[Omitted: the Court reproduces some of the U.S. Attorney's arguments, but later in the opinion it concludes that these did not provide a basis for reversal of the conviction.] Judge Manning strongly rebuked Lassar, but declined to declare a mistrial. Instead, the court instructed the jury to disregard Lassar's impermissible comments.

*F. Sentencing*

The jury convicted the three defendants on the single-count conspiracy indictment. On July 9, 1999, the court sentenced the defendants. United States Sentencing Guidelines § 2R1.1 mandated a base-offense level of ten and a seven-level increase because the volume of commerce affected was more than $100 million. With criminal histories in category I, the applicable range under the Guidelines for an offense level of seventeen was twenty-four to thirty months. The Presentence Investigation Reports (PSR) recommended a four-level increase for Andreas and three-level increase for Wilson based on their leadership roles in the conspiracy, pursuant to U.S.S.G. § 3B1.1. The court rejected the leadership role enhancements because it found that Wilson and Andreas were no more culpable than their co-conspirators. The court then sentenced each defendant to twenty-four months in prison.

II. ANALYSIS

On appeal, Andreas and Wilson raise ten issues including, among others, challenges to evidentiary rulings, the sufficiency of the evidence and the calculation of their sentences under the Sentencing Guidelines. The government appeals only one ruling, the denial of an upward adjustment for the defendants' leadership roles in the crime.

*A. The Tape-Recorded Evidence*

* * *

The defendants appeal the district court's decision to admit the tape recordings made by Whitacre on two grounds. First, they claim they were denied due process because evidence showed that the FBI and Whitacre engaged in "selective taping" and destroyed exculpatory tapes, which rendered the tapes unreliable, misleading and the product of bad faith. Second, they allege that the tapes were made in violation of the federal wiretap statute, 18 U.S.C. § 2511. The district court considered and rejected these arguments, and we review that decision for abuse of discretion. * * * [The Court of Appeals found no such abuse of discretion either in the trial court' s decision to admit the tapes despite lapses in the FBI's supervision of Whitacre or its decision that there was no reversible violation of the wiretap statute.]

*B. Barrie Cox*

The government and Cox entered into a use immunity agreement to facilitate Cox's interview with the FBI and the DOJ in preparation for ADM's impending plea agreement, which would settle all charges against the corporation. At all times, the government was preparing to prosecute Wilson and Andreas criminally, which makes the defendants' request that this Court interpret the Cox immunity agreement (the "agreement" or "letters") to immunize them truly remarkable. They contend that this absurd result follows from a logical chain beginning with the government's *intent* to immunize Andreas and Wilson, even though Andreas and Wilson were the prime individual targets of the government's three-year investigation. The defendants contend they are third-party beneficiaries of the agreement and that because the government cannot present an entirely independent source for Cox's testimony, the indictment must be dismissed, or at the very least, Cox's testimony regarding the citric-acid conspiracy should have been suppressed. We decline to take the first step down this too clever road.

> Without deciding whether third parties can ever be immunized by another's compelled testimony,[FN4] we agree with the district court that Wilson and Andreas do not have standing to enforce the terms of the Cox agreement. * * *

*2. Citric-Acid Conspiracy Evidence*

Defendant Andreas objected to the admission of Cox's testimony regarding the citric-acid conspiracy as unduly prejudicial. Andreas contends that no evidence showed he had been involved in the citric-acid conspiracy, and therefore it could not be admitted against him under Rule 404(b) of the Federal Rules of Evidence, which allows evidence of other crimes or bad acts to be used to show a defendant's motive, plan or intent in the instant crime. Rule 404(b) strictly prohibits the evidence of

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other crimes or bad acts to support the inference that the defendant has a propensity to commit that type of crime, but we do not believe that happened here. First, Andreas contends vigorously that the evidence of the citric-acid conspiracy fails to implicate him in any crime, including the citric-acid conspiracy, so it follows that the potential for an impermissible inference regarding his character must be nil. However, we find an alternative basis for allowing Cox's testimony.

Rule 404(b) guards against the impermissible inference that because a defendant committed Crime A at some time in the past, he is more likely to have committed Crime B, the crime charged in the present. The risk that the jury may improperly comprehend and weigh evidence of prior bad acts looms so large that courts in this country have long forbidden the government from invoking it. *See* Victor J. Gold, *Federal Rule of Evidence 403: Observations on the Nature of Unfairly Prejudicial Evidence,* 58 Wash. L.Rev. 497, 524-30 (1983). Yet we have carved out two important categories of cases where the rule does not apply. The first, and most common, is expressly stated in the rule itself, and that allows the use of other crimes evidence for purposes other than to show a propensity to commit the crime, such as to show the defendant's motive, plan or intent. *See* Fed.R.Evid. 404(b) ("Evidence of other crimes, wrongs, or acts ... may, however, be admissible for other purposes, such as proof of motive, opportunity, intent, preparation, plan, knowledge, identity, or absence of mistake or accident....").

The second exception, which applies here, covers acts that are so intricately interwoven with the facts of the charged crime that to omit the evidence relating to it would lead to confusion or leave an unexplainable gap in the narrative of the crime. *See United States v. Akinrinade,* 61 F.3d *1279, 1285-86 (7th Cir.1995).* While not an express exception to Rule 404(b), this type of evidence is permitted by virtue of not being included within the province of the rule. "Other crimes or acts" does not include those acts that are part and parcel of the charged crime itself; they simply are not "other." To omit the evidence would leave unanswered some questions regarding the charged offense. Such evidence includes acts that although not charged ascrimes, "are directly related to the charged offense." *United States v. Adames,* 56 F.3d 737, 742 (7th Cir.1995). "[T]he question is whether the evidence is properly admitted to provide the jury with a complete story of the crime...." *United States v. Ramirez,* 45 F.3d 1096, 1102 (7th Cir.1995) (internal quotation omitted).

Andreas' situation mirrors Adames. That case involved a drug conspiracy in which one of the defendants, Adames, had been caught in a drug sting operation in Texas (the "Texas sting") unrelated to his co-defendants in the charged offense. *Adames,* 56 F.3d at 741. However, the Texas sting prevented Adames from delivering the promised amount of marijuana and caused other changes in the conspirators' plan. The codefendants moved to exclude evidence of the Texas sting on the ground that it was a separate, extraneous conspiracy that did not implicate them at all. Like Andreas, they also moved to exclude on the basis that even if allowable under Rule 404(b), it would be unduly prejudicial and should be barred by Rule 403.

The trial court found, and we agreed, that the Texas sting was sufficiently linked to the charged offense to be admitted notwithstanding Rule 404(b). *Id.* at 742. The Texas sting provided direct evidence of the crime charged and therefore could not be considered "other crimes" evidence. Furthermore, the Texas sting was not so shocking, repulsive or emotionally charged that its probative value was outweighed by its prejudicial effect. We noted that probative evidence is always prejudicial, but the question remains whether it is unfairly prejudicial. *Id.*

The evidence of the citric-acid conspiracy answered at least three relevant questions. First, the jurors heard the conspirators in tape- recorded meetings discussing the citric-acid conspiracy, and they heard Wilson explaining that certain aspects of the lysine conspiracy, such as the bogus trade association, would operate in the same way. The evidence of the citric- acid conspiracy was relevant to explain these references in the conspirators' conversations.

Second, testimony at trial showed that in the halls of ADM's Decatur headquarters, the lysine and citric-acid conspiracies were closely related parts of a master plan to control prices and product supply through collusion with competitors. The citric-acid conspiracy, of which Andreas was aware, provided the blueprint for and motivating force behind the nascent lysine scheme. Many of the lysine cartel's meetings revolved around the need to allocate sales volume, a lesson dictated by the experience in the citric-acid conspiracy.

Finally, omitting the citric-acid evidence would leave Wilson's participation in the lysine conspiracy unexplained. Wilson--head of the corn division--was called in to work on the bioproducts project solely because he had experience with cartels that he

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gained from the citric-acid conspiracy. Wilson was to tutor Whitacre in running a citric-acid type conspiracy. The inference cannot be missed that since Wilson reported directly to Andreas, Andreas must have known why his corn processing chief was working so closely and traveling so much with the bioproducts chief. Because Wilson's entire reason for getting involved in lysine was to share his criminal experience with Whitacre, it takes little imagination to see how evidence of the citric-acid conspiracy implicated Andreas. To omit this evidence would, as in *Adames,* leave an unexplained gap in the narrative of the crime. We find the evidence of the citric-acid conspiracy was relevant to Andreas' guilt and not unfairly prejudicial.

*C.* Per Se *Violations*

The grand jury indictment charged the defendants with engaging in a "conspiracy to suppress and eliminate competition by fixing the price and allocating the sales volumes of lysine ... the substantial terms of [the conspiracy] were: (a) to agree to fix and maintain prices ... and (b) to agree to allocate the sales volumes of lysine among the corporate conspirators." The government's theory of the case held that the conspirators sought to raise prices by two independent but related means--price fixing and volume agreements--either one of which would accomplish the ultimate goal of the conspiracy. The court instructed the jury that it could convict the defendants of violating § 1 of the Sherman Antitrust Act if it found the defendants entered into an agreement *either* to fix prices or to "divide sales of a product among the various competitors." The defendants moved for acquittal on the sales volume portion of the indictment, arguing that it could not be considered a *per se* antitrust violation. The court denied the motion and a subsequent renewed motion for acquittal following the conviction. We review *de novo* a denial of motion for acquittal, but view the evidence in the light most favorable to the government. *See United States v. Hach,* 162 F.3d 937, 942 (7th Cir.1998).

On appeal, Wilson and Andreas contend that the jury instruction impermissibly allowed the jury to convict them for allocating sales volumes without requiring the government to prove with economic evidence that such an allocation unreasonably restrained trade. Violations of § 1 require evidence proving that the charged practice had the effect of unreasonably restraining trade under the "rule of reason," except in the limited cases referred to as *per se* violations. *See White Motor Co. v. United States,* 372 U.S. 253, 261-62, 83 S.Ct. 696, 9 L.Ed.2d 738 (1963); *see also Broadcast Music, Inc. v. CBS, Inc.,* 441 U.S. 1, 7-8, 99 S.Ct. 1551, 60 L.Ed.2d 1 (1979). *Per se* violations are ones that "always or almost always tend to restrict competition and decrease output" such that the court may dispense with the requirement of economic evidence. *Id.* at 19-20, 99 S.Ct. 1551. *Per se* violations are "naked restraints of trade with no purpose except stifling of competition," *White Motor,* 372 U.S. at 263, 83 S.Ct. 696, and have been characterized as so "plainly anti-competitive" and lacking "any redeeming virtue" that they are presumed illegal under § 1. *See Broadcast Music,* 441 U.S. at 8, 99 S.Ct. 1551 (internal quotations and citations omitted). Courts apply per se treatment only after "considerable experience" with a particular business practice has inevitably resulted in a finding of anticompetitive effects. *United States v. Topco Assocs., Inc.,* 405 U.S. 596, 607, 92 S.Ct. 1126, 31 L.Ed.2d 515 (1972); *Bunker Ramo Corp. v. United Business Forms, Inc.,* 713 F.2d 1272, 1284 (7th Cir.1983). The defendants do not contend that price fixing is not a *per se* violation, only that the agreement to allocate sales volumes, which according to the indictment and jury charge was a separate and independent goal of the conspiracy, should be subject to rule of reason analysis. We will reverse jury verdicts in multiple-goal conspiracies when the potential exists that the jury convicted the defendant on an improper ground. *See United States v. McKinney,* 954 F.2d 471, 475 (7th *Cir.1992).*

The issue then is whether the agreement to divide the market among the five lysine producers constituted a *per se* violation of the Sherman Act. The defendants' argument relies heavily on the fact that neither the words "sales volume allocation" nor any practices precisely identical to their scheme appear in the case law as a *per se* violation. The agreement did feature some clever characteristics that the conspirators hoped would help them avoid detection, but these small differences are not sufficient to distinguish their plot from more common *per se* prohibited practices. For instance, a conventional illegal agreement to allocate particular customers raises a strong chance that the customers themselves would become suspicious when the customers found that they could not buy the product from certain companies. *See, e.g., United States v. Socony-Vacuum Oil Co.,* 310 U.S. 150, 60 S.Ct. 811, 84 L.Ed. 1129 (1940); *United States v. Cooperative Theatres of Ohio, Inc.,* 845 F.2d 1367 (6th Cir.1988). The lysine cartel's plan avoided this risk by allowing the customer to choose from whom to buy. Because the product was entirely fungible and priced equivalently, the source of the product did not matter

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to either consumers or suppliers, so the customers' choices mattered little until the end of the year.

Other types of market divisions, such as those based on geography, *see, e.g.,* Palmer v. BRG of Georgia, Inc., 498 U.S. 46, 111 S.Ct. 401, 112 L.Ed.2d 349 (1990), or product lines, made little sense and were unnecessary for this particular industry. Similarly, a conventional illegal agreement to limit industry output, *see, e.g.,* Westinghouse Elec. Corp. v. Gulf Oil Corp., 588 F.2d 221, 226 (7th Cir.1978), would be less desirable since the conspirators believed market demand was growing. So long as the lysine price remained high, it served the conspirators' best interests to allow for market growth, and the agreement adequately accounted for divvying up that growth.

Yet the fact that the lysine producers' scheme did not fit precisely the characterization of a prototypical *per se* practice does not remove it from *per se* treatment. At bottom, the lysine cartel's agreement was a conspiracy to limit the producers' output and thereby raise prices. Functionally, an agreement to restrict output works in most cases to raises prices above a competitive level, *see* General Leaseways, Inc. v. National Truck Leasing Ass'n, 744 F.2d 588, 594 (7th Cir.1984), and for this reason, output restrictions have long been treated as *per se* violations. *See* Federal Trade Comm'n v. Superior Court Trial Lawyers Ass'n, 493 U.S. 411, 110 S.Ct. 768, 107 L.Ed.2d 851 (1990); *National Collegiate Athletic Ass'n v. Board of Regents,* 468 U.S. 85, 100, 104 S.Ct. 2948, 82 L.Ed.2d 70 (1984); *Socony-Vacuum,* 310 U.S. 150, 223, 60 S.Ct. 811, 84 L.Ed. 1129. A prototypical output restriction raises prices by reducing supply below demand. Here, the volume division among the lysine competitors restricted competition over those sales that would lower the commodity price.

Putting aside for a moment the provision for market growth, the sales volume allocation divided the market's expected demand among the five companies on an annual basis. Each agreed not to sell more than their allotment. If after eleven months of a given year, a producer had reached its allocation, the agreement would require it to turn down any additional sales, thereby limiting its output. If it did not stop sales, the agreement required the over-limit producer to purchase an amount equal to its excess from a producer who had fallen short. This would erase the effect of the surplus sales, returning the producer to a state as if it had limited its output.

The agreement allowing for market growth did not change the essential nature of the sales volume allocation as a volume limitation; it merely allowed for per-producer volume limits in a growing market. An output limitation in a static market might give each producer a specific tonnage that it could sell. In a growing market, an output limitation could achieve the same end by giving each producer a specific tonnage plus a proportionate share of the growth. Although no one could know exactly how much the market would grow until the final numbers were in, fairly good estimates could be made, and any errors could be corrected at the year-end accounting. This meant that, as in the static market scenario, a producer that reached its expected limit by the start of the eleventh month would be prohibited from making any additional sales. The volume agreement, then, limited competition over those sales that would lower the price, and as we said in *General Leaseways,* 744 F.2d at 594, such an agreement can be treated as a *per se* offense.

The conspirators began discussing the volume limits at their first meeting in Mexico City when Wilson proposed the idea and explained its vital importance to the overall scheme to control the industry. Ajinomoto, ADM and the others began haggling over how much each would be allowed to produce. This argument continued until Andreas and Yamada met in Irvine, and Andreas threatened to flood the market unless Ajinomoto agreed to the volume limits. The conspirators left this meeting with an agreement that Ajinomoto would sell 84,000 tons of lysine and ADM would sell 67,000 tons, with adjustments for expected growth in the market. This agreement constituted an output limitation, which long has been condemned as a *per se* violation of the Sherman Act. Therefore, the jury instruction correctly advised the jurors of the required elements of a § 1 violation.

Although output limitations have been treated under the *per se* rule, the Supreme Court has recognized special circumstances when horizontal agreements on production could be pro-competitive and therefore treated under rule of reason analysis. *See* NCAA, 468 U.S. at 117, 104 S.Ct. 2948; *Broadcast Music,* 441 U.S. at 19, 99 S.Ct. 1551. In these case, output limitations have been shown to be potentially pro-competitive because of the unique nature of the product involved, and therefore the cases merited rule of reason treatment. In *NCAA,* the output restriction addressed declining fan attendance caused by widespread television coverage of the athletic contests. Without some restriction on television coverage, the schools feared they would lose too much ticket-based revenue to continue holding games at all.

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Here, the district court found nothing in the record that rose to the level of the special circumstances in *NCAA* and *Broadcast Music* to warrant departure from *per se* treatment. Nothing suggests that a market allocation was necessary to maintain a competitive industry. In contrast to *NCAA,* where each school's athletic program relied on the continued existence of competing schools to stage intercollegiate games, each lysine competitor could have continued selling its product without the others. While market demand might not support the full production of five companies at a profitable price, this fact does not distinguish lysine from many other markets. ADM's entrance into the market may have resulted in oversupply and lower prices for consumers, but this does not grant a license to violate the antitrust laws.

*D. Intent Requirement*

Andreas and Wilson next appeal the district court's refusal to give a requested instruction highlighting their defense theory on intent. The defendants argued at trial that whenever they seemed to be agreeing and conspiring with their competitors to violate the antitrust laws, they were actually playing a clever game of deception. By pretending to agree, they sought to put the Asian companies at a disadvantage so that they would share information and fall into a false sense of security, while ADM aggressively pursued new customers. Their proposed intent instruction would have advised the jury that an agreement does not exist if "one party did not intend to abide by the agreement." We review *de novo* a district court's decision to give or not to give a jury instruction, *see* United States v. Brack, 188 F.3d 748, 761 (7th Cir.1999), but review the language of an instruction with great deference, upholding instructions that "are accurate statements of the law and which are supported by the record." *United States v. Vang,* 128 F.3d 1065, 1069 (7th Cir.1997) *(quoting Doe v. Johnson,* 52 F.3d 1448, 1456 (7th Cir.1995)).

We agree that a defendant's subjective intent is a required element of a criminal antitrust violation, *see* United States v. United States Gypsum Co., 438 U.S. 422, 434-36, 98 S.Ct. 2864, 57 L.Ed.2d 854 (1978), and that a defendant who pretended to agree but did not intend to honor the agreement could not be convicted of a crime. *See* United States v. Bestway Disposal Corp., 724 F.Supp. 62, 67 (S.D.N.Y.1988). However, we reject the defendants' claim of error for two reasons.

First, the defendants' theory was not supported by any evidence in the record. A defense jury instruction must be given only if "the instruction reflects a theory that is supported by the evidence." *United States v. Fawley,* 137 F.3d 458, 468 (7th Cir.1998) (citation omitted). Andreas and Wilson presented no evidence, nor did any emerge during the government's case in chief, that they never intended to abide by the agreements. In fact, all evidence showed they fully intended to abide by the agreement. Some of the witnesses testified to distrust among the conspirators, but the evidence showed a lack of trust in their co-conspirators to abide by the agreement, not a lack of intent that they themselves would abide by it. The conspirators actually instituted verification measures to force each other to abide by the terms of their agreement and eliminate the potential incentive for themselves and each other to cheat. ADM, through Wilson and Whitacre, proposed these verification measures, belying any reasonable possibility that they intended to cheat.

Second, the jury instructions as given adequately covered this possible defense theory. A defense jury instruction must be given only if "the instruction reflects a theory which is not already part of the charge." *Id.* The district court instructed the jury:

> [Y]ou must determine whether the evidence shows beyond a reasonable doubt that the defendant knowingly and intentionally became a member of the charged conspiracy to fix prices and allocate sales volumes. "Knowingly" means that the defendant realized what he was doing and was aware of the nature of his conduct and did not act through ignorance, mistake, or accident.
>
> In order to find that the defendant acted knowingly, you must find that he voluntarily and intentionally became a member of the conspiracy charged in the indictment, knowing of its goal and intending to help accomplish it.

A supposed conspirator who only pretended to agree to abide by an agreement would not "know[ ] of its goal and intend [ ] to help accomplish it." If the jury had a reasonable doubt whether Wilson, Whitacre and Andreas intended to abide by the agreement, this instruction would prevent the jury from convicting them.

The defendants sought an instruction that explained their theory in much more argumentative detail, but the court was under no obligation to render it. *See* Brack, 188 F.3d at 761; *United States v. Given,* 164 F.3d 389, 394 (7th Cir.1999). *U.S. Gypsum* requires reversal when the instruction allows conviction on an incorrect theory of the law. 438 U.S. at 446, 98

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S.Ct. 2864. For example, the district court in *U.S. Gypsum* gave an instruction that allowed the jury to convict the defendant entirely on an anticompetitive "effects" theory, which did not require a finding of criminal intent at all. *Id.* at 434-36, 98 S.Ct. 2864. The Supreme Court reversed because the "effects" instruction did not adequately reflect the statute and held that criminal intent required both an intent to enter the agreement and an intent to effectuate the goal of the conspiracy. *Id.* In contrast, the district court's instruction in this case that the defendants must have intended to "help accomplish" the known goal of the conspiracy is entirely consistent with the reasoning and holding of *U.S. Gypsum.*

*E. Sufficiency of the Evidence*

Andreas next asks us to overturn the jury's verdict because there was insufficient evidence to support it. We will overturn a jury verdict "only if the record contains no evidence, regardless of how it is weighed, from which the jury could find guilt beyond a reasonable doubt." *United States v. Agostino,* 132 F.3d 1183, 1192 (7th Cir.1997). We view "the evidence in the light most favorable to the prosecution," and decide whether "*any* rational trier of fact could have found the essential elements of the crime beyond a reasonable doubt." *Agostino,* 132 F.3d at 1192 (quoting *Jackson v. Virginia,* 443 U.S. 307, 319, 99 S.Ct. 2781, 61 L.Ed.2d 560 (1979)).

Andreas attended three meetings of the conspirators and served a vital role in the successful efforts to reach an agreement to implement the price- fixing and volume deals. The jury viewed videotape recordings of Andreas' meetings with the admitted co-conspirators and heard Andreas threaten to flood the market if they did not agree. Evidence at trial indicated that the details of the plan were arranged by upper management, but that all sides recognized that their corporate superiors remained in control of the deal and would be called in to settle any unresolved disputes. This in fact happened when the conspirators could not reach an agreement on output; Andreas and Yamada were called in as the deal closers, and they succeeded in that role. At the Irvine meeting, Andreas expressed his concerns about the management of the Asian firms in regard to whether they would be able to carry out their part of the price-fixing scheme. A jury rationally could understand Andreas' words at this meeting only to indicate his knowledge of, participation in and control of the entire plot.

Furthermore, Andreas directly supervised Wilson and Whitacre. They reported the results of the meetings to him, and he on more than one occasion coached them on what to say at an upcoming meeting. Evidence showed Andreas knew that the conspirators were working on a price deal and a volume deal and gave Whitacre orders on how to set up the volume agreement. In an April 1993 conversation heard by the jury, Andreas called Whitacre into his office before a meeting of the cartel and told Whitacre to pretend he was Yamada. Andreas then rehearsed for Whitacre what he would say to Yamada: "We go over there and say to 'em like we've thought it over carefully. Uhm, we know that you feel that we shouldn't be at the same size as you at this stage ... we've decided that the best thing for the industry would be that you and I decide that we will stay the same size." The FBI also caught Andreas on tape threatening the Asian companies and insisting on how he thought the volume production should be divided.

It would require a great leap of imagination to believe that Andreas knew nothing of the illegal deals on price and output carried out by his direct subordinates, yet happened to play a key role in Irvine and at subsequent meetings to facilitate those deals. The jury apparently, and reasonably, considered insincere and facetious Andreas' occasional statements that ADM would not do anything illegal at a time when he was actively playing a vital role in achieving a criminal purpose. In fact, the jury heard the conspirators laughing when Wilson reported Andreas' "we don't make deals" statement. None of the conspirators believed this, and the jury certainly was not required to believe it either. Based on the overwhelming evidence presented at trial, we cannot conclude that the jury acted irrationally in convicting Andreas of conspiring to restrain trade.

*F. Closing Arguments*

[In this section of the opinion, the Court concludes that the government's lawyers did not impermissibly vouch for their witnesses or violate the defendants' Fifth Amendment right not to be compelled to testify against themselves in their closing arguments.]

*G. Sentencing*

The defendants and the government each appeal one issue related to sentencing. The first, whether "volume of commerce" includes all sales or some subset of all sales affected by the conspiracy, is a question of law, which we review *de novo. See United States v. McClanahan,* 136 F.3d 1146, 1149 (7th Cir.1998). However, once we determine the

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correct legal principle, we review deferentially the lower court's findings of fact regarding the volume of commerce affected. *See United States v. Hammick,* 36 F.3d 594, 597-98 *(7th Cir.1994)* (holding that factual findings in sentencing context are reviewed for clear error). The second issue is whether the district court correctly denied a sentencing enhancement based on the defendants' leadership roles in the conspiracy, a factual finding which we also review for clear error. *See id.*

*1. Volume of Commerce Enhancement*

The district court enhanced Andreas' and Wilson's sentences based on a volume of commerce affected by the conspiracy greater than $100 million. *See* U.S. Sentencing Guidelines Manual § 2R1.1(b)(2)(G). After an evidentiary hearing, at which both sides presented evidence and argument regarding the amount of sales affected by the conspiracy, the court accepted the report of the U.S. Probation Office that the volume of commerce amounted to $168 million. The court, relying in part on the Sixth Circuit's opinion in *United States v. Hayter Oil Co.,* 51 F.3d 1265 (6th Cir.1995), rejected the defendants' argument that "affected commerce" means only that quantity sold at the targeted price and determined that "affected commerce" includes all sales made within the scope of the conspiracy, which amounted conservatively to $168 million.

Wilson and Andreas contend that "affected commerce" means only sales that reflect a successful price agreement, meaning sales at or above the target price. This is clearly wrong. When construing the Guidelines, we look first to the plain language, and where that is unambiguous we need look no further. This is one of those cases.

Section 2R1.1 directs the court to increase the base offense level by seven if the "volume of commerce attributable to the defendant" was more than $100 million. It then explains that "the volume of commerce attributable to an individual participant in a conspiracy is the volume of commerce done by him or his principal in goods or services that were affected by the violation." U.S.S.G. § 2R1.1. The plain language of this section makes clear that the volume of commerce includes only those sales "affected by the violation," rather than *all sales.* However, "affected" is a very broad term whose breadth does not support the unduly constricted meaning given to it by the defendants, *i.e.,* only those sales made at the price set by the conspirators. In this view, had the price been 70-cents per pound and the conspirators agreed to raise it to $1.05, none of the subsequent sales between $.70 and $1.04 would be affected by the conspiracy. This interpretation is ridiculous. To support this view, the defendants cite a district court case from New York. *See United States v. SKW Metals & Alloys,* 4 F.Supp.2d 166, 172 (W.D.N.Y.1997). The Second Circuit, agreeing that this argument is plainly wrong, reversed *SKW Metals* after Andreas and Wilson filed their initial briefs. *See United States v. SKW Metals & Alloys, Inc.,* 195 F.3d 83, 91 (2d Cir.1999) *("SKW Metals II").* In their reply, the defendants now argue that, consistent with *SKW Metals II,* no sales were affected by the conspiracy because the conspiracy was entirely, or almost entirely, ineffective.

In *Hayter Oil,* the court held that "affected" meant all sales "during the period of the conspiracy, without regard to whether individual sales were made at the target price." 51 F.3d at 1273. *Hayter Oil* involved a simple conspiracy by gasoline station owners in a Tennessee town to set prices at a certain above-market level. Because of competition from non-conspirators and cheating by conspirators, the price did not always hold at the agreed level, and frequent meetings of the conspirators were required to reestablish the price. The district court sentenced the defendants based on sales only at the agreed level and not on all sales affected by the conspiracy. *See id.* at 1272. The Sixth Circuit reversed and held that the plain language of the Guidelines allowed for a much broader definition of "affected," including "all commerce that was influenced, directly or indirectly, by the price-fixing conspiracy." *Id.* at 1273. That would include sales made above the market price, even though below the target price. Ultimately, the court held that standard may have encompassed all sales of gasoline, assuming that all sales were a penny or more above the market price. To that extent, we would agree with the outcome of *Hayter Oil* to include all sales during the time period of the conspiracy, but would disagree to the extent that it forecloses the possibility that some sales might have been unaffected even though occurring during the conspiracy.

The Sixth Circuit reasoned that a broad definition of affected would encompass "even sales lost due to, in accordance with the normal economic principles of supply and demand, the decreased demand that accompanies higher prices." *Id.* We agree in principle with this focus on sales broadly affected by the changed dynamics of a market influenced by illegal restraints. Economic decisions, such as pricing and production, depend on the interplay of a host of variables, none of which can act "independently" in any meaningful sense of that word. In most cases,

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an agreement to raise prices necessarily affects demand, which will affect output, and the burden to show that some sales were "unaffected" is a difficult one.

However, like the Second Circuit, we disagree with the *Hayter Oil* holding in so far as it implies that all sales during the time period of the price- fixing conspiracy should be counted for purposes of § 2R1.1 simply because they occurred during the period of the conspiracy. While *Hayter Oil* reflects a possible and not unreasonable reading of the Guidelines, it is not the most natural one. Section 2R1.1 counts "the volume of commerce done by him or his principal in goods or services that were affected by the violation." Recognizing that many companies have multiple product lines that compete in separate markets, this language may simply instruct the court to count only the commerce in the product line that was the subject of the illegal agreement. "Affected" might mean all sales of lysine, which was a product line within the scope of the agreement, but not corn oil, which was not. That reading would permit counting all lysine sales during the time period of the conspiracy and even those sales at or below the market price.

Although a permissible reading, we do not adopt *Hayter Oil* because the purpose of the § 2R1.1 enhancement is to gauge the harm inflicted by the illegal agreement. *See* U.S.S.G. § 2R1.1 background para. 4 ("Tying the offense level to the scale or scope of the offense is important in order to ensure that the sanction is in fact punitive ... [but] damages are difficult and time consuming to establish. The volume of commerce is an acceptable and more readily measurable substitute [for determining the scale of the offense]."). Theoretically, sales that were entirely unaffected did not harm consumers and therefore should not be counted for sentencing because they would not reflect the scale or scope of the offense.

In *SKW Metals II,* the Second Circuit agreed with *Hayter Oil* in reversing the trial court's judgment that affected sales meant only sales at or above the target price in a price-fixing conspiracy. *See* 195 F.3d at 90. The court also adopted a broad reading of "affected" in line with the realities of the economic marketplace in which few things are ever truly "unaffected" by other market forces. *See id.* The court reasoned that "[s]ales can be 'affected' by a conspiracy when the conspiracy merely acts upon or influences negotiations, sale prices, the volume of goods sold, or other transactional terms. While a price-fixing conspiracy is operating ... it is reasonable to conclude that all sales made by defendants during that period are 'affected.' " *Id.* The court refused to adopt the government's categorical position that all sales be counted regardless of whether they were "affected" by the conspiracy. *Id.* at 91-92.

An action may affect commerce in many ways other than achieving a pre- determined price level, and we will not frustrate the goal of this provision by grafting some narrow meaning onto the ordinary use of the word "affected." The Guidelines provision serves to set the punishment based on a measurement of the harm done by the crime, and the drafters chose "volume of commerce" as a proxy for determining that harm. Conspiracies to limit output have broad-ranging effects on all decisions made by the former competitors from the moment of their inception. Decisions to expand production, decrease price, institute promotions or compete for certain customers all are affected by an agreement to limit production. *See SKW Metals II,* 195 F.3d at 90. An agreement to raise prices, similarly, affects the conspirators' decisions related to production and consumers' decisions related to demand. Therefore, the presumption must be that all sales during the period of the conspiracy have been affected by the illegal agreement, since few if any factors in the world of economics can be held in strict isolation.

Still, it is conceivable that under a price agreement, sales made before new price schedules are issued or new quotes given to potential customers may be wholly unaffected, or that some subsequent sales might be sold at the actual market price. *See, e.g., id.* at 93 (Newman, J., concurring) (positing example of "rare instance" where a supplier may quote a bargain price for his brother-in-law without regard to the agreed price).[FN10] We agree with the Second Circuit that these odd sales completely unaffected by the conspiracy should not be counted for sentencing purposes. *See id.* at 92.

FN10. We acknowledge this example as one of the rare instances when a price fixer would forgo anticompetitive profits, but it also illustrates how rare the occasion when a price fixer able to charge higher prices would act in an economically irrational way and sell below the inflated market price.

The burden of proof under the Guidelines requires only that the government establish relevant conduct by a preponderance of the evidence, *see United States v. Kroledge,* 201 F.3d 900, 908-09 (7th Cir.2000), a standard that supports a rebuttable presumption that all sales during the conspiracy were

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affected by the illegal agreement. *See SKW Metals II,* 195 F.3d at 93-94. (Newman, J., concurring) (requiring defendant prove that one or more sales were not affected by the conspiracy). Courts frequently require defendants to prove affirmative defenses by a preponderance of the evidence, *see, e.g., United States v. Hunte,* 196 F.3d 687, 693 (7th Cir.1999) (requiring defendant to prove basis for a downward departure by a preponderance of the evidence); United States v. Wicks, 132 F.3d 383, 389 (7th Cir.1997) (holding that a defendant must prove an affirmative defense at sentencing stage by a preponderance of evidence). Evidence of the "rare circumstance" of a completely unaffected transaction "would be peculiarly within the knowledge of the defendant," *SKW Metals II,* 195 F.3d at 93, and the defendant should bear the burden of proving that rare circumstance by a preponderance of the evidence.

Because horizontal agreements to restrain trade, whether by price or output restrictions, naturally affect all sales during the period that the conspiracy operates, the trial court correctly determined the volume of commerce based on all sales within the scope of the conspiracy. Andreas and Wilson presented evidence at sentencing that certain sales were not affected, and the district court considered that proof. The lysine conspiracy restrained trade by allocating each market participant's output and fixing prices. Together these two methods served to raise the price beginning in the summer of 1992 and lasting for nearly three years. The price fluctuated, and cartel members cheated each other when they could, but the evidence soundly supports a volume of commerce influenced by the conspiracy of at least $168 million. Based on the evidence at trial, the court was entitled to find that the conspiracy was indeed successful at affecting more than $100 million in commerce.

*2. Leadership Roles*

The government requested that Andreas' and Wilson's sentences be increased based on their leadership roles in the conspiracy. *See* U.S.S.G. § 3B1.1. The district court denied the enhancement, finding that neither man was more culpable than his co-conspirators. We review for clear error the district court's application of a sentencing enhancement under § 3B1.1. *See United States v. Golden,* 954 F.2d 1413, 1418 (7th Cir.1992).

Section 3B1.1 enhances a defendant's sentence based on the defendant's role in the offense. An organizer or leader of a criminal activity that "involved five or more participants or was otherwise extensive" receives a four-level increase, while a manager or supervisor earns a three-level increase. *See* U.S.S.G. § 3B1.1(a), (b). Section 3B1.1 requires that the district court find that the "defendant organized or supervised a criminal activity involving four other participants." *United States v. Kamoga,* 177 F.3d 617, 621 (7th Cir.1999). The district court found that the conspiracy satisfied the size requirements of § 3B1.1in , but that Andreas and Wilson did not control the requisite number of participants to merit the increase. *See United States v. Mustread,* 42 F.3d 1097, 1103 (7th Cir.1994). After reviewing the record, we hold that the district court erred in making this finding of fact.

Evidence submitted at trial and during the sentencing phase indicated that at least three sales executives--Marty Allison, Alfred Jansen and John Ashley--in addition to Andreas, Wilson and Whitacre, helped to implement the pricing and volume allocation schemes. Even discounting Whitacre, who was a government agent during part of the conspiracy and therefore cannot be counted as a participant for that part, *see* U.S.S.G. § 3B1.1 application note 1, the crime still involved the requisite number of participants for an enhancement.

Furthermore, the court should have considered Andreas' control over the foreign co-conspirators at the Irvine meeting as counting toward the minimum number of participants needed for the § 3B1.1 enhancement. A co- conspirator who used his power to guide or direct other conspirators qualifies as an organizer even though his control was not absolute. *See Kamoga,* 177 F.3d at 621. The need to negotiate some details of the conspiracy with the cartel members also does not strip a defendant of the organizer role. *See United States v. Evans,* 92 F.3d 540, 545 (7th Cir.1996) (recognizing possibility of collective leadership fulfilling § 3B1.1); *United States v. Barnes,* 993 F.2d 680, 685 (9th Cir.1993).

The district court erred in focusing on the conspiracy as a union of equals, which it was only in part. Neither the Guidelines nor our cases require the "participants" to be mere drones working for their queen. In *Evans,* 92 F.3d at 545, we recognized the "concept of collective leadership," which is the case here. Evidence from the Irvine meeting showed that Andreas used coercive power to force the foreign competitors to accept ADM's leadership role in the cartel, demonstrating his control over the cartel and its participants. When the cartel had internal squabbles and disputes, Andreas was called in to resolve them. ADM's market power gave Andreas the ability to coerce the other cartel members into

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submission, and the evidence is clear that he used that power to lead the conspiracy. The fact that control over co-conspirators was not absolute and that he had to negotiate does not negate the conclusion that Andreas was the ultimate leader of the price-fixing cabal.

The evidence at trial conclusively showed that Wilson engaged in the conspiracy by running the meetings and speaking for ADM. He appears on countless tapes proposing ways to run the cartel and ways to make it more efficient. His entire purpose in attending lysine meetings as the head of the corn processing division was to bring his management skills to the cartel. Neither he nor Andreas can claim in any meaningful way to be merely equally culpable with the other conspirators since it was ADM that suggested the scheme, planned it and carried it out. Therefore, we find the district court's decision to deny the four- and three-level enhancements for Andreas and Wilson, respectively, to be clearly erroneous.

*III. CONCLUSION*

For the reasons stated above, the convictions of Andreas and Wilson are AFFIRMED and the cases are REMANDED to the district court for resentencing in accordance with this opinion.

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United States Sentencing Commission
Guidelines Manual
Effective November 1, 1987, Including Amendments Effective January 1, 1988, through November 1, 2001 [FNa]

Chapter Two - Offense Conduct
Part R - Antitrust Offenses

## §2R1.1. BID-RIGGING, PRICE-FIXING OR MARKET-ALLOCATION AGREEMENTS AMONG COMPETITORS

(a) Base Offense Level: 10

(b) Specific Offense Characteristics

(1) If the conduct involved participation in an agreement to submit non-competitive bids, increase by 1 level.

(2) If the volume of commerce attributable to the defendant was more than $400,000, adjust the offense level as follows:

| Volume of Commerce (Apply the Greatest) | | Adjustment to Offense Level |
|---|---|---|
| (A) | More than $400,000 | add 1 |
| (B) | More than $1,000,000 | add 2 |
| (C) | More than $2,500,000 | add 3 |
| (D) | More than $6,250,000 | add 4 |
| (E) | More than $15,000,000 | add 5 |
| (F) | More than $37,500,000 | add 6 |
| (G) | More than $100,000,000 | add 7. |

For purposes of this guideline, the volume of commerce attributable to an individual participant in a conspiracy is the volume of commerce done by him or his principal in goods or services that were affected by the violation. When multiple counts or conspiracies are involved, the volume of commerce should be treated cumulatively to determine a single, combined offense level.

(c) Special Instruction for Fines

(1) For an individual, the guideline fine range shall be from one to five percent of the volume of commerce, but not less than $20,000.

(d) Special Instructions for Fines - Organizations

(1) In lieu of the pecuniary loss under subsection (a)(3) of §8C2.4 (Base Fine),

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use 20 percent of the volume of affected commerce.

(2) When applying §8C2.6 (Minimum and Maximum Multipliers), neither the minimum nor maximum multiplier shall be less than 0.75.

(3) In a bid-rigging case in which the organization submitted one or more complementary bids, use as the organization's volume of commerce the greater of (A) the volume of commerce done by the organization in the goods or services that were affected by the violation, or (B) the largest contract on which the organization submitted a complementary bid in connection with the bid-rigging conspiracy.

Commentary

Statutory Provision: 15 U.S.C. § 1. For additional statutory provision(s), see Appendix A (Statutory Index).

Application Notes:

1. The provisions of §3B1.1 (Aggravating Role) and §3B1.2 (Mitigating Role) should be applied to an individual defendant as appropriate to reflect the individual's role in committing the offense. For example, if a sales manager organizes or leads the price-fixing activity of five or more participants, a 4- level increase is called for under §3B1.1. An individual defendant should be considered for a downward adjustment under §3B1.2 for a mitigating role in the offense only if he was responsible in some minor way for his firm's participation in the conspiracy.

2. In setting the fine for individuals, the court should consider the extent of the defendant's participation in the offense, his role, and the degree to which he personally profited from the offense (including salary, bonuses, and career enhancement). If the court concludes that the defendant lacks the ability to pay the guideline fine, it should impose community service in lieu of a portion of the fine. The community service should be equally as burdensome as a fine.

3. The fine for an organization is determined by applying Chapter Eight (Sentencing of Organizations). In selecting a fine for an organization within the guideline fine range, the court should consider both the gain to the organization from the offense and the loss caused by the organization. It is estimated that the average gain from price-fixing is 10 percent of the selling price. The loss from price-fixing exceeds the gain because, among other things, injury is inflicted upon consumers who are unable or for other reasons do not buy the product at the higher prices. Because the loss from price-fixing exceeds the gain, subsection (d)(1) provides that 20 percent of the volume of affected commerce is to be used in lieu of the pecuniary loss under §8C2.4(a)(3). The purpose for specifying a percent of the volume of commerce is to avoid the time and expense that would be required for the court to determine the actual gain or loss. In cases in which the actual monopoly overcharge appears to be either substantially more or substantially less than 10 percent, this factor should be considered in setting the fine within the guideline fine range.

4. Another consideration in setting the fine is that the average level of mark-up due to price-fixing may tend to decline with the volume of commerce involved.

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5. It is the intent of the Commission that alternatives such as community confinement not be used to avoid imprisonment of antitrust offenders.

6. Understatement of seriousness is especially likely in cases involving complementary bids. If, for example, the defendant participated in an agreement not to submit a bid, or to submit an unreasonably high bid, on one occasion, in exchange for his being allowed to win a subsequent bid that he did not in fact win, his volume of commerce would be zero, although he would have contributed to harm that possibly was quite substantial. The court should consider sentences near the top of the guideline range in such cases.

7. In the case of a defendant with previous antitrust convictions, a sentence at, or even above, the maximum of the applicable guideline range may be warranted. See §4A1.3 (Adequacy of Criminal History Category).

Background: These guidelines apply to violations of the antitrust laws. Although they are not unlawful in all countries, there is near universal agreement that restrictive agreements among competitors, such as horizontal price-fixing (including bid-rigging) and horizontal market-allocation, can cause serious economic harm. There is no consensus, however, about the harmfulness of other types of antitrust offenses, which furthermore are rarely prosecuted and may involve unsettled issues of law. Consequently, only one guideline, which deals with horizontal agreements in restraint of trade, has been promulgated.

The agreements among competitors covered by this section are almost invariably covert conspiracies that are intended to, and serve no purpose other than to, restrict output and raise prices, and that are so plainly anticompetitive that they have been recognized as illegal per se, i.e., without any inquiry in individual cases as to their actual competitive effect. The Commission believes that the most effective method to deter individuals from committing this crime is through imposing short prison sentences coupled with large fines. The controlling consideration underlying this guideline is general deterrence.

Under the guidelines, prison terms for these offenders should be much more common, and usually somewhat longer, than typical under pre-guidelines practice. Absent adjustments, the guidelines require confinement of six months or longer in the great majority of cases that are prosecuted, including all bid-rigging cases. The court will have the discretion to impose considerably longer sentences within the guideline ranges. Adjustments from Chapter Three, Part E (Acceptance of Responsibility) and, in rare instances, Chapter Three, Part B (Role in the Offense), may decrease these minimum sentences; nonetheless, in very few cases will the guidelines not require that some confinement be imposed. Adjustments will not affect the level of fines.

Tying the offense level to the scale or scope of the offense is important in order to ensure that the sanction is in fact punitive and that there is an incentive to desist from a violation once it has begun. The offense levels are not based directly on the damage caused or profit made by the defendant because damages are difficult and time consuming to establish. The volume of commerce is an acceptable and more readily measurable substitute. The limited empirical data available as to pre-guidelines practice showed that fines increased with the volume of commerce and the term of imprisonment probably did as well.

The Commission believes that the volume of commerce is liable to be an understated measure of seriousness in some bid-rigging cases. For this reason, and consistent

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with pre-guidelines practice, the Commission has specified a 1- level increase for bid-rigging.

Substantial fines are an essential part of the sentence. For an individual, the guideline fine range is from one to five percent of the volume of commerce, but not less than $20,000. For an organization, the guideline fine range is determined under Chapter Eight (Sentencing of Organizations), but pursuant to subsection (d)(2), the minimum multiplier is at least 0.75. This multiplier, which requires a minimum fine of 15 percent of the volume of commerce for the least serious case, was selected to provide an effective deterrent to antitrust offenses. At the same time, this minimum multiplier maintains incentives for desired organizational behavior. Because the Department of Justice has a well- established amnesty program for organizations that self-report antitrust offenses, no lower minimum multiplier is needed as an incentive for self- reporting. A minimum multiplier of at least 0.75 ensures that fines imposed in antitrust cases will exceed the average monopoly overcharge.

The Commission believes that most antitrust defendants have the resources and earning capacity to pay the fines called for by this guideline, at least over time on an installment basis. The statutory maximum fine is $350,000 for individuals and $10,000,000 for organizations, but is increased when there are convictions on multiple counts.

Historical Note: Effective November 1, 1987. Amended effective November 1, 1989 (see Appendix C, amendments 211 and 303); November 1, 1991 (see Appendix C, amendments 377 and 422).

[FNa]. Incorporating amendments effective January 15, 1988; June 15, 1988; October 15, 1988; November 1, 1989; November 1, 1990; November 1, 1991; November 1, 1992; November 1, 1993; November 1, 1994; November 1, 1995; November 1, 1996; November 1, 1997; November 1, 1998; November 1, 1999; November 1, 2000; and November 1, 2001.

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MI 99 S.Ct. 1551
60 L.Ed.2d 1, 201 U.S.P.Q. 497, 1979-1 Trade Cases P 62,558, 1978-81 Copr.L.Dec. P 25,064
**(Cite as: 441 U.S. 1, 99 S.Ct. 1551)**

Supreme Court of the United States

BROADCAST MUSIC, INC., et al., Petitioners,
v.
COLUMBIA BROADCASTING SYSTEM, INC., et al.
AMERICAN SOCIETY OF COMPOSERS, AUTHORS AND PUBLISHERS, et al., Petitioners,
v.
COLUMBIA BROADCASTING SYSTEM, INC., et al.

**Nos. 77-1578, 77-1583.**

Argued Jan. 15, 1979.
Decided April 17, 1979.

Mr. Justice WHITE delivered the opinion of the Court.

This case involves an action under the antitrust and copyright laws brought by respondent Columbia Broadcasting System, Inc. (CBS), against petitioners, American Society of Composers, Authors and Publishers (ASCAP) and Broadcast Music, Inc. (BMI), and their members and affiliates.[FN1] The basic question presented is whether the issuance by ASCAP and BMI to CBS of blanket licenses to copyrighted musical compositions at fees negotiated by them is price fixing *per se* unlawful under the antitrust laws.

FN1. The District Court certified the case as a defendant class action. 400 F.Supp. 737, 741 n. 2 (S.D.N.Y.1975).

I

CBS operates one of three national commercial television networks, supplying programs to approximately 200 affiliated stations and telecasting approximately 7,500 network programs per year. Many, but not all, of these programs make use of copyrighted music recorded on the soundtrack. CBS also owns television and radio stations in various cities. It is " 'the giant of the world in the use of music rights,' " the " 'No. 1 outlet in the history of entertainment.' " [FN2]

FN2. *Id.*, at 771, quoting a CBS witness. CBS is also a leading music publisher, with publishing subsidiaries affiliated with both ASCAP and BMI, and is the world's largest manufacturer and seller of records and tapes. *Ibid.*

Since 1897, the copyright laws have vested in the owner of a copyrighted musical composition the exclusive right to perform the work publicly for profit,[FN3] but the legal right is not self-enforcing. In 1914, Victor Herbert and a handful of other composers organized ASCAP because those who performed copyrighted music for profit were so numerous and widespread, and most performances so fleeting, that as a practical matter it was impossible for the many individual copyright owners to negotiatewith and license the users and to detect unauthorized uses. "ASCAP was organized as a 'clearing-house' for copyright owners and users to solve these problems" associated with the licensing of music. 400 F.Supp. 737, 741 (S.D.N.Y.1975). As ASCAP operates today, its 22,000 members grant it nonexclusive rights to license nondramatic performances of their works, and ASCAP issues licenses and distributes royalties to copyright owners in accordance with a schedule reflecting the nature and amount of the use of their music and other factors.

FN3. Act of Jan. 6, 1897, 29 Stat. 481.

BMI, a nonprofit corporation owned by members of the broadcasting industry, [FN4] was organized in 1939, is affiliated with or represents some 10,000 publishing companies and 20,000 authors and composers, and operates in much the same manner as ASCAP. Almost every domestic copyrighted composition is in the repertory either of ASCAP, with a total of three million compositions, or of BMI, with one million.

FN4. CBS was a leader of the broadcasters who formed BMI, but it disposed of all of its interest in the corporation in 1959. 400 F.Supp., at 742.

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Both organizations operate primarily through blanket licenses, which give the licensees the right to perform any and all of the compositions owned by the members or affiliates as often as the licensees desire for a stated term. Fees for blanket licenses are ordinarily a percentage of total revenues or a flat dollar amount, and do not directly depend on the amount or type of music used. Radio and television broadcasters are the largest users of music, and almost all of them hold blanket licenses from both ASCAP and BMI. Until this litigation, CBS held blanket licenses from both organizations for its television network on a continuous basis since the late 1940's and had never attempted to secure any other form of license from either ASCAP [FN5] or any of its members. *Id.*, at 752-754.

FN5. Unless the context indicates otherwise, references to ASCAP alone in this opinion usually apply to BMI as well. See n. 20, *infra.*

The complaint filed by CBS charged various violations of the Sherman Act [FN6] and the copyright laws.[FN7] CBS argued that ASCAP and BMI are unlawful monopolies and that the blanket license is illegal price fixing, an unlawful tying arrangement, a concerted refusal to deal, and a misuse of copyrights. The District Court, though denying summary judgment to certain defendants, ruled that the practice did not fall within the *per se* rule. 337 F.Supp. 394, 398 (S.D.N.Y.1972). After an 8-week trial, limited to the issue of liability, the court dismissed the complaint, rejecting again the claim that the blanket license was price fixing and a *per se* violation of § 1 of the Sherman Act, and holding that since direct negotiation with individual copyright owners is available and feasible there is no undue restraint of trade, illegal tying, misuse of copyrights, or monopolization. 400 F.Supp., at 781-783.

FN6. 15 U.S.C. §§ 1 and 2.

FN7. CBS seeks injunctive relief for the antitrust violations and a declaration of copyright misuse. 400 F.Supp., at 741.

Though agreeing with the District Court's factfinding and not disturbing its legal conclusions on the other antitrust theories of liability,[FN8] the Court of Appeals held that the blanket license issued to television networks was a form of price fixing illegal *per se* under the Sherman Act. 562 F.2d 130, 140 (CA2 1977). This conclusion, without more, settled the issue of liability under the Sherman Act, established copyright misuse,[FN9] and required reversal of the District Court's judgment, as well as a remand to consider the appropriate remedy.[FN10]

FN8. The Court of Appeals affirmed the District Court's rejection of CBS's monopolization and tying contentions but did not rule on the District Court's conclusion that the blanket license was not an unreasonable restraint of trade. *See* 562 F.2d 130, 132, 135, 141 n. 29 (CA2 1977).

FN9. At CBS's suggestion, the Court of Appeals held that the challenged conduct constituted misuse of copyrights solely on the basis of its finding of unlawful price fixing. *Id.*, at 141 n. 29.

FN10. The Court of Appeals went on to suggest some guidelines as to remedy, indicating that despite its conclusion on liability the blanket license was not totally forbidden. The Court of Appeals said:
"Normally, after a finding of price-fixing, the remedy is an injunction against the price-fixing--in this case, the blanket license. We think, however, that if on remand a remedy can be fashioned which will ensure that the blanket license will not affect the price or negotiations for direct licenses, the blanket license need not be prohibited in all circumstances. The blanket license is not simply a 'naked restraint' ineluctably doomed to extinction. There is not enough evidence in the present record to compel a finding that the blanket license does not serve a market need for those who wish full protection against infringement suits or who, for some other business reason, deem the blanket license desirable. The blanket license includes a practical covenant not to sue for infringement of any ASCAP copyright as well as an indemnification against suits by others.
"Our objection to the blanket license is that it reduces price competition among the members and provides a disinclination to

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compete. We think that these objections may be removed if ASCAP itself is required to provide some form of per use licensing which will ensure competition among the individual members with respect to those networks which wish to engage in per use licensing." Id., at 140 (footnotes omitted).

ASCAP and BMI petitioned for certiorari, presenting the questions of the applicability of the *per se* rule and of whether this constitutes misuse of copyrights. CBS did not cross petition to challenge the failure to sustain its other antitrust claims. We granted certiorari because of the importance of the issues to the antitrust and copyright laws. 439 U.S. 817, 99 S.Ct. 77, 58 L.Ed.2d 107 (1978). Because we disagree with the Court of Appeals' conclusions with respect to the *per se* illegality of the blanket license, we reverse its judgment and remand the cause for further appropriate proceedings.

II

In construing and applying the Sherman Act's ban against contracts, conspiracies, and combinations in restraint of trade, the Court has held that certain agreements or practices are so "plainly anticompetitive," *National Society of Professional Engineers v. United States,* 435 U.S. 679, 692, 98 S.Ct. 1355, 1365, 55 L.Ed.2d 637 (1978); *Continental T.V., Inc. v. GTE Sylvania, Inc.,* 433 U.S. 36, 50, 97 S.Ct. 2549, 2558, 53 L.Ed.2d 568 (1977), and so often "lack . . . any redeeming virtue," *Northern Pac. R. Co. v. United States,* 356 U.S. 1, 5, 78 S.Ct. 514, 518, 2 L.Ed.2d 545 (1958), that they are conclusively presumed illegal without further examination under the rule of reason generally applied in Sherman Act cases. This *pro se* rule is a valid and useful tool of antitrust policy and enforcement.[FN11] And agreements among competitors to fix prices on their individual goods or services are among those concerted activities that the Court has held to be within the *per se* category.[FN12] But easy labels do not always supply ready answers.

FN11. "This principle of *per se* unreasonableness not only makes the type of restraints which are proscribed by the Sherman Act more certain to the benefit of everyone concerned, but it also avoids the necessity for an incredibly complicated and prolonged economic investigation into the entire history of the industry involved, as well as related industries, in an effort to determine at large whether a particular restraint has been unreasonable--an inquiry so often wholly fruitless when undertaken." *Northern Pac. R. Co. v. United States,* 356 U.S. 1, 5, 78 S.Ct. 514, 518, 2 L.Ed.2d 545 (1958).
See *Continental T.V., Inc. v. GTE Sylvania Inc.,* 433 U.S. 36, 50 n. 16, 97 S.Ct. 2549, 2558 n. 16, 53 L.Ed.2d 568 (1977); *United States v. Topco Associates, Inc.,* 405 U.S. 596, 609 n. 10, 92 S.Ct. 1126, 1134 n. 10, 31 L.Ed.2d 515 (1972).

FN12. See cases discussed in n. 14, *infra.*

A

To the Court of Appeals and CBS, the blanket license involves "price fixing" in the literal sense: the composers and publishing houses have joined together into an organization that sets its price for the blanket license it sells.[FN13] But this is not a question simply of determining whether two or more potential competitors have literally "fixed" a "price." As generally used in the antitrust field, "price fixing" is a shorthand way of describing certain categories of business behavior to which the *per se* rule has been held applicable. The Court of Appeals' literal approach does not alone establish that this particular practice is one of those types or that it is "plainly anticompetitive" and very likely without "redeeming virtue." Literalness is overly simplistic and often overbroad. When two partners set the price of their goods or services they are literally "price fixing," but they are not *per se* in violation of the Sherman Act. See *United States v. Addyston Pipe & Steel Co.,* 85 F. 271, 280 (CA6 1898), aff'd, 175 U.S. 211, 20 S.Ct. 96, 44 L.Ed. 136 (1899). Thus, it is necessary to characterize the challenged conduct as falling within or without that category of behavior to which we apply the label "*per se* price fixing." That will often, but not always, be a simple matter.[FN14]

FN13. CBS also complains that it pays a flat fee regardless of the amount of use it makes of ASCAP compositions and even though many of its programs contain little or no music. We are unable to see how that alone could make out an antitrust violation or misuse of copyrights:
"Sound business judgment could indicate that such payment represents the most

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convenient method of fixing the business value of the privileges granted by the licensing agreement. . . . Petitioner cannot complain because it must pay royalties whether it uses Hazeltine patents or not. What it acquired by the agreement into which it entered was the privilege to use any or all of the patents and developments as it desired to use them." *Automatic Radio Mfg. Co. v. Hazeltine Research, Inc.*, 339 U.S. 827, 834, 70 S.Ct. 894, 898, 94 L.Ed. 1312 (1950).
See also *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100, 89 S.Ct. 1562, 23 L.Ed.2d 129 (1969).

FN14. Cf., *e. g., United States v. McKesson & Robbins, Inc.*, 351 U.S. 305, 76 S.Ct. 937, 100 L.Ed. 1209 (1956) (manufacturer/wholesaler agreed with independent wholesalers on prices to be charged on products it manufactured); *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 60 S.Ct. 811, 84 L.Ed. 1129 (1940) (firms controlling a substantial part of an industry agreed to purchase "surplus" gasoline with the intent and necessary effect of increasing the price); *United States v. Trenton Potteries Co.*, 273 U.S. 392, 47 S.Ct. 377, 71 L.Ed. 700 (1927) (manufacturers and distributors of 82% of certain vitreous pottery fixtures agreed to sell at uniform prices).

Consequently, as we recognized in *United States v. Topco Associates, Inc.*, 405 U.S. 596, 607-608, 92 S.Ct. 1126, 1133, 31 L.Ed.2d 515 (1972), "[i]t is only after considerable experience with certain business relationships that courts classify them as *per se* violations . . . ." See *White Motor Co. v. United States*, 372 U.S. 253, 263, 83 S.Ct. 696, 702, 9 L.Ed.2d 738 (1963). We have never examined a practice like this one before; indeed, the Court of Appeals recognized that "[i]n dealing with performing rights in the music industry we confront conditions both in copyright law and in antitrust law which are *sui generis*." 562 F.2d, at 132. And though there has been rather intensive antitrust scrutiny of ASCAP and its blanket licenses, that experience hardly counsels that we should outlaw the blanket license as a *per se* restraint of trade.

B

This litigation and other cases involving ASCAP and its licensing practices have arisen out of the efforts of the creators of copyrighted musical compositions to collect for the public performance of their works, as they are entitled to do under the Copyright Act. As already indicated, ASCAP and BMI originated to make possible and to facilitate dealings between copyright owners and those who desire to use their music. Both organizations plainly involve concerted action in a large and active line of commerce, and it is not surprising that, as the District Court found, "[n]either ASCAP nor BMI is a stranger to antitrust litigation." 400 F.Supp., at 743.

The Department of Justice first investigated allegations of anticompetitive conduct by ASCAP over 50 years ago.[FN15] A criminal complaint was filed in 1934, but the Government was granted a midtrial continuance and never returned to the courtroom. In separate complaints in 1941, the United States charged that the blanket license, which was then the only license offered by ASCAP and BMI, was an illegal restraint of trade and that arbitrary prices were being charged as the result of an illegal copyright pool. [FN16] The Government sought to enjoin ASCAP's exclusive licensing powers and to require a different form of licensing by that organization. The case was settled by a consent decree that imposed tight restrictions on ASCAP's operations.[FN17] Following complaints relating to the television industry, successful private litigation against ASCAP by movie theaters,[FN18] and a Government challenge to ASCAP's arrangements with similar foreign organizations, the1941 decree was reopened and extensively amended in 1950.[FN19]

FN15. Cohn, Music, Radio Broadcasters and the Sherman Act, 29 Geo.L.J. 407, 424 n. 91 (1941).

FN16. *E. g.*, complaint in *United States v. ASCAP*, Civ. No. 13- 95 (S.D.N.Y.1941), pp. 3-4.

FN17. *United States v. ASCAP*, 1940-1943 Trade Cases ¶ 56,104 (S.D.N.Y.1941).

FN18. See *Alden-Rochelle, Inc. v. ASCAP*, 80 F.Supp. 888 (S.D.N.Y.1948); *M. Witmark & Sons v. Jensen*, 80 F.Supp. 843 (D.C.Minn.1948), appeal dismissed *sub nom. M. Witmark & Sons v. Berger Amusement Co.*, 177 F.2d 515 (CA8 1949).

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*FN19. United States v. ASCAP,* 1950-1951 Trade Cases ¶ 62,595 (S.D.N.Y.1950).

Under the amended decree, which still substantially controls the activities of ASCAP, members may grant ASCAP only nonexclusive rights to license their works for public performance. Members, therefore, retain the rights individually to license public performances, along with the rights to license the use of their compositions for other purposes. ASCAP itself is forbidden to grant any license to perform one or more specified compositions in the ASCAP repertory unless both the user and the owner have requested it in writing to do so. ASCAP is required to grant to any user making written application a nonexclusive license to perform all ASCAP compositions either for a period of time or on a per-program basis. ASCAP may not insist on the blanket license, and the fee for the per-program license, which is to be based on the revenues for the program on which ASCAP music is played, must offer the applicant a genuine economic choice between the per-program license and the more common blanket license. If ASCAP and a putative licensee are unable to agree on a fee within 60 days, the applicant may apply to the District Court ***12** for a determination of a reasonable fee, with ASCAP having the burden of proving reasonableness.[FN20]

FN20. BMI is in a similar situation. The original decree against BMI is reported as *United States v. BMI,* 1940-1943 Trade Cases ¶ 56,096 (E.D.Wis.1941). A new consent judgment was entered in 1966 following a monopolization complaint filed in 1964. *United States v. BMI,* 1966 Trade Cases ¶ 71,941 (S.D.N.Y.). The ASCAP and BMI decrees do vary in some respects. The BMI decree does not specify that BMI may only obtain nonexclusive rights from its affiliates or that the District Court may set the fee if the parties are unable to agree. Nonetheless, the parties stipulated, and the courts below accepted, that "CBS could secure direct licenses from BMI affiliates with the same ease or difficulty, as the case may be, as from ASCAP members." 400 F.Supp., at 745.

The 1950 decree, as amended from time to time, continues in effect, and the blanket license continues to be the primary instrument through which ASCAP conducts its business under the decree. The courts have twice construed thedecree not to require ASCAP to issue licenses for selected portions of its repertory.[FN21] It also remains true that the decree guarantees the legal availability of direct licensing of performance rights by ASCAP members; and the District Court found, and in this respect the Court of Appeals agreed, that there are no practical impediments preventing direct dealing by the television networks if they so desire. Historically, they have not done so. Since 1946, CBS and other television networks have taken blanket licenses from ASCAP and BMI. It was not until this suit arose that the CBS network demanded any other kind of license.[FN22]

FN21. *United States v. ASCAP (Application of Shenandoah Valley Broadcasting, Inc.),* 208 F.Supp. 896 (S.D.N.Y.1962), *aff'd, 331 F.2d 117 (CA2), cert. denied, 377 U.S. 997, 84 S.Ct. 1917, 12 L.Ed.2d 1048 (1964); United States v. ASCAP (Application of National Broadcasting Co.),* 1971 Trade Cases ¶ 73,491 (S.D.N.Y.1970). See also *United States v. ASCAP (Motion of Metromedia, Inc.),* 341 F.2d 1003 (CA2 1965).

FN22. National Broadcasting Co. did, in 1971, request an annual blanket license for 2,217 specific ASCAP compositions most frequently used on its variety shows. It intended to acquire the remaining rights to background and theme music through direct transactions by it and its program packagers. See *United States v. ASCAP (Application of National Broadcasting Co.), supra.*

Of course, a consent judgment, even one entered at the behest of the Antitrust Division, does not immunize the defendant from liability for actions, including those contemplated by the decree, that violate the rights of nonparties. See *Sam Fox Publishing Co. v. United States,* 366 U.S. 683, 690, 81 S.Ct. 1309, 1313, 6 L.Ed.2d 604 (1961), which involved this same decree. But it cannot be ignored that the Federal Executive and Judiciary have carefully scrutinized ASCAP and the challenged conduct, have imposed restrictions on various of ASCAP's practices, and, by the terms of the decree, stand ready to provide further consideration, supervision, and perhaps invalidation of asserted anticompetitive practices.[FN23] In these circumstances, we have a unique indicator that the \fs20softlinechallenged practice may have redeeming

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competitive virtues and that the search for those values is not almost sure to be in vain.[FN24] Thus, although CBS is not bound by the Antitrust Division's actions, the decree is a fact of economic and legal life in this industry, and the Court of Appeals should not have ignored it completely in analyzing the practice. See *id.*, at 694-695, 81 S.Ct., at 1315-1316. That fact alone might not remove a naked price-fixing scheme from the ambit of the *per se* rule, but, as discussed*infra,* Part III, here we are uncertain whether the practice on its face has the effect, or could have been spurred by the purpose, of restraining competition among the individual composers.

FN23. 1950-1951 Trade Cases ¶ 62,595, p. 63,756.

FN24. Cf. *Continental T.V., Inc. v. GTE Sylvania Inc.,* 433 U.S., at 50 n. 16, 97 S.Ct., at 2558 n.16. Moreover, unthinking application of the *per se* rule might upset the balancing of economic power and of procompetitive and anticompetitive effect presumably worked out in the decree.

After the consent decrees, the legality of the blanket license was challenged in suits brought by certain ASCAP members against individual radio stations for copyright infringement. The stations raised as a defense that the blanket license was a form of price fixing illegal under the Sherman Act. The parties stipulated that it would be nearly impossible for each radio station to negotiate with each copyright holder separate licenses for the performance of his works on radio. Against this background, and relying heavily on the 1950 consent judgment, the Court of Appeals for the Ninth Circuit rejected claims that ASCAP was a combination in restraint of trade and that the blanket license constituted illegal price fixing. *K-91, Inc. v. Gershwin Publishing Corp.,* 372 F.2d 1 (1967), cert. denied, 389 U.S. 1045, 88 S.Ct. 761, 19 L.Ed.2d 838 (1968).

The Department of Justice, with the principal responsibility for enforcing the Sherman Act and administering the consent decrees relevant to this case, agreed with the result reached by the Ninth Circuit. In a submission *amicus curiae* opposing one station's petition for certiorari in this Court, the Department stated that there must be "some kind of central licensing agency by which copyright holders may offer their works in a common pool to all who wish to use them." Memorandum for United States as *Amicus Curiae* on Pet. for Cert. in *K-91, Inc. v. Gershwin Publishing Corp.,* O.T. 1967, No. 147, pp. 10- 11. And the Department elaborated on what it thought that fact meant for the proper application of the antitrust laws in this area:

> "The Sherman Act has always been discriminatingly applied in the light of economic realities. There are situations in which competitors have been permitted to form joint selling agencies or other pooled activities, subject to strict limitations under the antitrust laws to guarantee against abuse of the collective power thus created. *Associated Press v. United States,* 326 U.S. 1 [65 S.Ct. 1416, 89 L.Ed. 2013]; *United States v. St. Louis Terminal,* 224 U.S. 383 [32 S.Ct. 507, 56 L.Ed. 810]; *Appalachian Coals, Inc. v. United States,* 288 U.S. 344 [53 S.Ct. 471, 77 L.Ed. 825]; *Chicago Board of Trade v. United States,* 246 U.S. 231 [38 S.Ct. 242, 62 L.Ed. 683]. This case appears to us to involve such a situation. The extraordinary number of users spread across the land, the ease with which a performance may be broadcast, the sheer volume of copyrighted compositions, the enormous quantity of separate performances each year, the impracticability of negotiating individual licenses for each composition, and the ephemeral nature of each performance all combine to create unique market conditions for performance rights to recorded music." *Id.,* at 10 (footnote omitted).

The Department concluded that, in the circumstances of that case, the blanket licenses issued by ASCAP to individual radio stations were neither a *per se* violation of the Sherman Act nor an unreasonable restraint of trade.

As evidenced by its *amicus* brief in the present case, the Department remains of that view. Furthermore, the United States disagrees with the Court of Appeals in this case and urges that the blanket licenses, which the consent decree authorizes ASCAP to issue to television networks, are not *per se* violations of the Sherman Act. It takes no position, however, on whether the practice is an unreasonable restraint of trade in the context of the network television industry.

Finally, we note that Congress itself, in the new Copyright Act, has chosen to employ the blanket license and similar practices. Congress created a compulsory blanket license for secondary transmissions by cable television systems and provided that "[n]otwithstanding any provisions of

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the antitrust laws, . . . any claimants may agree among themselves as to the proportionate division of compulsory licensing fees among them, may lump their claims together and file them jointly or as a single claim, or may designate a common agent to receive payment on their behalf." 17 U.S.C. App. § 111(d)(5)(A). And the newly created compulsory license for the use of copyrighted compositions in jukeboxes is also a blanket license, which is payable to the performing-rights societies such as ASCAP unless an individual copyright holder can prove his entitlement to a share. § 116(c)(4). Moreover, in requiring noncommercial broadcasters to pay for their use of copyrighted music, Congress again provided that "[n]otwithstanding any provision of the antitrust laws" copyright owners "may designate common agents to negotiate, agree to, pay, or receive payments." § 118(b). Though these provisions are not directly controlling, they do reflect an opinion that the blanket license, and ASCAP, are economically beneficial in at least some circumstances.

There have been District Court cases holding various ASCAP practices, including its licensing practices, to be violative of the Sherman Act, [FN25] but even so, there is no nearly universal view that either the blanket or the per-program licenses issued by ASCAP at prices negotiated by it are a form of price fixing subject to automatic condemnation under the Sherman Act, rather than to a careful assessment under the rule of reason.

FN25. See cases cited n. 18, *supra*. Those cases involved licenses sold to individual movie theaters to "perform" compositions already on the motion pictures' soundtracks. ASCAP had barred its members from assigning performing rights to movie producers at the same time recording rights were licensed, and the theaters were effectively unable to engage in direct transactions for performing rights with individual copyright owners.

III

Of course, we are no more bound than is CBS by the views of the Department of Justice, the results in the prior lower court cases, or the opinions of various experts about the merits of the blanket license. But while we must independently examine this practice, all those factors should caution us against too easily finding blanket licensing subject to *per se* invalidation.

A

As a preliminary matter, we are mindful that the Court of Appeals' holding would appear to be quite difficult to contain. If, as the court held, there is a *per se* antitrust violation whenever ASCAP issues a blanket license to a television network for a single fee, why would it not also be automatically illegal for ASCAP to negotiate and issue blanket licenses to individual radio or television stations or to other users who perform copyrighted music for profit? [FN26] Likewise, if the present network licenses issued through ASCAP on behalf of its members are *per se* violations, why would it not be equally illegal for the members to authorize ASCAP to issue licenses establishing various categories of uses that a network might have for copyrighted music and setting a standard fee for each described use?

FN26. Certain individual television and radio stations, appearing here as *amici curiae*, argue that the *per se* rule should extend to ASCAP's blanket licenses with them as well. The television stations have filed an antitrust suit to that effect. *Buffalo Broadcasting Co. v. ASCAP*, 78 Civ. 5670 (SDNY, filed Nov. 27, 1978).

Although the Court of Appeals apparently thought the blanket license could be saved in some or even many applications, it seems to us that the *per se* rule does not accommodate itself to such flexibility and that the observations of the Court of Appeals with respect to remedy tend to impeach the *per se* basis for the holding of liability.[FN27]

FN27. See n. 10, *supra*. The Court of Appeals would apparently not outlaw the blanket license across the board but would permit it in various circumstances where it is deemed necessary or sufficiently desirable. It did not even enjoin blanket licensing with the television networks, the relief it realized would normally follow a finding of *per se* illegality of the license in that context. Instead, as requested by CBS, it remanded to the District Court to require ASCAP to offer in addition to blanket licensing some competitive form of per-use licensing. But per-use licensing by ASCAP, as recognized in the consent decrees, might be even more susceptible to the *per se* rule than blanket

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licensing.
The rationale for this unusual relief in a *per se* case was that "[t]he blanket license is not simply a 'naked restraint' ineluctably doomed to extinction." 562 F.2d, at 140. To the contrary, the Court of Appeals found that the blanket license might well "serve a market need" for some. *Ibid.* This, it seems to us, is not the *per se* approach, which does not yield so readily to circumstances, but in effect is a rather bobtailed application of the rule of reason, bobtailed in the sense that it is unaccompanied by the necessary analysis demonstrating why the particular licensing system is an undue competitive restraint.

CBS would prefer that ASCAP be authorized, indeed directed, to make all its compositions available at standard per-use rates within negotiated categories of use. 400 F.Supp., at 747 n. 7.[FN28] But if this in itself or in conjunction with blanket licensing constitutes illegal price fixing by copyright owners, CBS urges that an injunction issue forbidding ASCAP to issue any blanket license or to negotiate any fee except on behalf of an individual member for the use of his own copyrighted work or works. [FN29] Thus, we are called upon to determine that blanket licensing is unlawful across the board. We are quite sure, however, that the *per se* rule does not require any such holding.

FN28. Surely, if ASCAP abandoned the issuance of all licenses and confined its activities to policing the market and suing infringers, it could hardly be said that member copyright owners would be in violation of the antitrust laws by not having a common agent issue per-use licenses. Under the copyright laws, those who publicly perform copyrighted music have the burden of obtaining prior consent. Cf. *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S., at 139-140, 89 S.Ct., at 1585-1586.

FN29. In its complaint, CBS alleged that it would be "wholly impracticable" for it to obtain individual licenses directly from the composers and publishing houses, but it now says that it would be willing to do exactly that if ASCAP were enjoined from granting blanket licenses to CBS or its competitors in the network television business.

B

In the first place, the line of commerce allegedly being restrained, the performing rights to copyrighted music, exists at all only because of the copyright laws. Those who would use copyrighted music in public performances must secure consent from the copyright owner or be liable at least for the statutory damages for each infringement and, if the conduct is willful and for the purpose of financial gain, to criminal penalties. [FN30] Furthermore, nothing in the Copyright Act of 1976 indicates in the slightest that Congress intended to weaken the rights of copyright owners to control the public performance of musical compositions. Quite the contrary is true.[FN31] Although the copyright laws confer no rights on copyright owners to fix prices among themselves or otherwise to violate the antitrust laws, we would not expect that any market arrangements reasonably tlinenecessary to effectuate the rights that are granted would be deemed a *per se* violation of the Sherman Act. Otherwise, the commerce anticipated by the Copyright Act and protected against restraint by the Sherman Act would not exist at all or would exist only as a pale reminder of what Congress envisioned.[FN32]

FN30. 17 U.S.C. App. § 506.

FN31. See Koenigsberg, The 1976 Copyright Act: Advances for the Creator, 26 Cleve.St.L.Rev. 515, 524, 528 (1977).

FN32. Cf. *Silver v. New York Stock Exchange*, 373 U.S. 341, 83 S.Ct. 1246, 10 L.Ed.2d 389 (1963).
Because a musical composition can be "consumed" by many different people at the same time and without the creator's knowledge, the "owner" has no real way to demand reimbursement for the use of his property except through the copyright laws *and* an effective way to enforce those legal rights. See *Twentieth Century Music Corp. v. Aiken*, 422 U.S. 151, 162, 95 S.Ct. 2040, 2047, 45 L.Ed.2d 84 (1975). It takes an organization of rather large size to monitor most or all uses and to deal with users on behalf of the composers. Moreover, it is inefficient to have too many such organizations duplicating each other's

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monitoring of use.

C

More generally, in characterizing this conduct under the *per se* rule, [FN33] our inquiry must focus on whether the effect and, here because it tends to show effect, see *United States v. United States Gypsum Co.*, 438 U.S. 422, 436 n. 13, 98 S.Ct. 2864, 2873 n. 13, 57 L.Ed.2d 854 (1978), the purpose of the practice are to threaten the proper operation of our predominantly free-market economy--that is, whether the practice facially appears to be one that would always or almost always tend to restrict competition and decrease output, and in what portion of the market, or instead one designed to "increase economic efficiency and render markets more, rather than less, competitive." *Id.* at 441 n. 16, 98 S.Ct., at 2875 n. 16; see *National Society of Professional Engineers v. United States*, 435 U.S., at 688, 98 S.Ct., at 1363; *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S., at 50 n. 16, 97 S.Ct., at 2558 n. 16; *Northern Pac. R. Co. v. United States*, 356 U.S., at 4, 78 S.Ct., at 517.

FN33. The scrutiny occasionally required must not merely subsume the burdensome analysis required under the rule of reason, see *National Society of Professional Engineers v. United States*, 435 U.S. 679, 690-692, 98 S.Ct. 1355, 1364-1366, 55 L.Ed.2d 637 (1978), or else we should apply the rule of reason from the start. That is why the *per se* rule is not employed until after considerable experience with the type of challenged restraint.

The blanket license, as we see it, is not a "naked restrain[t] of trade with no purpose except stifling of competition," *White Motor Co. v. United States*, 372 U.S. 253, 263, 83 S.Ct. 696, 702, 9 L.Ed.2d 738 (1963), but rather accompanies the integration of sales, monitoring, and enforcement against unauthorized copyright use. See L. Sullivan, Handbook of the Law of Antitrust § 59, p. 154 (1977). As we have already indicated, ASCAP and the blanket license developed together out of the practical situation in the marketplace: thousands of users, thousands of copyright owners, and millions of compositions. Most users want unplanned, rapid, and indemnified access to any and all of the repertory of compositions, and the owners want a reliable method of collecting for the use of their copyrights. Individual sales transactions in this industry are quite expensive, as would be individual monitoring and enforcement, especially in light of the resources of single composers. Indeed, as both the Court of Appeals and CBS oftlinerecognize, the costs are prohibitive for licenses with individual radio stations, nightclubs, and restaurants, 562 F.2d, at 140, n. 26, and it was in that milieu that the blanket license arose.

A middleman with a blanket license was an obvious necessity if the thousands of individual negotiations, a virtual impossibility, were to be avoided. Also, individual fees for the use of individual compositions would presuppose an intricate schedule of fees and uses, as well as a difficult and expensive reporting problem for the user and policing task for the copyright owner. Historically, the market for public-performance rights organized itself largely around the single-fee blanket license, which gave unlimited access to the repertory and reliable protection against infringement. When ASCAP's major and user-created competitor, BMI, came on the scene, it also turned to the blanket license.

With the advent of radio and television networks, market conditions changed, and the necessity for and advantages of a blanket license for those users may be far less obvious than is the case when the potential users are individual television or radio stations, or the thousands of other individuals and organizations performing copyrighted compositions in public.[FN34] But even for television network licenses, ASCAP reduces costs absolutely by creating a blanket license that is sold only a few, instead of thousands, [FN35] of times, and that obviates the need for closely monitoring the networks to see that they do not use more than they pay for.[FN36] ASCAP also provides the necessary resources for blanket sales and enforcement, resources unavailable to the vast majority of composers and publishing houses. Moreover, a bulk license of some type is a necessary consequence of the integration necessary to achieve these efficiencies, and a necessary consequence of an aggregate license is that its price must be established.

FN34. And of course changes brought about by new technology or new marketing techniques might also undercut the justification for the practice.

FN35. The District Court found that CBS would require between 4,000 and 8,000 individual license transactions per year. 400

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F.Supp., at 762.

FN36. To operate its system for distributing the license revenues to its members, ASCAP relies primarily on the networks' records of which compositions are used.

D

This substantial lowering of costs, which is of course potentially beneficial to both sellers and buyers, differentiates the blanket license from individual use licenses. The blanket license is composed of the individual compositions plus the aggregating service. Here, the whole is truly greater than the sum of its parts; it is, to some extent, a different product. The blanket license has certain unique characteristics: It allows the licensee immediate use of covered compositions, without the delay of prior individual negotiations [FN37] and great flexibility in the choice of musical material. Many consumers clearly prefer the characteristics and cost advantages of this marketable package,[FN38] and even small- performing rights societies that have occasionally arisen to compete with ASCAP and BMI have offered blanket licenses.[FN39] Thus, to the extent the blanket license is a different product, ASCAP is not really a joint sales agency offering the individual goods of many sellers, but is a separate seller offering its blanket license, of which the individual compositions are raw material.[FN40] ASCAP, in short, made a market in which individual composers are inherently unable to compete fully effectively.[FN41]

FN37. See Timberg, The Antitrust Aspects of Merchandising Modern Music: The ASCAP Consent Judgment of 1950, 19 Law & Contemp.Prob. 294, 297 (1954) ("The disk-jockey's itchy fingers and the bandleader's restive baton, it is said, cannot wait for contracts to be drawn with ASCAP's individual publisher members, much less for the formal acquiescence of a characteristically unavailable composer or author"). Significantly, ASCAP deals only with nondramatic performance rights. Because of their nature, dramatic rights, such as for musicals, can be negotiated individually and well in advance of the time of performance. The same is true of various other rights, such as sheet music, recording, and synchronization, which are licensed on an individual basis.

FN38. Cf. *United States v. Grinnell Corp.*, 384 U.S. 563, 572-573, 86 S.Ct. 1698, 1704-1705, 16 L.Ed.2d 778 (1966); *United States v. Philadelphia Nat. Bank*, 374 U.S. 321, 356-357, 83 S.Ct. 1715, 1737-1738, 10 L.Ed.2d 915 (1963).

FN39. Comment, Music Copyright Associations and the Antitrust Laws, 25 Ind.L.J. 168, 170 (1950). See also Garner, *United States v. ASCAP* : The Licensing Provisions of the Amended Final Judgment of 1950, 23 Bull.Copyright Soc. 119, 149 (1975) ("no performing rights are licensed on other than a blanket basis in any nation in the world").

FN40. Moreover, because of the nature of the product--a composition can be simultaneously "consumed" by many users--composers have numerous markets and numerous incentives to produce, so the blanket license is unlikely to cause decreased output, one of the normal undesirable effects of a cartel. And since popular songs get an increased share of ASCAP's revenue distributions, composers compete even within the blanket license in terms of productivity and consumer satisfaction.

FN41. Cf. *United States v. Socony-Vacuum Oil Co.*, 310 U.S., at 217, 60 S.Ct., at 841 (distinguishing *Chicago Bd. of Trade v. United States*, 246 U.S. 231, 38 S.Ct. 242, 62 L.Ed. 683 (1918), on the ground that among the effects of the challenged rule there "was the creation of a public market"); *United States v. Trenton Potteries Co.*, 273 U.S., at 401, 47 S.Ct., at 381 (distinguishing *Chicago Bd. of Trade* on the ground that it did not involve "a price agreement among competitors in an open market").

E

Finally, we have some doubt--enough to counsel against application of the *per se* rule--about the extent to which this practice threatens the "central

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nervous system of the economy," *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 226 n. 59, 60 S.Ct. 811, 845 n. 59, 84 L.Ed. 1129 (1940), that is, competitive pricing as the free market's means of allocating resources. Not all arrangements among actual or potential competitors that have an impact on price are *per se* violations of the Sherman Act or even unreasonable restraints. Mergers among competitors eliminate competition, including price competition, but they are not *per se* illegal, and many of them withstand attack under any existing antitrust standard. Joint ventures and other cooperative arrangements are also not usually unlawful, at least not as price-fixing schemes, where the agreement on price is necessary to market the product at all.

Here, the blanket-license fee is not set by competition among individual copyright owners, and it is a fee for the use of any of the compositions covered by the license. But the blanket license cannot be wholly equated with a simple horizontal arrangement among competitors. ASCAP does set the price for its blanket license, but that license is quite different from anything any individual owner could issue. The individual composers and authors have neither agreed not to sell individually in any other market nor use the blanket license to mask price fixing in such other markets. [FN42] Moreover, the substantial restraints placed on ASCAP and its members by the consent decree must not be ignored. The District Court found that there was no legal, practical, or conspiratorial impediment to CBS's obtaining individual licenses; CBS, in short, had a real choice.

FN42. "CBS does not claim that the individual members and affiliates ('sellers') of ASCAP and BMI have agreed among themselves as to the prices to be charged for the particular 'products' (compositions) offered by each of them." 400 F.Supp., at 748.

With this background in mind, which plainly enough indicates that over the years, and in the face of available alternatives, the blanket license has provided an acceptable mechanism for at least a large part of the market for the performing rights to copyrighted musical compositions, we cannot agree that it should automatically be declared illegal in all of its many manifestations. Rather, when attacked, it should be subjected to a more discriminating examination under the rule of reason. It may not ultimately survive that attack, but that is not the issue before us today.

IV

As we have noted, n. 27, *supra*, the enigmatic remarks of the Court of Appeals with respect to remedy appear to have departed from the court's strict, *per se* approach and to have invited a more careful analysis. But this left the general import of its judgment that the licensing practices of ASCAP and BMI under the consent decree are *per se* violations of the Sherman Act. We reverse that judgment, and the copyright misuse judgment dependent upon it, see n. 9, *supra*, and remand for further proceedings to consider any unresolved issues that CBS may have properly brought to the Court of Appeals.[FN43] Of course, this will include an assessment under the rule of reason of the blanket license as employed in the television industry, if that issue was preserved by CBS in the Court of Appeals.[FN44]

FN43. It is argued that the judgment of the Court of Appeals should nevertheless be affirmed on the ground that the blanket license is a tying arrangement in violation of § 1 of the Sherman Act or on the ground that ASCAP and BMI have monopolized the relevant market contrary to § 2. The District Court and the Court of Appeals rejected both submissions, and we do not disturb the latter's judgment in these respects, particularly since CBS did not file its own petition for certiorari challenging the Court of Appeals' failure to sustain its tying and monopolization claims.

FN44. The Court of Appeals did not address the rule-of-reason issue, and BMI insists that CBS did not preserve the question in that court. In any event, if the issue is open in the Court of Appeals, we prefer that that court first address the matter. Because of the United States' interest in the enforcement of the consent decree, we assume it will continue to play a role in this litigation on remand.

The judgment of the Court of Appeals is reversed, and the cases are remanded to that court for further proceedings consistent with this opinion.

*It is so ordered.*

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Mr. Justice STEVENS, dissenting. [This opinion is omitted here. In it, Justice Stevens agrees that the ASCAP blanket license is not a per se violation of the antitrust laws, but he concludes that the record is sufficient to support a finding that conclude that it is a monopolistic restraint of trade proscribed by the Sherman Act; on that basis, he would have affirmed the judgment of the court of appeals.]

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111 S.Ct. 401
112 L.Ed.2d 349, 59 USLW 3383, 59 USLW 3390, 1990-2 Trade Cases P 69,250
**(Cite as: 498 U.S. 46, 111 S.Ct. 401)**

Supreme Court of the United States

Jay PALMER, et al.
v.
BRG OF GEORGIA, INC., et al.

**No. 89-1667.**

Nov. 26, 1990.

PER CURIAM.
In preparation for the 1985 Georgia Bar Examination, petitioners contracted to take a bar review course offered by respondent BRG of Georgia, Inc. (BRG). In this litigation they contend that the price of BRG's course was enhanced by reason of an unlawful agreement between BRG and respondent Harcourt Brace Jovanovich Legal and Professional Publications (HBJ), the Nation's largest provider of bar review materials and lecture services. The central issue is whether the 1980 agreement between respondents violated § 1 of the Sherman Act.[FN1]

FN1. Section 1 of the Sherman Act, 26 Stat. 209, as amended and set forth in 15 U.S.C. § 1, provides in relevant part:
"Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal."
We do not reach the other claims alleged in petitioners' nine-count complaint, including violations of § 2 of the Sherman Act, 15 U.S.C. § 2.

HBJ began offering a Georgia bar review course on a limited basis in 1976, and was in direct, and often intense, competition with BRG during the period from 1977 to 1979. BRG and HBJ were the two main providers of bar review courses in Georgia during this time period. In early 1980, they entered into an agreement that gave BRG an exclusive license to market HBJ's material in Georgia and to use its trade name "Bar/Bri." The parties agreed that HBJ would not compete with BRG in Georgia and that BRG would not compete with HBJ outside of Georgia.[FN2] Under the agreement, HBJ received $100 per student enrolled by BRG and 40% of all revenues over $350. Immediately after the **402 1980 agreement, the price of BRG's course was increased from $150 to over $400.

FN2. The 1980 agreement contained two provisions, one called a "Covenant Not to Compete" and the other called "Other Ventures." The former required HBJ not to "directly or indirectly own, manage, operate, join, invest, control, or participate in or be connected as an officer, employee, partner, director, independent contractor or otherwise with any business which is operating or participating in the preparation of candidates for the Georgia State Bar Examination." Plaintiffs' Motion for Partial Summary Judgment, Attachment E, p. 10. The latter required BRG not to compete against HBJ in States in which HBJ currently operated outside the State of Georgia. *Id.*, at 15.

On petitioners' motion for partial summary judgment as to the § 1 counts in the complaint and respondents' motion for summary judgment, the District Court held that the agreement was lawful. The United States Court of Appeals for the Eleventh Circuit, with one judge dissenting, agreed with the District Court that *per se* unlawful horizontal price fixing required an explicit agreement on prices to be charged or that one party have the right to be consulted about the other's prices. The Court of Appeals also agreed with the District Court that to prove a *per se* violation under a geographic market allocation theory, petitioners had to show that respondents had subdivided some relevant market in which they had previously competed. 874 F.2d 1417 (1989).[FN3] The Court of Appeals denied a petition for rehearing en banc that had been supported by the United States. 893 F.2d 293 (1990)lain .[FN4]

FN3. In dissent, Judge Clark explained that in his view HBJ and BRG were capable of engaging in *per se* horizontal restraints because they had competed against each other and then had joined forces. He

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believed the District Court's analysis was flawed because it had failed to recognize that the agreements could be price-fixing agreements even without explicit reference to price and because it had failed to recognize that allocation, rather than subdivision, of markets could also constitute a *per se* antitrust violation.

FN4. The United States, as *amicus curiae,* had urged the court to adopt the views of the dissent.

In *United States v. Socony-Vacuum Oil Co.,* 310 U.S. 150, 60 S.Ct. 811, 84 L.Ed. 1129 (1940), we held that an agreement among competitors to engage in a program of buying surplus gasoline on the spot market in order to prevent prices from falling sharply was unlawful, even though there was no direct agreement on the actual prices to be maintained. We explained that "[u]nder the Sherman Act a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate or foreign commerce is illegal *per se.*" *Id.,* at 223, 60 S.Ct., at 844. See also *Catalano, Inc. v. Target Sales, Inc.,* 446 U.S. 643, 100 S.Ct. 1925, 64 L.Ed.2d 580 (1980) (*per curiam* ); *National Society of Professional Engineers v. United States,* 435 U.S. 679, 98 S.Ct. 1355, 55 L.Ed.2d 637 (1978).

The revenue-sharing formula in the 1980 agreement between BRG and HBJ, coupled with the price increase that took place immediately after the parties agreed to cease competing with each other in 1980, indicates that this agreement was "formed for the purpose and with the effect of raising" the price of the bar review course. It was, therefore, plainly incorrect for the District Court to enter summary judgment in respondents' favor.[FN5] Moreover, it is equally clear that the District Court and the Court of Appeals erred when they assumed that an allocation of markets or submarkets by competitors is not unlawful unless the market in which the two previously competed is divided between them.

FN5. See *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 255, 106 S.Ct. 2505, 2513, 91 L.Ed.2d 202 (1986) ("The evidence of the nonmovant is to be believed, and all justifiable inferences are to be drawn in his favor").

In *United States v. Topco Associates, Inc.,* 405 U.S. 596, 92 S.Ct. 1126, 31 L.Ed.2d 515 (1972), we held that agreements between competitors to allocate territories to minimize competition are illegal:

"One of the classic examples of a *per se* violation of § 1 is an agreement between competitors at the same level of the market structure to allocate territories in order to minimize competition.... This Court has reiterated time and time again that '[h]orizontal territorial limitations ... are naked restraints of trade with no purpose except stifling of competition.' Such limitations are *per se* violations of the Sherman Act." *Id.,* at 608, 92 S.Ct., at 1133-34 (citations omitted).

The defendants in *Topco* had never competed in the same market, but had simply agreed to allocate markets. Here, HBJ and BRG had previously competed in the Georgia market; under their allocation agreement, BRG received that market, while HBJ received the remainder of the United States. Each agreed not to compete in the other's territories. Such agreements are anticompetitive regardless of whether the parties split a market within which both do business or whether they merely reserve one market for one and another for the other.[FN6] Thus, the 1980 agreement between HBJ and BRG was unlawful on its face.

FN6. See *Arizona v. Maricopa County Medical Society,* 457 U.S. 332, 344, n. 15, 102 S.Ct. 2466, 2473, n. 15, 73 L.Ed.2d 48 (1982) ("division of markets" is *per se* offense).

The petition for a writ of certiorari is granted, the judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion.[FN7]

FN7. In 1982, in connection with the settlement of another lawsuit, respondents made certain changes in their arrangement. Because the District Court found that the 1980 agreement did not violate § 1 of the Sherman Act, it did not address whether the 1982 modified agreement constituted a withdrawal from, or abandonment of, the conspiracy. In *United States v. Kissel,* 218 U.S. 601, 31 S.Ct. 124, 54 L.Ed. 1168 (1910), we held that antitrust conspiracies may continue in time beyond the original conspiratorial agreement until either the

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conspiracy's objectives are abandoned or succeed. *Id.*, at 608-609, 31 S.Ct., at 126. Thus, it is an unsettled factual issue whether the conspiratorial objectives manifest in the 1980 agreement between HBJ and BRG have continued in spite of the 1982 modifications.

*It is so ordered.*

Justice SOUTER took no part in the consideration or decision of this case.

Justice MARSHALL, dissenting.

Although I agree that the limited information before us appears to indicate that the Court of Appeals erred in its decision below, I continue to believe that summary dispositions deprive litigants of a fair opportunity to be heard on the merits and significantly increase the risk of an erroneous decision. See *Smith v. Ohio,* 494 U.S. 541, 544, 110 S.Ct. 1288, 1290, 108 L.Ed.2d 464 (1990)(MARSHALL, J., dissenting); *Pennsylvania v. Bruder,* 488 U.S. 9, 11- 12, 109 S.Ct. 205, 207, 102 L.Ed.2d 172 (1988) (MARSHALL, J., dissenting); *Rhodes v. Stewart,* 488 U.S. 1, 4-5, 109 S.Ct. 202, tline203-204, 102 L.Ed.2d 1 (1988) (MARSHALL, J., dissenting); *Buchanan v. Stanships, Inc.,* 485 U.S. 265, 269-270, 108 S.Ct. 1130, 1132, 99 L.Ed.2d 289 (1988) ***51** MARSHALL, J., dissenting); *Commissioner v. McCoy,* 484 U.S. 3, 7-8, 108 S.Ct. 217, 219- 220, 98 L.Ed.2d 2 (1987) (MARSHALL, J., dissenting). I therefore dissent from the Court's decision today to reverse summarily the judgment below.

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**H**

United States Court of Appeals,
Tenth Circuit.

SCFC ILC, INC., doing business as MountainWest Financial, Inc., Plaintiff-Counter-Defendant-Appellee,
v.
VISA USA, INC., Defendant-Counter-Claimant-Appellant,
v.
SEARS, ROEBUCK AND COMPANY, an Illinois corporation; et al.

**No. 93-4105.**

Sept. 23, 1994.

Before MOORE and SETH, Circuit Judges, and DAUGHERTY, District Judge. [FN*]

FN* Honorable Frederick A. Daugherty, Senior District Judge for the United States District Court for the Western District of Oklahoma, sitting by designation.

JOHN P. MOORE, Circuit Judge.

Visa USA provides payment services to its 6,000 members which individually issue credit cards to consumers. Sears, Roebuck and Company, a competitor offering its own credit card, the Discover Card, wanted to become a Visa USA member and also issue Visa cards. The question presented by this case is whether Visa USA's refusal to admit Sears to its joint venture restrains trade in violation of section 1 of the Sherman Act, 15 U.S.C. § 1. Rejecting Visa USA's legal and factual challenges to the jury's adverse verdict, the district court found the evidence of exclusion constituted antitrust injury and harm to competition. *SCFC ILC, Inc. v. Visa U.S.A., Inc.*, 819 F.Supp. 956, 990 (D.Utah 1993). We conclude, however, the exclusion does not trigger section 1 liability and reverse.

**I. Background**

As set forth more extensively in the district court's order, the factual background of this dispute encompasses the history of the general purpose credit card industry. What is known today "everywhere you want to be" as *Visa* has evolved over the last forty years from direct extensions of credit for a single purpose; for example, oil company or department store credit cards, to a "charge card which could be used for general purposes at a wide variety of retail establishments." *Id.* at 963 n. 2. The resulting card was offered without geographic restrictions under the neutral trademark, Visa.

Now, to its approximately 6,000 associates, Visa USA, [FN1] the umbrella organization, provides technology to process credit card transactions and regulates and coordinates the individual programs through rules and bylaws proposed by management and adopted by a board of directors (the Board). [FN2] The bylaws cover a range of issues: members' liability, termination, and confidentiality, to name a few. However, since its inception, each Visa USA member independently decides the terms and conditions of credit extensions, the number of cards issued, and the interest rates charged. That is, individual banks establish, operate, and promote their own credit card programs under the Visa aegis, while Visa USA serves as a clearinghouse for the ultimate transaction between issuer, consumer, and merchant. The fees members pay to Visa USA for its services vary according to a formula established by the association.

FN1. In this opinion, Visa USA designates the joint venture named as the defendant. We refer to its credit cards simply as Visa.

FN2. The Visa USA Board draws its members from twelve designated regions, each electing a representative, generally a bank's chief executive officer or chief operating officer. Based on a formula, larger regions may have a second board seat. Seven directors are elected nationally, and a separate seat is reserved for a director who represents small banks. Citicorp has its own seat on the board based on the rule of automatic appointment to any member with more than ten percent of the total volume of outstanding cards. MasterCard board members are not permitted to sit on the Visa USA board.

Any financial institution which is eligible for federal deposit insurance may become a Visa USA member.

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Among its current membership are Citicorp, Ford Motor Company, General Electric, and ITT. Although the membership was originally restricted to exclusively issuing Visa cards, a challenge to the bylaw prohibiting members from issuing MasterCard forced Visa USA to withdraw the rule. *See Worthen Bank & Trust Co. v. National BankAmericard, Inc.*, 345 F.Supp. 1309 (E.D.Ark.1972), *rev'd*, 485 F.2d 119 (8th Cir.1973), *cert. denied*, 415 U.S. 918, 94 S.Ct. 1417, 39 L.Ed.2d 473 (1974). Consequently, Visa USA members now generally offer both Visa and MasterCard, a practice referred to in the industry as *duality*.

Prior to its entry into the general credit card arena, Sears [FN3] [Omitted] mustered a bankcard steering committee to investigate the alternatives of developing its own general purpose charge card or joining the Visa USA/MasterCard association. In 1985, Sears introduced the Discover Card, its own proprietary card, one "owned and distributed solely by a single business entity," 819 F.Supp. at 963 n. 3., to be marketed and issued nationally. This entry was intended to compete with Visa, MasterCard, American Express, and Citibank's Diners' Club/Carte Blanche, the only other national proprietary cards. Despite Visa USA's aggressive efforts to thwart its new rival, *id.* at 963, Discover succeeded with such innovations as preapproved, no fee cards offering cash back bonuses to cardholders and deeper discounts to merchants. In fact, at the time of this litigation, Sears was the largest individual issuer of credit cards in terms of the number of cards distributed and the second largest, following Citicorp, in credit card receivables volume. [FN4] To compete with the Visa Gold Card and American Express Optima Card, Sears also introduced an upscale Discover Card called Prime Issue. Another Sears' entity, Sears Payment Services (SPS), assists other companies in operating their credit card programs.

> FN4. In 1991, approximately 24 million Discover cards had been issued, while Citicorp had approximately 21 million cards in the market.

In 1988, Greenwood Trust Company, a Sears-owned Delaware bank which issues Discover Card, applied for membership in Visa USA, prompting the Board to adopt the bylaw which is the genesis of this antitrust litigation. The amendment to the Board rule, Bylaw 2.06, stated:

> Notwithstanding (a) above, if permitted by applicable law, the corporation shall not accept for membership any applicant which is issuing, directly or indirectly, Discover cards or American Express cards, or any other cards deemed competitive by the Board of Directors; an applicant shall be deemed to be issuing such cards if its parent, subsidiary or affiliate issues such cards.

Subsequently, the Board denied Greenwood Trust's application to Visa USA.

In 1990, the Resolution Trust Corporation sold Sears the assets, including the Visa USA membership, of MountainWest Savings and Loan Association, a bankrupt savings and loan in Sandy, Utah. Sears then created a new entity, SCFC ILC, Inc., doing business as MountainWest Financial, by merging the Sandy bank with Basin Loans, a Utah Industrial Loan Company.

Through this vehicle, Sears was poised to inaugurate a national Visa program it dubbed the Prime Option card, a charge card featuring a two-tiered interest rate, 9.9% for the first two months and 15.9% thereafter. To this end, Sears moved Discover's top executives to Prime Option and ordered an initial printing of 1.5 million Prime Option Visa cards. However, upon inadvertently discovering the plan, Visa USA cancelled the printing and invoked Bylaw 2.06 to exclude Sears from the association. Sears then instituted this antitrust litigation.

## II. Fed.R.Civ.P. 50(b) Review

In this appeal, Visa USA contends Sears has failed to carry its burden of showing Visa USA's conduct was harmful to competition in violation of section 1. Indeed, Visa USA underscores, the district court conceded had it tried the facts, it "would have concluded that the harm to competition from letting Sears into the Visa system is greater than any harm from keeping Sears out." 819 F.Supp. at 983. Sears, however, urges this fact-intensive case persuaded the jury that preventing consumers access to the Prime Option card and destroying rivals' incentives to develop new proprietary cards harmed competition.

Nonetheless, we focus only on those relevant antitrust facts, which, when viewed most favorably to Sears, underpin our plenary review under Fed.R.Civ.P. 50(b). In the context of this case, if there is evidence upon which a jury could properly find Visa USA restrained trade, we must affirm. 5A

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J. Moore & J. Lucas, *Moore's Federal Practice* ¶ 50.07[2], at 50-76 (2d ed. 1994). Naturally, we do not weigh the credibility of the evidence when reviewing the record. However, if the evidence is insufficient "under the controlling law," Fed.R.Civ.P. 50(a), we must enter judgment as a matter of law for the moving party.

Having stated its contrary view, but reluctant to substitute its judgment for that of the jury, the district court articulated those facts which it opined could become the basis for judgment:

1. Testimony of Sears' expert, Professor James Kearl, on the appropriateness of calculating Visa USA's market power by aggregating the individual market shares of Visa USA and MasterCard; and his conclusion that Visa USA exercised market power through its collective power to make rules; and testimony about the "presence of high profits."
2. Dean Witter's president, Phillip Purcell's testimony had Sears known that developing the Discover Card would disqualify it from Visa USA entry, it would not have placed a new proprietary card in the market.
3. Testimony that no new proprietary cards had been introduced in the relevant market since Bylaw 2.06 was enacted although memberships in Visa USA and MasterCard increased.
4. Testimony that Prime Option "would be a low-cost card which would be supported by powerful marketing and advertising strategies on a national level." 819 F.Supp. at 986-87.
5. Testimony by Sears' executives that Discover Card, in the face of Prime Option's entry, would remain an aggressive competitor.
6. Testimony that intersystem competition will not be harmed "because Prime Option Visa was designed to reach that part of the market that Discover does not reach." *Id.* at 987.
7. Testimony that "Sears would benefit significantly from issuing Prime Option Visa as opposed to Prime Option Discover or another separate proprietary card." *Id.*

This evidence, which the district court found sufficient to impose section 1 liability, however, must be placed in the specialized province of antitrust law and section 1. We do so fully recognizing both the evolving legal precedent and the objectives of antitrust regulation: "to improve people's lives ... [through] economic efficiency ... more efficient production methods ... [and] through increased innovation." Stephen Breyer, *The Cutting Edge of Antitrust: Lessons from Deregulation,* 57 Antitrust L.J. 771 (1989). That antitrust objectives often collide with these goals simply reminds us "[a]ntitrust is an imperfect tool for the regulation of competition." Frank H. Easterbrook, *The Limits of Antitrust,* 63 Tex.L.Rev. 1, 39 (1984).

**III. Joint Ventures and Section I**

Section 1 forbids agreements in restraint of trade. [FN5] Read costively, section 1 might prohibit "every conceivable contract or combination ... anywhere in the whole field of human activity." *Standard Oil Co. of N.J. v. United States,* 221 U.S. 1, 60, 31 S.Ct. 502, 516, 55 L.Ed. 619 (1911) . However, "the 'rule of reason' limits the Act's literal words by forbidding only those arrangements the anticompetitive consequences of which outweigh their legitimate business justifications." *Clamp-All Corp. v. Cast Iron Soil Pipe Inst.,* 851 F.2d 478, 486 (1st Cir.1988) (citing 7 P. Areeda & D. Turner *Antitrust Law* ¶ 1500, at 362-63 (1978)), *cert. denied,* 488 U.S. 1007 (1989). Hence, when we ask if a particular practice is "reasonable" or "unreasonable," or if the practice is "anticompetitive," we use these terms with special antitrust meaning reflecting the "Act's basic objectives, the protection of a competitive process that brings to consumers the benefits of lower prices, better products, and more efficient production methods." *Id.* at 486. In this lexicon, a practice ultimately judged anticompetitive is one which harms competition, not a particular competitor. *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.,* 429 U.S. 477, 488, 97 S.Ct. 690, 697, 50 L.Ed.2d 701 *cert. denied,* 429 U.S. 1090, 97 S.Ct. 1099, 51 L.Ed.2d 535 (1977); *Brown Shoe Co. v. United States,* 370 U.S. 294, 319-20, 82 S.Ct. 1502, 1521-21, 8 L.Ed.2d 510 (1962).

FN5. In part, section 1 states, "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal."

Of course, reasonability is of no consequence when certain practices, for example, price fixing, are entirely void of redeeming competitive rationales. These we deem *per se* illegal under section 1, no offsetting economic or efficiency justifications salvaging them. "This *per se* approach permits categorical judgments with respect to certain business practices that have proved to be predominantly

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anticompetitive." *Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.*, 472 U.S. 284, 289, 105 S.Ct. 2613, 2617, 86 L.Ed.2d 202 (1985).

The sharp line between *per se* and rule of reason analysis, however, especially blurs under section 1 when the actors change. In the case of a joint venture, present here in the Visa USA association, competitive incentives between independent firms are intentionally restrained and their functions and operations integrated to achieve efficiencies and increase output. *See* Joseph F. Brodley, *Joint Ventures and Antitrust Policy,* 95 Harv.L.Rev. 1523, 1524 (1982). Although virtually any collaborative activity among business firms may be called a joint venture, joint ventures differ from mergers and cartels

> by the extent to which they integrate the resources of their partners. A cartel constitutes a naked agreement among competitors unaccompanied by any integration of resources. In a joint venture, partners contribute assets, such as, capital, technology, or production facilities to a common endeavor. This integration of resources creates economic efficiencies that cannot be achieved by naked agreements among competitors. Indeed, the efficiencies created by joint ventures are similar to those resulting from mergers--risk- sharing, economies of scale, access to complementary resources and the elimination of duplication and waste. Joint ventures, however, differ from mergers in a critical way: because they are less integrated than mergers, *they allow their partners to continue to compete with each other in the relevant market.*

Thomas A. Piraino, Jr., *Beyond Per Se, Rule of Reason or Merger Analysis: A New Antitrust Standard for Joint Ventures,* 76 Minn.L.Rev. 1, 7 (1991) (italics added). The whole becomes greater than the sum of its parts. However, at its center remains an agreement among competitors to eliminate competition in some way.

The Supreme Court has recognized this tension in its evolving treatment of allegedly anticompetitive agreements by joint ventures. In *Broadcast Music, Inc. v. Columbia Broadcasting, Inc.*, 441 U.S. 1, 99 S.Ct. 1551, 60 L.Ed.2d 1 (1979) (BMI), the Court refused to condemn under a *per se* analysis blanket licenses which amounted to price fixing among the participants. The joint venture, the American Society of Composers, Authors and Publishers (ASCAP), was created as a clearinghouse through which individual music copyright owners licensed their compositions, and ASCAP then monitored the use of their work. Virtually all participants in the copyright music market participated in ASCAP. However, eschewing *per se* treatment, the Court acknowledged, "Joint ventures and other cooperative arrangements are also not usually unlawful, at least not as price-fixing schemes, where the agreement on price is necessary to market the product at all." *Id.* at 23, 99 S.Ct. at 1564. Viewed in this light, the efficiency justification of increasing the aggregate output in the market rendered the agreement procompetitive.

Similarly, in *NCAA v. Board of Regents of Univ. of Okla.*, 468 U.S. 85, 104 S.Ct. 2948, 82 L.Ed.2d 70 (1984), the Court held inappropriate the application of *per se* treatment to the NCAA's horizontal price fixing and output limitation of the number of games college football teams could negotiate to televise. Again the Court recognized the horizontal restraint on competition was essential to make the product available at all. *Id.* at 101, 104 S.Ct. at 2960. Under a rule of reason analysis, however, the rule decreased output and had the effect of increasing prices. While cooperation may be necessary and justified, the Court suggested it fit a different mold, such as, "rules defining the condition of the contest, the eligibility of participants, or the manner in which members of a joint enterprise shall share the responsibilities and the benefits of the total venture." *Id.* at 117, 104 S.Ct. at 2969.

Finally, in *Northwest Wholesale Stationers,* 472 U.S. at 284, 105 S.Ct. at 2613, the Court looked at the economic efficiency justifications of a joint purchasing cooperative to determine the anticompetitive effect of its expelling a member who did not comply with one of the cooperative's rules. Rejecting *per se* condemnation, the Court suggested the disclosure rule which excluded plaintiff from membership might be necessary to monitor the creditworthiness of the cooperative's members. "Wholesale purchasing cooperatives must establish and enforce reasonable rules in order to function effectively.... Unless the cooperative possesses market power or exclusive access to an element essential to effective competition, the conclusion that expulsion is virtually always likely to have an anticompetitive effect is not warranted." *Id.* at 296, 105 S.Ct. at 2620-21 (citations omitted).

In rejecting automatic *per se* treatment in these joint venture cases, [FN6] [omitted] the Court directs us instead to look at the challenged agreement to judge

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whether it represents the essential reason for the competitors' cooperation or reflects a matter merely ancillary to the venture's operation; whether it has the effect of decreasing output; and whether it affects price. Underlying these cases is an effort to appreciate the economic reality of the particular business behavior to assure that the procompetitive goals, in fact, are neither undervalued nor mask a reduction in competition. Key to the analysis of "the competitive significance of the restraint," *NCAA*, 468 U.S. at 103, 104 S.Ct. at 2961 (quoting *National Soc'y of Professional Eng'r v. United States*, 435 U.S. 679, 692, 98 S.Ct. 1355, 1365, 55 L.Ed.2d 637 (1978)), is the Court's appreciation that the horizontal restraint may be essential to create the product in the first instance. That understanding properly values the proprietary rights and incentives for innovation embodied by the joint venture as well as concerns about free-riding, "the diversion of value from a business rival's efforts without payment." *Chicago Professional Sports Ltd. Partnership v. NBA*, 961 F.2d 667, 675 (7th Cir.), *cert. denied*, 506 U.S. 954, 113 S.Ct. 409, 121 L.Ed.2d 334 (1992).

We do not read the Court's precedent involving joint ventures to imply any special treatment or differing antitrust analysis. [FN7] Indeed, aside from clarifying the inappropriateness of automatically invoking *per se* scrutiny of a joint venture's alleged antitrust violation, the Court has not articulated a different rule of reason approach. Thus, under the Court's precedent, cooperative business activity in one setting may permit its participants to achieve market efficiencies or economies of scale, while in another, a similar activity might run afoul under rule of reason review.

FN7. We would note, however, some of the commentary on the antitrust treatment of joint ventures suggests a different approach. *See, e.g.*, Thomas A. Piraino, Jr., *Beyond Per Se, Rule of Reason or Analysis: A New Antitrust Standard for Joint Ventures*, 76 Minn.L.Rev. 1 (1992); Joseph F. Brodley, *Joint Ventures and Antitrust Policy*, 95 Harv.L.Rev. 1523 (1982).

Again, in the context of section 1, the focus of the procompetitive justifications for the business practice remains the ultimate consumer. To be judged anticompetitive, the agreement must actually or potentially harm consumers. *Stamatakis Indus., Inc. v. King*, 965 F.2d 469 (7th Cir.1992). That concept cannot be overemphasized and is especially essential when a successful competitor alleges antitrust injury at the hands of a rival. Indeed, "[w]henever producers invoke the antitrust laws and consumers are silent, this inquiry becomes especially pressing." *Chicago Professional Sports*, 961 F.2d at 670.

**IV. Market Power**

Rule of reason analysis first asks whether the offending competitor, here Visa USA, possesses market power in the relevant market where the alleged anticompetitive activity occurs. The answer to that question may end the suit or permit an abbreviated rule of reason inquiry.

Broadly, market power is the ability to raise price by restricting output. [FN8] [omitted] "[I]n economic terms [it] is the ability to raise price without a total loss of sales." 2 P. Areeda & D. Turner, *Antitrust Law* ¶ 501, at 322 (1978). Without market power, consumers shop around to find a rival offering a better deal. Indeed,

> if we accept the notion that the point of antitrust is promoting consumer welfare, then it is clear why the concept of market power plays such a prominent role in antitrust analysis. If the structure of the market is such that there is little potential for consumers to be harmed, we need not be especially concerned with how firms behave because the presence of effective competition will provide a powerful antidote to any effort to exploit consumers.

George A. Hay, *Market Power in Antitrust*, 60 Antitrust L.J. 807, 808 (1992) [hereinafter *Market Power* ].

Consequently, whether a firm possesses market power may facilitate the determination that the practice harms competition and not simply a single competitor. Proof of market power, then, for many courts is a critical first step, or "screen," or "filter," [FN9] which is often dispositive of the case. *Valley Liquors, Inc. v. Renfield Importers, Ltd.*, 822 F.2d 656, 666- 67 (7th Cir.), *cert. denied*, 484 U.S. 977, 108 S.Ct. 488, 98 L.Ed.2d 486 (1987). If market power is found, the court may then proceed under rule of reason analysis to assess the procompetitive justifications of the alleged anticompetitive conduct. *National Bancard Corp. (NaBanco) v. VISA, U.S.A.*, 779 F.2d 592, 603 (11th Cir.), *cert. denied*, 479 U.S. 923, 107 S.Ct. 329, 93 L.Ed.2d 301 (1986).

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FN9. These screens or filters are presumptions in antitrust analysis. They "help to screen out cases in which the risk of loss to consumers and the economy is sufficiently small that there is no need of extended inquiry and significant risk that inquiry would lead to wrongful condemnation or to the deterrence of competitive activity as firms try to steer clear of the danger zone." Frank H. Easterbrook, *The Limits of Antitrust*, 63 Tex.L.Rev. 1, 17 (1984) . These "simple rules [ ] will filter the category of probably-beneficial practices out of the legal system, leaving to assessment under the Rule of Reason only those with significant risks of competitive injury." *Id.*

While this approach is "the norm under Section 2 of the Sherman Act, where a firm cannot be found liable unless it has achieved monopoly power or there is a dangerous probability of its doing so," *Market Power*, at 808, this two-step analysis has become equally helpful under section 1. [FN10] *See, e.g.*, *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210 (D.C.Cir.1986), *cert. denied*, 479 U.S. 1033, 107 S.Ct. 880, 93 L.Ed.2d 834 (1987); *Ball Memorial Hosp., Inc. v. Mutual Hosp. Ins., Inc.*, 784 F.2d 1325 (7th Cir.1986).

FN10. Again, we recognize the overlaps in analysis between section 1 and section 2 cases as did the district court. Nevertheless, the differences must be underscored, the former involving conduct that doesn't alter market structure; the latter, "a pernicious market structure in which the concentration of power saps the salubrious influence of competition." *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 272 (2d Cir.1979), *cert. denied*, 444 U.S. 1093, 100 S.Ct. 1061, 62 L.Ed.2d 783 (1980).

The market power query begins with the determination of the relevant market, "that is, a market relevant to the legal issue before the court." P. Areeda & H. Hovenkamp, *Antitrust Law* ¶ 518.1c, at 535 (Supp.1993) [hereinafter *1993 Supplement* ]. "The 'market' which one must study to determine when a producer has monopoly power will vary with the part of commerce under consideration. The tests are constant. That market is composed of products that have reasonable interchangeability for the purposes for which they are produced--price, use and qualities considered." *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 404, 76 S.Ct. 994, 1012, 100 L.Ed. 1264 (1956). We also look to the geographic reach of the group of sales or sellers to determine the relevant market. *Brown Shoe Co. v. United States*, 370 U.S. 294, 324, 82 S.Ct. 1502, 1523, 8 L.Ed.2d 510 (1962). Further, "[b]ecause the ability of consumers to turn to other suppliers restrains a firm from raising prices above the competitive level, the definition of the 'relevant market' rests on a determination of available substitutes." *Rothery Storage*, 792 F.2d at 218.

> To define a market in product and geographic terms is to say that if prices were appreciably raised or volume appreciably curtailed for the product within a given area, while demand held constant, supply from other sources could not be expected to enter promptly enough and in large enough amounts to restore the old price and volume.

*Id.* (quoting L. Sullivan, *Antitrust* § 12, at 41 (1977)).

Although these concepts provide a shorthand for rule of reason analysis, we would be amiss to imply their application is necessarily facile. Each may be problematic:

> There is no subject in antitrust law more confusing than market definition. One reason is that the concept, even in the pristine formulation of economists, is deliberately an attempt to oversimplify--for working purposes--the very complex economic interactions between a number of differently situated buyers and sellers, each of whom in reality has different costs, needs, and substitutes. Further, when lawyers and judges take hold of the concept, they impose on it nuances and formulas that reflect administrative and antitrust policy goals. This adaption is legitimate (economists have no patent on the concept), but it means that normative and descriptive ideas become intertwined in the process of market definition.

*United States Healthcare, Inc. v. Healthsource, Inc.*, 986 F.2d 589, 598 (1st Cir.1993) . By defining the relevant market, however, we identify the firms that compete with each other. Plugged into the market power inquiry, we may then determine whether the alleged anticompetitive activity restrained trade, that is, raised price or reduced output.

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**V. Issuer Market**

This case illustrates both the utility and difficulties of the market power tool. In this lawsuit, Sears and Visa USA stipulated "the relevant market is the general purpose charge card market in the United States." 819 F.Supp. at 966. Presently, the only participants in this market are Visa USA, MasterCard, American Express, Citibank (Diners Club and Carte Blanche), and Sears (Discover Card). Competition among these five firms to place their individual credit cards into a consumer's pocket is called *intersystem*. "Interbrand competition is the competition among the manufacturers of the same generic product ... and is the primary concern of antitrust law." *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 52 n. 19, 97 S.Ct. 2549, 2558 n. 19, 53 L.Ed.2d 568 (1977).

In its complaint, Sears alleged the amendment to Bylaw 2.06 represented a concerted refusal to deal which unreasonably restrained trade in the general purpose charge card market. The parties agreed, and the testimony clearly established that in this relevant market competition occurs only at the issuer level. That is, to the extent that Visa USA is in the market, it operates in the *systems* market, not the *issuer* market. Its *members* issue cards, competing with each other to offer better terms or more attractive features for their individual credit card programs. This is *intrasystem* competition.

The issuer market, thus, remains atomistic, each issuer financial institution, bank, or other entity being independent from another. [FN11] Although Sears does not dispute this characterization of the market, it contends it attempted to launch its Prime Option program under the Visa aegis to "compete more effectively" at the issuer level. By offering multiple credit cards, Discover and Prime Option Visa, Sears contended it would then "strengthen competition."

FN11. Although approximately 6,000 financial institutions separately are issuers in the association, setting fees, interest rates, and other conditions, approximately 19,000 "participating members" offer cards under their own names and utilize the services of their issuing bank. Robert E. Litan, *Consumers, Competition, and Choice, The Impact of Price Controls on the Credit Card Industry*, March 1992.

If the general credit card issuer market is the relevant market, however, the evidence the district court relied upon to deny the Rule 50(b) motion belies Sears' contention and calls into question the definition of relevant market the court apparently adopted. First, the district court recounted the market shares of each intersystem competitor: "Visa was estimated to possess 45.6% of the nationwide general purpose charge card market; MasterCard, 26.4%; American Express, 20.5%; Discover Card, 5.5%; and Diners Club, 2.0%." 819 F.Supp. at 966 (footnote omitted). Within Visa USA's intersystem share, aggregated to include MasterCard issuers as well, the district court noted the evidence showed "in 1991 the ten largest issuers of Visa and MasterCard accounted for approximately 48% of the total Visa/MasterCard charge volume. The top-ten issuers were Citicorp, First Chicago, AT & T, Chase Manhattan, MBNA America, Bank of America, Nationsbank, Chemical Bank, Banc One, and Wells Fargo Bank. The largest issuer, Citicorp, accounted for approximately $42.5 billion in charge volume in 1991-- representing approximately 15.8% of the Visa/MasterCard market and 11.4% of the entire general purpose charge card market." *Id.* at 966 n. 8.

While these raw figures may suggest Visa USA possesses market power in the intersystem market, the parties have established a different paradigm. By their agreement, the context of this case was intended to focus on the issuance of credit cards as the relevant market. Indeed, that is the market the district court defined for the jury. To determine, therefore, whether Visa USA possesses market power, we must compare *issuers*, the point where both Sears and Visa USA agreed they compete. At that level, testimony from both Sears and Visa experts established Discover Card is the second largest issuer preceded only by Citicorp in terms of charge volume, that is, what consumers owe on their credit cards.

Based on the district court's figures, Citicorp's charge volume represented about 15.8% of the Visa/MasterCard market share, aggregated at 72% of the general purpose credit card market. If we compare issuers' charge volume, our calculations demonstrate Citicorp's is 21.9% in the relevant market, while that of Sears Discover Card is 5%. Neither figure reflects *at the issuer* level that Visa USA through its members possesses market power.

Nevertheless, Sears' expert, Dr. James Kearl, upon whom the district court relied to conclude the evidence was sufficient to establish Visa USA's market power, explained he looked at the collective,

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aggregated shares of Visa and MasterCard, because "we have a collective rule, bylaw 2.06 ... I found that the collective share was very large, and as a consequence my conclusion was that the collective rule was *an exercise of market power.*" (italics added). Dr. Kearl opined the association members

> have both incentive and the ability to exercise that market power. They have the incentive because this market share was large and they want to protect that market share. And they also had the incentive because since this is large, *if they can keep prices up or from falling they can make a lot of money.*

(italics added).

Second, despite the stipulation on the relevant market, "the market relevant to the legal issue before the court," *1993 Supplement,* at 535, the testimony reflects that Sears, in fact, sought to expand its competition not specifically in the general purpose credit card market but in a segment of that market represented by financial institutions or banks. For example, Sears' executive, William O'Hara, stated, "We were trying to compete *in that segment* of the general purpose credit card market called the bank association segment." (emphasis added.) Visa USA's witness, Richard Rosenberg, explained he voted for Bylaw 2.06, believing that because a non-bank like Dean Witter did not have to comply with certain requirements imposed on banks like the Community Reinvestment Act, Sears would have a competitive advantage over its bank rivals.

Indeed, albeit the stipulation, as the trial progressed, the "relevant market" devolved into *Visa USA's share* of the defined market. Thus, the legal issue was transformed, equating exclusion from Visa USA to exclusion from the market. [FN12] The evidence, however, does not support this mutation. The district court recognized five active rivals presently compete at the intersystem level. Of that market, for example, Citicorp represents 21.9%, American Express 20.5%, and Sears 5%. At the issuer level, where intrasystem competition occurs, the court found, and the parties' experts agreed, the market is remarkably unconcentrated. [FN13] Given the wide range of interest rates and terms offered by various issuers and Sears' recognized intersystem strength, we are at a loss to find the evidence to support the district court's contrary conclusion.

FN12. This revision of the market distinguishes this case from *Reazin v. Blue Cross & Blue Shield of Kan.,* 899 F.2d 951 (10th Cir.), *cert. denied,* 497 U.S. 1005, 110 S.Ct. 3241, 111 L.Ed.2d 752 (1990), upon which Sears relies.

FN13. Ironically, the district court rejected Visa USA's argument that the present market is highly concentrated, such that admitting Sears would constitute a violation of section 7 of the Clayton Act. After discussing the Herfindahl-Hirschman Index (HHI), which is used to determine market concentration, the district court rejected Visa USA's aggregation of market shares, stating "the court agrees with Visa's expert Professor Schmalensee that *each* individual issuer of Visa and MasterCard cards should be included in the HHI analysis, resulting in a system HHI of below 500." *SCFC ILC, Inc. v. Visa U.S.A., Inc.,* 819 F.Supp. 956, 994 (D.Utah 1993). This figure represents an unconcentrated market.

From this standpoint, even if Visa USA possesses market power, Dr. Kearl's testimony that Visa USA exercised that market power in *its ability* to make collective rules misses the point in the context of joint ventures. "A joint venture made more efficient by ancillary restraints, is a fusion of the productive capacities of the members of the venture." *Rothery Storage,* 792 F.2d at 230. The very existence of a joint venture in the first instance is premised on a pooling of resources to affect competition in some manner and is made functional through some form of cooperative behavior or rule-making. However, the Court has made clear, as previously discussed, cooperative conduct alone is not prohibited.

Hence, it is not the rule-making *per se* that should be the focus of the market power analysis, but the effect of those rules--whether they increase price, decrease output, or otherwise capitalize on barriers to entry that potential rivals cannot overcome. Although Dr. Kearl testified "if they can keep prices up or from falling they can make a lot of money" to support his conclusion Visa USA possesses market power, there was no evidence that price had been increased, output had decreased, or other indicia of anticompetitive activity had occurred.

Thus, without any eye on effect, the very exercise of rule-making became the factual basis for rule of reason condemnation of Bylaw 2.06. Consequently,

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rule-making was not only divorced from its functional analysis but also from the facts of the case. "When an expert opinion is not supported by sufficient facts to validate it in the eyes of the law, or when indisputable record facts contradict or otherwise render the opinion unreasonable, it cannot support a jury's verdict." *Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, ----, 113 S.Ct. 2578, 2598, 125 L.Ed.2d 168 (1993). In this complex area, the Court cautioned, "Expert testimony is useful as a guide to interpreting market facts, but it is not a substitute for them." *Id.*

We believe the evidence cited by the district court to conclude Visa USA possessed market power is insufficient as a matter of law. Although the district court did not end its rule of reason inquiry upon that finding, the conclusion set the path for its uncharted journey upon a landscape of speculation, conjecture, and theoretical harm. The consequence is the finding of liability based on tendentious and conclusory statements, none of which amounts to evidence of restraint of trade. [FN14]

FN14. In particular, Sears' disincentive argument provides the widest array of speculation and raises concerns about its standing to represent the supposed injury of others hoping to start up proprietary charge cards. Nevertheless, the parties each shared in charting the court's terrain.

**VI. Efficiency Justifications**

We therefore return to the two-step analysis previously discussed to assess the procompetitive justifications of Bylaw 2.06 to counteract Sears' allegation the restraint is unreasonable. Visa USA maintained it instituted Bylaw 2.06 to protect its property from intersystem competitors who otherwise would enjoy a free ride at this time of entry. Its general counsel, Bennett Katz, described technological advancements Visa USA achieved and incentives for innovation to system-wide competition generated. In a letter informing Sears of the Board's action, he stated, "As I indicated to you by phone, we believe that intersystem competition should be preserved and enhanced; membership by Greenwood Trust Co. would have the opposite effect." Describing the industry as small, "we only have three basic competitors ... Visa and MasterCard ... American Express and Discover," Katz expressed concern about government regulation if the existing competition diminished or Visa USA became too large. [FN15] [omitted] In addition, there was testimony that after duality was permitted, MasterCard and Visa competed less aggressively, consumers regarding the two cards often as interchangeable. Other witnesses expressed concern, for example, about Sears' threat to their own profits; the effect a big player like Sears would have on the many small banks that compete in the Visa USA association; and Sears' likely ability to become a Board member and privy to confidential information.

Against these justifications, Sears offered testimony about a two-stage strategy in which it had always planned to enter the market first with its Discover Card and then with a low-cost Visa card; that marketing the Prime Option card as a Discover Card program would not meet the objectives of "Sears' branding strategy," and that consumers would be harmed by being denied the opportunity to select a Prime Option Visa card from the possible choices in the general charge card market. Broadly, Sears promised a low-cost, competitive alternative to the existing market's cards and elicited, through expert testimony, the prospect of other similarly situated potential intersystem competitors being excluded and discouraged from offering new rival cards because of Bylaw 2.06.

Most of this evidence relied upon by the district court is irrelevant to the central antitrust question posed, however. First, intent to harm a rival, protect and maximize profits, or "do all the business if they can," *Ball Memorial Hosp.*, 784 F.2d at 1325, is neither actionable nor sanctioned by the antitrust laws. "Competition, which is always deliberate, has never been a tort, intentional or otherwise." *Olympia Equip. Leasing Co. v. Western Union Tel. Co.*, 797 F.2d 370, 379 (7th Cir.1986), *cert. denied*, 480 U.S. 934, 107 S.Ct. 1574, 94 L.Ed.2d 765 (1987). "Most businessmen don't like their competitors or for that matter competition. They want to make as much money as possible and getting a monopoly is one way of making a lot of money." *Id.* Thus, evidence that a Board member voted for Bylaw 2.06 to discourage price competition within Visa USA may reveal a mental state but is not an objective basis upon which section 1 liability may be found. If Bylaw 2.06 is not "objectively anticompetitive the fact that it was motivated by hostility to competitors ... is irrelevant." *Id.* (citation omitted).

What we ask under section 1 is whether the alleged restraint is reasonably related to Visa USA's operation and no broader than necessary to effectuate

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the association's business. *NaBanco*, 779 F.2d at 592, 601. That is, is Bylaw 2.06 ancillary, "subordinate and collateral ... [making] the main transaction more effective in accomplishing its purpose," which is to provide credit card services to its members? *Rothery Storage*, 792 F.2d at 224. If it is not ancillary, does it restrain trade in a manner which alters the structure of the general purpose credit card market and, thus, harms consumers?

We think the analysis in *Rothery Storage* helps us resolve this question. There, Atlas Van Lines adopted a new policy to prohibit any affiliated company from handling interstate hauling both under its own name as well as under the Atlas name. The policy was intended to prevent its affiliates from using Atlas equipment, facilities, and services for interstate hauling while independently negotiating contracts for their own accounts. [FN16] Atlas announced the rule was necessary to prevent its agents from benefiting from a free ride, increasing Atlas' liability for interstate shipments while using Atlas' resources without any attendant return of revenue.

FN16. The new policy responded as well to deregulation of the moving industry. Although regulatory constraints figured in the analysis, the resolution of the central issue was not dependent on that context.

> Atlas has required that any moving company doing business as its agent must not conduct independent interstate carrier operations. Thus, a carrier agent, in order to continue as an Atlas agent, must either abandon its independent interstate authority and operate only under Atlas' authority or create a new corporation (a 'carrier affiliate') to conduct interstate carriage separate from its operation as an Atlas agent. Atlas' agents may deal only with Atlas or other Atlas agents.

*Id.* at 217. [FN17] Several Atlas carrier agents claimed the policy constituted a group boycott and filed a complaint under section 1.

FN17. That is, its interstate rivals can no longer compete in interstate hauling both as Atlas agents and as independent agents. The policy, then, is analogous to the rule at issue here.

After a thorough and well-reasoned analysis, the D.C. Circuit rejected plaintiffs' claim, based not simply on the evidence Atlas did not possess market power in the market for the interstate carriage of used household goods, but also on the conclusion the new rule was ancillary to Atlas' main enterprise, enhancing consumer welfare by creating efficiency. *Id.* at 223. What improved the company's efficiency, the court found, was the elimination of the free ride:

> The restraints preserve the efficiencies of the nationwide van line by eliminating the problem of the free ride. There is, on the other hand, no possibility that the restraints can suppress market competition and so decrease output.

*Id.* at 229. This conclusion was built on the foundation of *BMI*, *NCAA*, and *Northwest Wholesale Stationers*.

Similarly, Visa USA urges its concern about protecting the property it has created over the years and preventing Sears and American Express, [FN18] successful rivals, from profiting by a free ride does not represent a refusal to deal or group boycott but is reasonably necessary to ensure the effective operation of its credit card services. It urges Bylaw 2.06 avoids "free- riding, an unlevel playing field, and the added costs that Sears would impose on VISA members by taking advantage of a brand and operating systems that it not only had done nothing to create but had chosen to compete against." Visa USA contends Sears does not need Visa USA to compete in the relevant market and cannot demonstrate it can only issue a low-cost card with Visa USA's help.

FN18. We note that American Express has never participated in this lawsuit.

Sears urges the justification is pretext. "In this case, the issue is whether the selective exclusion imposed by Visa's Bylaw 2.06 is ancillary to Visa's legitimate purposes as an open industry association." Sears contends Visa USA is a network joint venture, one whose integrative efficiencies actually grow as its membership increases. To accept Visa USA's analogy to a research venture, one expending individual talent and resources in a small laboratory only to be forced to include rival researchers, Sears argues, is naive. It protests everyone gets into Visa USA except Sears itself. In support, Sears relies on the bulwarks of exclusionary conduct cases.

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We do not believe either precedent or policy compels Sears' position, however. For example, *United States v. Terminal R.R. Ass'n of St. Louis*, 224 U.S. 383, 32 S.Ct. 507, 56 L.Ed. 810 (1912) (joint venture railroad companies that acquired Terminal Company, which controlled bridge across Mississippi River, approaches, and terminal at St. Louis, must admit rivals to permit use of facilities on nondiscriminatory terms), involved a "most extraordinary" situation in St. Louis, "and we base our conclusion in this case, in a large measure, upon that fact." *Id.* at 405, 32 S.Ct. at 513-14. In that setting, mandating the combined railroad companies admit their competitors merely permitted joint ownership of common facilities. "The defendants had not built or created anything except a combination to take over existing facilities." *1993 Supplement* ¶ 736.1, at 841.

Similarly, *Associated Press v. United States*, 326 U.S. 1, 65 S.Ct. 1416, 89 L.Ed. 2013 (1945) (joint venture news gathering agency must provide reasonable access to excluded firms), never stated a joint venture cannot exclude anyone. The Court's prohibition of the membership restriction was focussed particularly on the operation of the rule itself, where an individual Associated Press member could singly veto a rival's access to its local market. More importantly, the joint venture, "the largest news agency," was factually unique: its news gathering and dissemination capacity could not be duplicated and represented in and of itself a limitation on nonmembers. *Id.* at 13, 65 S.Ct. at 1421. [FN19]

FN19. *Terminal Railroad* and *Associated Press* are the roots of the essential facility analysis in antitrust. *See* Phillip E. Areeda, *Essential Facilities: An Epithet in Need of Limiting Principles*, 58 Antitrust L.J. 841 (1990).

We would also distinguish the much-quoted language in *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 105 S.Ct. 2847, 86 L.Ed.2d 467 (1985) (ski company's decision not to participate in an all-mountain lift ticket violated section 2). In that case, defendant ski company justified its refusal to continue offering an all-mountain lift ticket by asserting it had no duty to engage in joint marketing with a competitor. The Court responded by observing:

> The absence of a duty to transact business with another firm is, in some respects, merely the counterpart of the independent businessman's cherished right to select his customers and his associates. The high value that we have placed on the right to refuse to deal with other firms does not mean that the right is unqualified.

*Id.* at 601, 105 S.Ct. at 2856 (footnote omitted). In qualifying that right, the Court noted in the context of section 2 the refusal to deal had the effect of making "an important change in a pattern of distribution that had originated in a competitive market and had persisted for several years ... Ski Co.'s decision to terminate the all-Aspen ticket was thus a decision by a monopolist to make an important change in the character of the market." *Id.* at 603-04, 105 S.Ct. at 2858.

None of these conditions is present in this case. Bylaw 2.06 did not alter the character of the general purpose credit card market or change any present pattern of distribution. *Id.* Nor did it bar Sears from access to this market. There was no evidence Sears could only introduce a Prime Option card with Visa USA's help or that Visa USA's exclusion from its joint venture disabled Sears from developing its new card under the Discover mantle. More importantly, there was no evidence the bylaw harms consumers, the focus of the alleged violation. Indeed, the evidence established the current market in general purpose credit cards is structurally competitive, issuers targeting different consumer groups and consumer needs. In this market, Sears already competes vigorously. Surely, if its goal is to compete *more effectively* in that market, we do not believe this objective constitutes the proverbial sparrow the Sherman Act protects. "[A] producer's loss is no concern of the antitrust laws, which protect consumers from suppliers rather than suppliers from each other." *Stamatakis Indus.*, 965 F.2d at 471. [FN20]

FN20. Indeed, when the question becomes whether the restraint is reasonably necessary to achieve the joint venture's goals, "[e]xclusivity of venture membership will not generally be regarded as suspect." *1993 Supplement* ¶ 1506, at 1115. The Department of Justice has stated:

> [S]electivity in the membership of a joint venture often enhances a joint venture's procompetitive potential. Forcing joint ventures to open membership to all competitors (or to license the product of an R & D joint venture to all who seek

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> licenses) would decrease the incentives to form joint ventures ... For example, the inability to exclude those who would bring little or nothing to the joint venture, or those who would fail to share fully in the risks, would decrease the efficiency of the joint venture and reduce the expected reward from successfully accomplishing the joint venture's mission. An enforcement policy that denied a joint venture the ability to select its members might also encourage firms to forego risky endeavors in the hope of being able to gain access through antitrust litigation to the fruits of the successful endeavors of others. Thus, the Department [of Justice] generally will be concerned about a joint venture's policy of excluding others only if (i) an excluded firm cannot compete in a related market or markets ... in which the joint venture members are currently exercising market power without having access to the joint venture and (ii) there is no reasonable basis related to the efficient operation of the joint venture for excluding other firms.
> Justice Department, International Operations Antitrust Enforcement Policy 42 (Nov. 10, 1988) (CCH Supp.) (quoted in *1993 Supplement* ¶ 1506, at 1115).

Given Visa USA's justification the bylaw is necessary to prevent free- riding in a market in which there was no evidence price was raised or output decreased or Sears needed Visa USA to develop the new card, we are left with a vast sea of commercial policy into which Sears would have us wade. To impose liability on Visa USA for refusing to admit Sears or revise the bylaw to open its membership to intersystem rivals, we think, sucks the judiciary into an economic riptide of contrived market forces. Whatever currents Sears imagines Visa USA has wrongly created, we believe can be better corrected by the marketplace itself. The Sherman Act ultimately must protect competition, not a competitor, and were we tempted to collapse the distinction, we would distort its continuing viability to safeguard consumer welfare.

### VII. Conclusion

Reversal of the district court's order denying Visa USA's Rule 50(b) motion further dissipates the preemptive strike Visa USA attempted by requesting injunctive relief under section 7 of the Clayton Act. The reasoning which underpins our reversal of the district court's order and leaves the present entities in the market unchanged obviates scrutiny under section 7 of the Clayton Act. The district court properly denied relief.

We therefore **REVERSE** the district court's order holding Visa USA liable under section 1 of the Sherman Act. However, we **AFFIRM** its denial of an injunction to Visa USA under section 7 of the Clayton Act for reasons consistent with this opinion.

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Federal Trade Commission and United States Department of Justice

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# ANTITRUST GUIDELINES FOR COLLABORATIONS AMONG COMPETITORS

## PREAMBLE

In order to compete in modern markets, competitors sometimes need to collaborate. Competitive forces are driving firms toward complex collaborations to achieve goals such as expanding into foreign markets, funding expensive innovation efforts, and lowering production and other costs.

Such collaborations often are not only benign but procompetitive. Indeed, in the last two decades, the federal antitrust agencies have brought relatively few civil cases against competitor collaborations. Nevertheless, a perception that antitrust laws are skeptical about agreements among actual or potential competitors may deter the development of procompetitive collaborations.[1]

To provide guidance to business people, the Federal Trade Commission ("FTC") and the U.S. Department of Justice ("DOJ") (collectively, "the Agencies") previously issued guidelines addressing several special circumstances in which antitrust issues related to competitor collaborations may arise.[2] But none of these Guidelines represents a general statement of the Agencies' analytical approach to competitor collaborations. The increasing varieties and use of competitor collaborations have yielded requests for improved clarity regarding their treatment under the antitrust laws.

The new Antitrust Guidelines for Collaborations among Competitors ("Competitor Collaboration Guidelines") are intended to explain how the Agencies analyze certain antitrust issues raised by collaborations among competitors. Competitor collaborations and the market circumstances in which they operate vary widely. No set of guidelines can provide specific

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[1] Congress has protected certain collaborations from full antitrust liability by passing the National Cooperative Research Act of 1984 ("NCRA") and the National Cooperative Research and Production Act of 1993 ("NCRPA") (codified together at 15 U.S.C. §§ 4301-06). Relatively few participants in research and production collaborations have sought to take advantage of the protections afforded by the NCRA and NCRPA, however.

[2] The Statements of Antitrust Enforcement Policy in Health Care ("Health Care Statements") outline the Agencies' approach to certain health care collaborations, among other things. The Antitrust Guidelines for the Licensing of Intellectual Property ("Intellectual Property Guidelines") outline the Agencies' enforcement policy with respect to intellectual property licensing agreements among competitors, among other things. The 1992 DOJ/FTC Horizontal Merger Guidelines, as amended in 1997 ("Horizontal Merger Guidelines"), outline the Agencies' approach to horizontal mergers and acquisitions, and certain competitor collaborations.

answers to every antitrust question that might arise from a competitor collaboration. These Guidelines describe an analytical framework to assist businesses in assessing the likelihood of an antitrust challenge to a collaboration with one or more competitors. They should enable businesses to evaluate proposed transactions with greater understanding of possible antitrust implications, thus encouraging procompetitive collaborations, deterring collaborations likely to harm competition and consumers, and facilitating the Agencies' investigations of collaborations.

## SECTION 1: PURPOSE, DEFINITIONS, AND OVERVIEW

### 1.1 Purpose and Definitions

These Guidelines state the antitrust enforcement policy of the Agencies with respect to competitor collaborations. By stating their general policy, the Agencies hope to assist businesses in assessing whether the Agencies will challenge a competitor collaboration or any of the agreements of which it is comprised.[3] However, these Guidelines cannot remove judgment and discretion in antitrust law enforcement. The Agencies evaluate each case in light of its own facts and apply the analytical framework set forth in these Guidelines reasonably and flexibly.[4]

A "competitor collaboration" comprises a set of one or more agreements, other than merger agreements, between or among competitors to engage in economic activity, and the economic activity resulting therefrom.[5] "Competitors" include firms that are actual or potential competitors[6] in a relevant market.[7] Competitor collaborations involve one or more business activities, such as research and development ("R&D"), production, marketing, distribution, sales or purchasing. Information sharing and various trade association activities also may take place through competitor collaborations.

These Guidelines use the terms "anticompetitive harm," "procompetitive benefit," and "overall competitive effect" in analyzing the competitive effects of agreements among

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[3] These Guidelines neither describe how the Agencies litigate cases nor assign burdens of proof or production.

[4] The analytical framework set forth in these Guidelines is consistent with the analytical frameworks in the Health Care Statements and the Intellectual Property Guidelines, which remain in effect to address issues in their special contexts.

[5] These Guidelines do not address the possible exclusionary effects of agreements among competitors that may foreclose or limit competition by rivals.

[6] A firm is treated as a potential competitor if there is evidence that entry by that firm is reasonably probable in the absence of the relevant agreement, or that competitively significant decisions by actual competitors are constrained by concerns that anticompetitive conduct likely would induce the firm to enter.

[7] Firms also may be in a buyer-seller or other relationship, but that does not eliminate the need to examine the competitor relationship, if present.

competitors. All of these terms include actual and likely competitive effects. The Guidelines use the term "anticompetitive harm" to refer to an agreement's adverse competitive consequences, without taking account of offsetting procompetitive benefits. Conversely, the term "procompetitive benefit" refers to an agreement's favorable competitive consequences, without taking account of its anticompetitive harm. The terms "overall competitive effect" or "competitive effect" are used in discussing the combination of an agreement's anticompetitive harm and procompetitive benefit.

1.2 Overview of Analytical Framework

Two types of analysis are used by the Supreme Court to determine the lawfulness of an agreement among competitors: per se and rule of reason.[8] Certain types of agreements are so likely to harm competition and to have no significant procompetitive benefit that they do not warrant the time and expense required for particularized inquiry into their effects. Once identified, such agreements are challenged as per se unlawful.[9] All other agreements are evaluated under the rule of reason, which involves a factual inquiry into an agreement's overall competitive effect. As the Supreme Court has explained, rule of reason analysis entails a flexible inquiry and varies in focus and detail depending on the nature of the agreement and market circumstances.[10]

This overview briefly sets forth questions and factors that the Agencies assess in analyzing an agreement among competitors. The rest of the Guidelines should be consulted for the detailed definitions and discussion that underlie this analysis.

Agreements Challenged as Per Se Illegal. Agreements of a type that always or almost always tends to raise price or to reduce output are per se illegal. The Agencies challenge such agreements, once identified, as per se illegal. Types of agreements that have been held per se illegal include agreements among competitors to fix prices or output, rig bids, or share or divide markets by allocating customers, suppliers, territories, or lines of commerce. The Department of Justice prosecutes participants in such hard-core cartel agreements criminally. Because the courts conclusively presume such hard-core cartel agreements to be illegal, the Department of Justice treats them as such without inquiring into their claimed business purposes, anticompetitive harms, procompetitive benefits, or overall competitive effects.

Agreements Analyzed under the Rule of Reason. Agreements not challenged as per se illegal are analyzed under the rule of reason to determine their overall competitive effect. These include agreements of a type that otherwise might be considered per se illegal, provided they are reasonably related to, and reasonably necessary to achieve procompetitive benefits from, an

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[8] See National Soc'y of Prof'l. Eng'rs v. United States, 435 U.S. 679, 692 (1978).

[9] See FTC v. Superior Court Trial Lawyers Ass'n, 493 U.S. 411, 432-36 (1990).

[10] See California Dental Ass'n v. FTC, 119 S. Ct. 1604, 1617-18 (1999); FTC v. Indiana Fed'n of Dentists, 476 U.S. 447, 459-61 (1986); National Collegiate Athletic Ass'n v. Board of Regents of the Univ. of Okla., 468 U.S. 85, 104-13 (1984).

efficiency-enhancing integration of economic activity.

Rule of reason analysis focuses on the state of competition with, as compared to without, the relevant agreement. The central question is whether the relevant agreement likely harms competition by increasing the ability or incentive profitably to raise price above or reduce output, quality, service, or innovation below what likely would prevail in the absence of the relevant agreement.

Rule of reason analysis entails a flexible inquiry and varies in focus and detail depending on the nature of the agreement and market circumstances. The Agencies focus on only those factors, and undertake only that factual inquiry, necessary to make a sound determination of the overall competitive effect of the relevant agreement. Ordinarily, however, no one factor is dispositive in the analysis.

The Agencies' analysis begins with an examination of the nature of the relevant agreement. As part of this examination, the Agencies ask about the business purpose of the agreement and examine whether the agreement, if already in operation, has caused anticompetitive harm. In some cases, the nature of the agreement and the absence of market power together may demonstrate the absence of anticompetitive harm. In such cases, the Agencies do not challenge the agreement. Alternatively, where the likelihood of anticompetitive harm is evident from the nature of the agreement, or anticompetitive harm has resulted from an agreement already in operation, then, absent overriding benefits that could offset the anticompetitive harm, the Agencies challenge such agreements without a detailed market analysis.

If the initial examination of the nature of the agreement indicates possible competitive concerns, but the agreement is not one that would be challenged without a detailed market analysis, the Agencies analyze the agreement in greater depth. The Agencies typically define relevant markets and calculate market shares and concentration as an initial step in assessing whether the agreement may create or increase market power or facilitate its exercise. The Agencies examine the extent to which the participants and the collaboration have the ability and incentive to compete independently. The Agencies also evaluate other market circumstances, e.g. entry, that may foster or prevent anticompetitive harms.

If the examination of these factors indicates no potential for anticompetitive harm, the Agencies end the investigation without considering procompetitive benefits. If investigation indicates anticompetitive harm, the Agencies examine whether the relevant agreement is reasonably necessary to achieve procompetitive benefits that likely would offset anticompetitive harms.

### 1.3 Competitor Collaborations Distinguished from Mergers

The competitive effects from competitor collaborations may differ from those of mergers due to a number of factors. Mergers completely end competition between the merging parties in the relevant market(s). By contrast, most competitor collaborations preserve some form of competition among the participants. This remaining competition may reduce competitive

concerns, but also may raise questions about whether participants have agreed to anticompetitive restraints on the remaining competition.

Mergers are designed to be permanent, while competitor collaborations are more typically of limited duration. Thus, participants in a collaboration typically remain potential competitors, even if they are not actual competitors for certain purposes (e.g., R&D) during the collaboration. The potential for future competition between participants in a collaboration requires antitrust scrutiny different from that required for mergers.

Nonetheless, in some cases, competitor collaborations have competitive effects identical to those that would arise if the participants merged in whole or in part. The Agencies treat a competitor collaboration as a horizontal merger in a relevant market and analyze the collaboration pursuant to the Horizontal Merger Guidelines if: (a) the participants are competitors in that relevant market; (b) the formation of the collaboration involves an efficiency-enhancing integration of economic activity in the relevant market; (c) the integration eliminates all competition among the participants in the relevant market; and (d) the collaboration does not terminate within a sufficiently limited period[11] by its own specific and express terms.[12] Effects of the collaboration on competition in other markets are analyzed as appropriate under these Guidelines or other applicable precedent. See Example 1.[13]

## SECTION 2: GENERAL PRINCIPLES FOR EVALUATING AGREEMENTS AMONG COMPETITORS

### 2.1 Potential Procompetitive Benefits

The Agencies recognize that consumers may benefit from competitor collaborations in a variety of ways. For example, a competitor collaboration may enable participants to offer goods or services that are cheaper, more valuable to consumers, or brought to market faster than would be possible absent the collaboration. A collaboration may allow its participants to better use existing assets, or may provide incentives for them to make output-enhancing investments that would not occur absent the collaboration. The potential efficiencies from competitor collaborations may be achieved through a variety of contractual arrangements including joint ventures, trade or professional associations, licensing arrangements, or strategic alliances.

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[11] In general, the Agencies use ten years as a term indicating sufficient permanence to justify treatment of a competitor collaboration as analogous to a merger. The length of this term may vary, however, depending on industry-specific circumstances, such as technology life cycles.

[12] This definition, however, does not determine obligations arising under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a.

[13] Examples illustrating this and other points set forth in these Guidelines are included in the Appendix.

Efficiency gains from competitor collaborations often stem from combinations of different capabilities or resources. For example, one participant may have special technical expertise that usefully complements another participant's manufacturing process, allowing the latter participant to lower its production cost or improve the quality of its product. In other instances, a collaboration may facilitate the attainment of scale or scope economies beyond the reach of any single participant. For example, two firms may be able to combine their research or marketing activities to lower their cost of bringing their products to market, or reduce the time needed to develop and begin commercial sales of new products. Consumers may benefit from these collaborations as the participants are able to lower prices, improve quality, or bring new products to market faster.

### 2.2 Potential Anticompetitive Harms

Competitor collaborations may harm competition and consumers by increasing the ability or incentive profitably to raise price above or reduce output, quality, service, or innovation below what likely would prevail in the absence of the relevant agreement. Such effects may arise through a variety of mechanisms. Among other things, agreements may limit independent decision making or combine the control of or financial interests in production, key assets, or decisions regarding price, output, or other competitively sensitive variables, or may otherwise reduce the participants' ability or incentive to compete independently.

Competitor collaborations also may facilitate explicit or tacit collusion through facilitating practices such as the exchange or disclosure of competitively sensitive information or through increased market concentration. Such collusion may involve the relevant market in which the collaboration operates or another market in which the participants in the collaboration are actual or potential competitors.

### 2.3 Analysis of the Overall Collaboration and the Agreements of Which It Consists

A competitor collaboration comprises a set of one or more agreements, other than merger agreements, between or among competitors to engage in economic activity, and the economic activity resulting therefrom. In general, the Agencies assess the competitive effects of the overall collaboration and any individual agreement or set of agreements within the collaboration that may harm competition. For purposes of these Guidelines, the phrase "relevant agreement" refers to whichever of these three the evaluating Agency is assessing. Two or more agreements are assessed together if their procompetitive benefits or anticompetitive harms are so intertwined that they cannot meaningfully be isolated and attributed to any individual agreement. See Example 2.

### 2.4 Competitive Effects Are Assessed as of the Time of Possible Harm to Competition

The competitive effects of a relevant agreement may change over time, depending on changes in circumstances such as internal reorganization, adoption of new agreements as part of the collaboration, addition or departure of participants, new market conditions, or changes in market share. The Agencies assess the competitive effects of a relevant agreement as of the time of possible harm to competition, whether at formation of the collaboration or at a later time, as appropriate. See Example 3. However, an assessment after a collaboration has been formed is

sensitive to the reasonable expectations of participants whose significant sunk cost investments in reliance on the relevant agreement were made before it became anticompetitive.

## SECTION 3: ANALYTICAL FRAMEWORK FOR EVALUATING AGREEMENTS AMONG COMPETITORS

### 3.1 Introduction

Section 3 sets forth the analytical framework that the Agencies use to evaluate the competitive effects of a competitor collaboration and the agreements of which it consists. Certain types of agreements are so likely to be harmful to competition and to have no significant benefits that they do not warrant the time and expense required for particularized inquiry into their effects.[14] Once identified, such agreements are challenged as per se illegal.[15]

Agreements not challenged as per se illegal are analyzed under the rule of reason. Rule of reason analysis focuses on the state of competition with, as compared to without, the relevant agreement. Under the rule of reason, the central question is whether the relevant agreement likely harms competition by increasing the ability or incentive profitably to raise price above or reduce output, quality, service, or innovation below what likely would prevail in the absence of the relevant agreement. Given the great variety of competitor collaborations, rule of reason analysis entails a flexible inquiry and varies in focus and detail depending on the nature of the agreement and market circumstances. Rule of reason analysis focuses on only those factors, and undertakes only the degree of factual inquiry, necessary to assess accurately the overall competitive effect of the relevant agreement.[16]

The following sections describe in detail the Agencies' analytical framework.

### 3.2 Agreements Challenged as Per Se Illegal

Agreements of a type that always or almost always tends to raise price or reduce output are per se illegal.[17] The Agencies challenge such agreements, once identified, as per se illegal. Typically these are agreements not to compete on price or output. Types of agreements that have been held per se illegal include agreements among competitors to fix prices or output, rig bids, or share or divide markets by allocating customers, suppliers, territories or lines of commerce.[18] The Department of Justice prosecutes participants in such hard-core cartel agreements criminally. Because the courts conclusively presume such hard-core cartel agreements to be illegal, the Department of Justice treats them as such without inquiring into their claimed business purposes, anticompetitive harms, procompetitive benefits, or overall competitive

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[14] See Continental TV, Inc. v. GTE Sylvania Inc., 433 U.S. 36, 50 n.16 (1977).

[15] See Superior Court Trial Lawyers Ass'n, 493 U.S. at 432-36.

[16] See California Dental Ass'n, 119 S. Ct. at 1617-18; Indiana Fed'n of Dentists, 476 U.S. at 459-61; NCAA, 468 U.S. at 104-13.

[17] See Broadcast Music, Inc. v. Columbia Broadcasting Sys., 441 U.S. 1, 19-20 (1979).

[18] See, e.g., Palmer v. BRG of Georgia, Inc., 498 U.S. 46 (1990) (market allocation); United States v. Trenton Potteries Co., 273 U.S. 392 (1927) (price fixing).

effects.

If, however, participants in an efficiency-enhancing integration of economic activity enter into an agreement that is reasonably related to the integration and reasonably necessary to achieve its procompetitive benefits, the Agencies analyze the agreement under the rule of reason, even if it is of a type that might otherwise be considered per se illegal.[19] See Example 4. In an efficiency-enhancing integration, participants collaborate to perform or cause to be performed (by a joint venture entity created by the collaboration or by one or more participants or by a third party acting on behalf of other participants) one or more business functions, such as production, distribution, or R&D, and thereby benefit, or potentially benefit, consumers by expanding output, reducing price, or enhancing quality, service, or innovation. Participants in an efficiency-enhancing integration typically combine, by contract or otherwise, significant capital, technology, or other complementary assets to achieve procompetitive benefits that the participants could not achieve separately. The mere coordination of decisions on price, output, customers, territories, and the like is not integration, and cost savings without integration are not a basis for avoiding per se condemnation. The integration must promote procompetitive benefits that are cognizable under the efficiencies analysis set forth in Section 3.36 below. Such procompetitive benefits may enhance the participants' ability or incentives to compete and thus may offset an agreement's anticompetitive tendencies. See Examples 5 through 7.

An agreement may be "reasonably necessary" without being essential. However, if the participants could achieve an equivalent or comparable efficiency-enhancing integration through practical, significantly less restrictive means, then the Agencies conclude that the agreement is not reasonably necessary.[20] In making this assessment, except in unusual circumstances, the Agencies consider whether practical, significantly less restrictive means were reasonably available when the agreement was entered into, but do not search for a theoretically less restrictive alternative that was not practical given the business realities.

Before accepting a claim that an agreement is reasonably necessary to achieve procompetitive benefits from an integration of economic activity, the Agencies undertake a limited factual inquiry to evaluate the claim.[21] Such an inquiry may reveal that efficiencies from an agreement that are possible in theory are not plausible in the context of the particular collaboration. Some claims - such as those premised on the notion that competition itself is unreasonable - are insufficient as a matter of law,[22] and others may be implausible on their face.

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[19] See Arizona v. Maricopa County Medical Soc'y, 457 U.S. 332, 339 n.7, 356-57 (1982) (finding no integration).

[20] See id. at 352-53 (observing that even if a maximum fee schedule for physicians' services were desirable, it was not necessary that the schedule be established by physicians rather than by insurers); Broadcast Music, 441 U.S. at 20-21 (setting of price "necessary" for the blanket license).

[21] See Maricopa, 457 U.S. at 352-53, 356-57 (scrutinizing the defendant medical foundations for indicia of integration and evaluating the record evidence regarding less restrictive alternatives).

[22] See Indiana Fed'n of Dentists, 476 U.S. at 463-64; NCAA, 468 U.S. at 116-17; Prof'l. Eng'rs, 435 U.S. at 693-96. Other claims, such as an absence of market power, are no defense to

In any case, labeling an arrangement a "joint venture" will not protect what is merely a device to raise price or restrict output;[23] the nature of the conduct, not its designation, is determinative.

3.3 Agreements Analyzed under the Rule of Reason

Agreements not challenged as per se illegal are analyzed under the rule of reason to determine their overall competitive effect. Rule of reason analysis focuses on the state of competition with, as compared to without, the relevant agreement. The central question is whether the relevant agreement likely harms competition by increasing the ability or incentive profitably to raise price above or reduce output, quality, service, or innovation below what likely would prevail in the absence of the relevant agreement.[24]

Rule of reason analysis entails a flexible inquiry and varies in focus and detail depending on the nature of the agreement and market circumstances.[25] The Agencies focus on only those factors, and undertake only that factual inquiry, necessary to make a sound determination of the overall competitive effect of the relevant agreement. Ordinarily, however, no one factor is dispositive in the analysis.

Under the rule of reason, the Agencies' analysis begins with an examination of the nature of the relevant agreement, since the nature of the agreement determines the types of anticompetitive harms that may be of concern. As part of this examination, the Agencies ask about the business purpose of the agreement and examine whether the agreement, if already in operation, has caused anticompetitive harm.[26] If the nature of the agreement and the absence of market power[27] together demonstrate the absence of anticompetitive harm, the Agencies do not challenge the agreement. See Example 8. Alternatively, where the likelihood of anticompetitive harm is evident from the nature of the agreement,[28] or anticompetitive harm has resulted from an

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per se illegality. See Superior Court Trial Lawyers Ass'n, 493 U.S. at 434-36; United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 224-26 & n.59 (1940).

[23] See Timken Roller Bearing Co. v. United States, 341 U.S. 593, 598 (1951).

[24] In addition, concerns may arise where an agreement increases the ability or incentive of buyers to exercise monopsony power. See infra Section 3.31(a).

[25] See California Dental Ass'n, 119 S. Ct. at 1612-13, 1617 ("What is required . . . is an enquiry meet for the case, looking to the circumstances, details, and logic of a restraint."); NCAA, 468 U.S. 109 n.39 ("the rule of reason can sometimes be applied in the twinkling of an eye") (quoting Phillip E. Areeda, The "Rule of Reason" in Antitrust Analysis: General Issues 37-38 (Federal Judicial Center, June 1981)).

[26] See Board of Trade of the City of Chicago v. United States, 246 U.S. 231, 238 (1918).

[27] That market power is absent may be determined without defining a relevant market. For example, if no market power is likely under any plausible market definition, it does not matter which one is correct.

[28] See California Dental Ass'n, 119 S. Ct. at 1612-13, 1617 (an "obvious anticompetitive effect" would warrant quick condemnation); Indiana Fed'n of Dentists, 476 U.S. at 459; NCAA, 468 U.S. at 104, 106-10.

agreement already in operation,[29] then, absent overriding benefits that could offset the anticompetitive harm, the Agencies challenge such agreements without a detailed market analysis.[30]

If the initial examination of the nature of the agreement indicates possible competitive concerns, but the agreement is not one that would be challenged without a detailed market analysis, the Agencies analyze the agreement in greater depth. The Agencies typically define relevant markets and calculate market shares and concentration as an initial step in assessing whether the agreement may create or increase market power[31] or facilitate its exercise and thus poses risks to competition.[32] The Agencies examine factors relevant to the extent to which the participants and the collaboration have the ability and incentive to compete independently, such as whether an agreement is exclusive or non-exclusive and its duration.[33] The Agencies also evaluate whether entry would be timely, likely, and sufficient to deter or counteract any anticompetitive harms. In addition, the Agencies assess any other market circumstances that may foster or impede anticompetitive harms.

If the examination of these factors indicates no potential for anticompetitive harm, the Agencies end the investigation without considering procompetitive benefits. If investigation indicates anticompetitive harm, the Agencies examine whether the relevant agreement is reasonably necessary to achieve procompetitive benefits that likely would offset anticompetitive harms.[34]

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[29] See Indiana Fed'n of Dentists, 476 U.S. at 460-61 ("Since the purpose of the inquiries into market definition and market power is to determine whether an arrangement has the potential for genuine adverse effects on competition, 'proof of actual detrimental effects, such as a reduction of output,' can obviate the need for an inquiry into market power, which is but a 'surrogate for detrimental effects.'") (quoting 7 Phillip E. Areeda, Antitrust Law P1511, at 424 (1986)); NCAA, 468 U.S. at 104-08, 110 n.42.

[30] See Indiana Fed'n of Dentists, 476 U.S. at 459-60 (condemning without "detailed market analysis" an agreement to limit competition by withholding x-rays from patients' insurers after finding no competitive justification).

[31] Market power to a seller is the ability profitably to maintain prices above competitive levels for a significant period of time. Sellers also may exercise market power with respect to significant competitive dimensions other than price, such as quality, service, or innovation. Market power to a buyer is the ability profitably to depress the price paid for a product below the competitive level for a significant period of time and thereby depress output.

[32] See Eastman Kodak Co. v. Image Technical Services, Inc., 504 U.S. 451, 464 (1992).

[33] Compare NCAA, 468 U.S. at 113-15, 119-20 (noting that colleges were not permitted to televise their own games without restraint), with Broadcast Music, 441 U.S. at 23-24 (finding no legal or practical impediment to individual licenses).

[34] See NCAA, 468 U.S. at 113-15 (rejecting efficiency claims when production was limited, not enhanced); Prof'l. Eng'rs, 435 U.S. at 696 (dictum) (distinguishing restraints that promote competition from those that eliminate competition); Chicago Bd. of Trade, 246 U.S. at 238 (same).

3.31 Nature of the Relevant Agreement: Business Purpose, Operation in the Marketplace and Possible Competitive Concerns

The nature of the agreement is relevant to whether it may cause anticompetitive harm. For example, by limiting independent decision making or combining control over or financial interests in production, key assets, or decisions on price, output, or other competitively sensitive variables, an agreement may create or increase market power or facilitate its exercise by the collaboration, its participants, or both. An agreement to limit independent decision making or to combine control or financial interests may reduce the ability or incentive to compete independently. An agreement also may increase the likelihood of an exercise of market power by facilitating explicit or tacit collusion,[35] either through facilitating practices such as an exchange of competitively sensitive information or through increased market concentration.

In examining the nature of the relevant agreement, the Agencies take into account inferences about business purposes for the agreement that can be drawn from objective facts. The Agencies also consider evidence of the subjective intent of the participants to the extent that it sheds light on competitive effects.[36] The Agencies do not undertake a full analysis of procompetitive benefits pursuant to Section 3.36 below, however, unless an anticompetitive harm appears likely.

The Agencies also examine whether an agreement already in operation has caused anticompetitive harm.[37] Anticompetitive harm may be observed, for example, if a competitor collaboration successfully mandates new, anticompetitive conduct or successfully eliminates procompetitive pre-collaboration conduct, such as withholding services that were desired by consumers when offered in a competitive market. If anticompetitive harm is found, examination of market power ordinarily is not required. In some cases, however, a determination of anticompetitive harm may be informed by consideration of market power.

The following sections illustrate competitive concerns that may arise from the nature of particular types of competitor collaborations. This list is not exhaustive. In addition, where these sections address agreements of a type that otherwise might be considered per se illegal, such as agreements on price, the discussion assumes that the agreements already have been determined to be subject to rule of reason analysis because they are reasonably related to, and reasonably necessary to achieve procompetitive benefits from, an efficiency-enhancing integration of economic activity. See supra Section 3.2.

3.31(a) Relevant Agreements that Limit Independent Decision Making or Combine Control or

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[35] As used in these Guidelines, "collusion" is not limited to conduct that involves an agreement under the antitrust laws.

[36] Anticompetitive intent alone does not establish an antitrust violation, and procompetitive intent does not preclude a violation. See, e.g., Chicago Bd. of Trade, 246 U.S. at 238. But extrinsic evidence of intent may aid in evaluating market power, the likelihood of anticompetitive harm, and claimed procompetitive justifications where an agreement's effects are otherwise ambiguous.

[37] See id.

Financial Interests

The following is intended to illustrate but not exhaust the types of agreements that might harm competition by eliminating independent decision making or combining control or financial interests.

Production Collaborations. Competitor collaborations may involve agreements jointly to produce a product sold to others or used by the participants as an input. Such agreements are often procompetitive.[38] Participants may combine complementary technologies, know-how, or other assets to enable the collaboration to produce a good more efficiently or to produce a good that no one participant alone could produce. However, production collaborations may involve agreements on the level of output or the use of key assets, or on the price at which the product will be marketed by the collaboration, or on other competitively significant variables, such as quality, service, or promotional strategies, that can result in anticompetitive harm. Such agreements can create or increase market power or facilitate its exercise by limiting independent decision making or by combining in the collaboration, or in certain participants, the control over some or all production or key assets or decisions about key competitive variables that otherwise would be controlled independently.[39] Such agreements could reduce individual participants' control over assets necessary to compete and thereby reduce their ability to compete independently, combine financial interests in ways that undermine incentives to compete independently, or both.

Marketing Collaborations. Competitor collaborations may involve agreements jointly to sell, distribute, or promote goods or services that are either jointly or individually produced. Such agreements may be procompetitive, for example, where a combination of complementary assets enables products more quickly and efficiently to reach the marketplace. However, marketing collaborations may involve agreements on price, output, or other competitively significant variables, or on the use of competitively significant assets, such as an extensive distribution network, that can result in anticompetitive harm. Such agreements can create or increase market power or facilitate its exercise by limiting independent decision making; by combining in the collaboration, or in certain participants, control over competitively significant assets or decisions about competitively significant variables that otherwise would be controlled independently; or by combining financial interests in ways that undermine incentives to compete

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[38] The NCRPA accords rule of reason treatment to certain production collaborations. However, the statute permits per se challenges, in appropriate circumstances, to a variety of activities, including agreements to jointly market the goods or services produced or to limit the participants' independent sale of goods or services produced outside the collaboration. NCRPA, 15 U.S.C. §§ 4301-02.

[39] For example, where output resulting from a collaboration is transferred to participants for independent marketing, anticompetitive harm could result if that output is restricted or if the transfer takes place at a supracompetitive price. Such conduct could raise participants' marginal costs through inflated per-unit charges on the transfer of the collaboration's output. Anticompetitive harm could occur even if there is vigorous competition among collaboration participants in the output market, since all the participants would have paid the same inflated transfer price.

independently. For example, joint promotion might reduce or eliminate comparative advertising, thus harming competition by restricting information to consumers on price and other competitively significant variables.

Buying Collaborations. Competitor collaborations may involve agreements jointly to purchase necessary inputs. Many such agreements do not raise antitrust concerns and indeed may be procompetitive. Purchasing collaborations, for example, may enable participants to centralize ordering, to combine warehousing or distribution functions more efficiently, or to achieve other efficiencies. However, such agreements can create or increase market power (which, in the case of buyers, is called "monopsony power") or facilitate its exercise by increasing the ability or incentive to drive the price of the purchased product, and thereby depress output, below what likely would prevail in the absence of the relevant agreement. Buying collaborations also may facilitate collusion by standardizing participants' costs or by enhancing the ability to project or monitor a participant's output level through knowledge of its input purchases.

Research & Development Collaborations. Competitor collaborations may involve agreements to engage in joint research and development ("R&D"). Most such agreements are procompetitive, and they typically are analyzed under the rule of reason.[40] Through the combination of complementary assets, technology, or know-how, an R&D collaboration may enable participants more quickly or more efficiently to research and develop new or improved goods, services, or production processes. Joint R&D agreements, however, can create or increase market power or facilitate its exercise by limiting independent decision making or by combining in the collaboration, or in certain participants, control over competitively significant assets or all or a portion of participants' individual competitive R&D efforts. Although R&D collaborations also may facilitate tacit collusion on R&D efforts, achieving, monitoring, and punishing departures from collusion is sometimes difficult in the R&D context.

An exercise of market power may injure consumers by reducing innovation below the level that otherwise would prevail, leading to fewer or no products for consumers to choose from, lower quality products, or products that reach consumers more slowly than they otherwise would. An exercise of market power also may injure consumers by reducing the number of independent competitors in the market for the goods, services, or production processes derived from the R&D collaboration, leading to higher prices or reduced output, quality, or service. A central question is whether the agreement increases the ability or incentive anticompetitively to reduce R&D efforts pursued independently or through the collaboration, for example, by slowing the pace at which R&D efforts are pursued. Other considerations being equal, R&D agreements are more likely to raise competitive concerns when the collaboration or its participants already possess a secure source of market power over an existing product and the new R&D efforts might cannibalize their supracompetitive earnings. In addition, anticompetitive harm generally is more likely when R&D competition is confined to firms with specialized characteristics or assets, such as intellectual property, or when a regulatory approval process limits the ability of

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[40] See NCRPA, 15 U.S.C. §§ 4301-02. However, the statute permits per se challenges, in appropriate circumstances, to a variety of activities, including agreements to jointly market the fruits of collaborative R&D or to limit the participants' independent R&D or their sale or licensing of goods, services, or processes developed outside the collaboration. Id.

late-comers to catch up with competitors already engaged in the R&D.

3.31(b) Relevant Agreements that May Facilitate Collusion

Each of the types of competitor collaborations outlined above can facilitate collusion. Competitor collaborations may provide an opportunity for participants to discuss and agree on anticompetitive terms, or otherwise to collude anticompetitively, as well as a greater ability to detect and punish deviations that would undermine the collusion. Certain marketing, production, and buying collaborations, for example, may provide opportunities for their participants to collude on price, output, customers, territories, or other competitively sensitive variables. R&D collaborations, however, may be less likely to facilitate collusion regarding R&D activities since R&D often is conducted in secret, and it thus may be difficult to monitor an agreement to coordinate R&D. In addition, collaborations can increase concentration in a relevant market and thus increase the likelihood of collusion among all firms, including the collaboration and its participants.

Agreements that facilitate collusion sometimes involve the exchange or disclosure of information. The Agencies recognize that the sharing of information among competitors may be procompetitive and is often reasonably necessary to achieve the procompetitive benefits of certain collaborations; for example, sharing certain technology, know-how, or other intellectual property may be essential to achieve the procompetitive benefits of an R&D collaboration. Nevertheless, in some cases, the sharing of information related to a market in which the collaboration operates or in which the participants are actual or potential competitors may increase the likelihood of collusion on matters such as price, output, or other competitively sensitive variables. The competitive concern depends on the nature of the information shared. Other things being equal, the sharing of information relating to price, output, costs, or strategic planning is more likely to raise competitive concern than the sharing of information relating to less competitively sensitive variables. Similarly, other things being equal, the sharing of information on current operating and future business plans is more likely to raise concerns than the sharing of historical information. Finally, other things being equal, the sharing of individual company data is more likely to raise concern than the sharing of aggregated data that does not permit recipients to identify individual firm data.

3.32 Relevant Markets Affected by the Collaboration

The Agencies typically identify and assess competitive effects in all of the relevant product and geographic markets in which competition may be affected by a competitor collaboration, although in some cases it may be possible to assess competitive effects directly without defining a particular relevant market(s). Markets affected by a competitor collaboration include all markets in which the economic integration of the participants' operations occurs or in which the collaboration operates or will operate,[41] and may also include additional markets in

[41] For example, where a production joint venture buys inputs from an upstream market to incorporate in products to be sold in a downstream market, both upstream and downstream markets may be "markets affected by a competitor collaboration."

which any participant is an actual or potential competitor.[42]

3.32(a) Goods Markets

In general, for goods[43] markets affected by a competitor collaboration, the Agencies approach relevant market definition as described in Section 1 of the Horizontal Merger Guidelines. To determine the relevant market, the Agencies generally consider the likely reaction of buyers to a price increase and typically ask, among other things, how buyers would respond to increases over prevailing price levels. However, when circumstances strongly suggest that the prevailing price exceeds what likely would have prevailed absent the relevant agreement, the Agencies use a price more reflective of the price that likely would have prevailed. Once a market has been defined, market shares are assigned both to firms currently in the relevant market and to firms that are able to make "uncommitted" supply responses. See Sections 1.31 and 1.32 of the Horizontal Merger Guidelines.

3.32(b) Technology Markets

When rights to intellectual property are marketed separately from the products in which they are used, the Agencies may define technology markets in assessing the competitive effects of a competitor collaboration that includes an agreement to license intellectual property. Technology markets consist of the intellectual property that is licensed and its close substitutes; that is, the technologies or goods that are close enough substitutes significantly to constrain the exercise of market power with respect to the intellectual property that is licensed. The Agencies approach the definition of a relevant technology market and the measurement of market share as described in Section 3.2.2 of the Intellectual Property Guidelines.

3.32(c) Research and Development: Innovation Markets

In many cases, an agreement's competitive effects on innovation are analyzed as a separate competitive effect in a relevant goods market. However, if a competitor collaboration may have competitive effects on innovation that cannot be adequately addressed through the analysis of goods or technology markets, the Agencies may define and analyze an innovation market as described in Section 3.2.3 of the Intellectual Property Guidelines. An innovation market consists of the research and development directed to particular new or improved goods or processes and the close substitutes for that research and development. The Agencies define an innovation market only when the capabilities to engage in the relevant research and development can be associated with specialized assets or characteristics of specific firms.

3.33 Market Shares and Market Concentration

Market share and market concentration affect the likelihood that the relevant agreement

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[42] Participation in the collaboration may change the participants' behavior in this third category of markets, for example, by altering incentives and available information, or by providing an opportunity to form additional agreements among participants.

[43] The term "goods" also includes services.

will create or increase market power or facilitate its exercise. The creation, increase, or facilitation of market power will likely increase the ability and incentive profitably to raise price above or reduce output, quality, service, or innovation below what likely would prevail in the absence of the relevant agreement.

Other things being equal, market share affects the extent to which participants or the collaboration must restrict their own output in order to achieve anticompetitive effects in a relevant market. The smaller the percentage of total supply that a firm controls, the more severely it must restrict its own output in order to produce a given price increase, and the less likely it is that an output restriction will be profitable. In assessing whether an agreement may cause anticompetitive harm, the Agencies typically calculate the market shares of the participants and of the collaboration.[44] The Agencies assign a range of market shares to the collaboration. The high end of that range is the sum of the market shares of the collaboration and its participants. The low end is the share of the collaboration in isolation. In general, the Agencies approach the calculation of market share as set forth in Section 1.4 of the Horizontal Merger Guidelines.

Other things being equal, market concentration affects the difficulties and costs of achieving and enforcing collusion in a relevant market. Accordingly, in assessing whether an agreement may increase the likelihood of collusion, the Agencies calculate market concentration. In general, the Agencies approach the calculation of market concentration as set forth in Section 1.5 of the Horizontal Merger Guidelines, ascribing to the competitor collaboration the same range of market shares described above.

Market share and market concentration provide only a starting point for evaluating the competitive effect of the relevant agreement. The Agencies also examine other factors outlined in the Horizontal Merger Guidelines as set forth below:

The Agencies consider whether factors such as those discussed in Section 1.52 of the Horizontal Merger Guidelines indicate that market share and concentration data overstate or understate the likely competitive significance of participants and their collaboration.

In assessing whether anticompetitive harm may arise from an agreement that combines control over or financial interests in assets or otherwise limits independent decision making, the Agencies consider whether factors such as those discussed in Section 2.2 of the Horizontal Merger Guidelines suggest that anticompetitive harm is more or less likely.

In assessing whether anticompetitive harms may arise from an agreement that may increase the likelihood of collusion, the Agencies consider whether factors such as those discussed in Section 2.1 of the Horizontal Merger Guidelines suggest that anticompetitive harm

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[44] When the competitive concern is that a limitation on independent decision making or a combination of control or financial interests may yield an anticompetitive reduction of research and development, the Agencies typically frame their inquiries more generally, looking to the strength, scope, and number of competing R&D efforts and their close substitutes. See supra Sections 3.31(a) and 3.32(c).

is more or less likely.

In evaluating the significance of market share and market concentration data and interpreting the range of market shares ascribed to the collaboration, the Agencies also examine factors beyond those set forth in the Horizontal Merger Guidelines. The following section describes which factors are relevant and the issues that the Agencies examine in evaluating those factors.

3.34 Factors Relevant to the Ability and Incentive of the Participants and the Collaboration to Compete

Competitor collaborations sometimes do not end competition among the participants and the collaboration. Participants may continue to compete against each other and their collaboration, either through separate, independent business operations or through membership in other collaborations. Collaborations may be managed by decision makers independent of the individual participants. Control over key competitive variables may remain outside the collaboration, such as where participants independently market and set prices for the collaboration's output.

Sometimes, however, competition among the participants and the collaboration may be restrained through explicit contractual terms or through financial or other provisions that reduce or eliminate the incentive to compete. The Agencies look to the competitive benefits and harms of the relevant agreement, not merely the formal terms of agreements among the participants.

Where the nature of the agreement and market share and market concentration data reveal a likelihood of anticompetitive harm, the Agencies more closely examine the extent to which the participants and the collaboration have the ability and incentive to compete independent of each other. The Agencies are likely to focus on six factors: (a) the extent to which the relevant agreement is non-exclusive in that participants are likely to continue to compete independently outside the collaboration in the market in which the collaboration operates; (b) the extent to which participants retain independent control of assets necessary to compete; (c) the nature and extent of participants' financial interests in the collaboration or in each other; (d) the control of the collaboration's competitively significant decision making; (e) the likelihood of anticompetitive information sharing; and (f) the duration of the collaboration.

Each of these factors is discussed in further detail below. Consideration of these factors may reduce or increase competitive concern. The analysis necessarily is flexible: the relevance and significance of each factor depends upon the facts and circumstances of each case, and any additional factors pertinent under the circumstances are considered. For example, when an agreement is examined subsequent to formation of the collaboration, the Agencies also examine factual evidence concerning participants' actual conduct.

3.34(a) Exclusivity

The Agencies consider whether, to what extent, and in what manner the relevant agreement permits participants to continue to compete against each other and their collaboration,

either through separate, independent business operations or through membership in other collaborations. The Agencies inquire whether a collaboration is non-exclusive in fact as well as in name and consider any costs or other impediments to competing with the collaboration. In assessing exclusivity when an agreement already is in operation, the Agencies examine whether, to what extent, and in what manner participants actually have continued to compete against each other and the collaboration. In general, competitive concern likely is reduced to the extent that participants actually have continued to compete, either through separate, independent business operations or through membership in other collaborations, or are permitted to do so.

3.34(b) Control over Assets

The Agencies ask whether the relevant agreement requires participants to contribute to the collaboration significant assets that previously have enabled or likely would enable participants to be effective independent competitors in markets affected by the collaboration. If such resources must be contributed to the collaboration and are specialized in that they cannot readily be replaced, the participants may have lost all or some of their ability to compete against each other and their collaboration, even if they retain the contractual right to do so.[45] In general, the greater the contribution of specialized assets to the collaboration that is required, the less the participants may be relied upon to provide independent competition.

3.34(c) Financial Interests in the Collaboration or in Other Participants

The Agencies assess each participant's financial interest in the collaboration and its potential impact on the participant's incentive to compete independently with the collaboration. The potential impact may vary depending on the size and nature of the financial interest (e.g., whether the financial interest is debt or equity). In general, the greater the financial interest in the collaboration, the less likely is the participant to compete with the collaboration.[46] The Agencies also assess direct equity investments between or among the participants. Such investments may reduce the incentives of the participants to compete with each other. In either case, the analysis is sensitive to the level of financial interest in the collaboration or in another participant relative to the level of the participant's investment in its independent business operations in the markets affected by the collaboration.

3.34(d) Control of the Collaboration's Competitively Significant Decision Making

The Agencies consider the manner in which a collaboration is organized and governed in assessing the extent to which participants and their collaboration have the ability and incentive to compete independently. Thus, the Agencies consider the extent to which the collaboration's

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[45] For example, if participants in a production collaboration must contribute most of their productive capacity to the collaboration, the collaboration may impair the ability of its participants to remain effective independent competitors regardless of the terms of the agreement.

[46] Similarly, a collaboration's financial interest in a participant may diminish the collaboration's incentive to compete with that participant.

governance structure enables the collaboration to act as an independent decision maker. For example, the Agencies ask whether participants are allowed to appoint members of a board of directors for the collaboration, if incorporated, or otherwise to exercise significant control over the operations of the collaboration. In general, the collaboration is less likely to compete independently as participants gain greater control over the collaboration's price, output, and other competitively significant decisions.[47]

To the extent that the collaboration's decision making is subject to the participants' control, the Agencies consider whether that control could be exercised jointly. Joint control over the collaboration's price and output levels could create or increase market power and raise competitive concerns. Depending on the nature of the collaboration, competitive concern also may arise due to joint control over other competitively significant decisions, such as the level and scope of R&D efforts and investment. In contrast, to the extent that participants independently set the price and quantity[48] n48 of their share of a collaboration's output and independently control other competitively significant decisions, an agreement's likely anticompetitive harm is reduced.[49]

3.34(e) Likelihood of Anticompetitive Information Sharing

The Agencies evaluate the extent to which competitively sensitive information concerning markets affected by the collaboration likely would be disclosed. This likelihood depends on, among other things, the nature of the collaboration, its organization and governance, and safeguards implemented to prevent or minimize such disclosure. For example, participants might refrain from assigning marketing personnel to an R&D collaboration, or, in a marketing collaboration, participants might limit access to competitively sensitive information regarding their respective operations to only certain individuals or to an independent third party. Similarly, a buying collaboration might use an independent third party to handle negotiations in which its participants' input requirements or other competitively sensitive information could be revealed. In general, it is less likely that the collaboration will facilitate collusion on competitively

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[47] Control may diverge from financial interests. For example, a small equity investment may be coupled with a right to veto large capital expenditures and, thereby, to effectively limit output. The Agencies examine a collaboration's actual governance structure in assessing issues of control.

[48] Even if prices to consumers are set independently, anticompetitive harms may still occur if participants jointly set the collaboration's level of output. For example, participants may effectively coordinate price increases by reducing the collaboration's level of output and collecting their profits through high transfer prices, i.e., through the amounts that participants contribute to the collaboration in exchange for each unit of the collaboration's output. Where a transfer price is determined by reference to an objective measure not under the control of the participants, (e.g., average price in a different unconcentrated geographic market), competitive concern may be less likely.

[49] Anticompetitive harm also is less likely if individual participants may independently increase the overall output of the collaboration.

sensitive variables if appropriate safeguards governing information sharing are in place.

3.34(f) Duration of the Collaboration

The Agencies consider the duration of the collaboration in assessing whether participants retain the ability and incentive to compete against each other and their collaboration. In general, the shorter the duration, the more likely participants are to compete against each other and their collaboration.

3.35 Entry

Easy entry may deter or prevent profitably maintaining price above, or output, quality, service or innovation below, what likely would prevail in the absence of the relevant agreement. Where the nature of the agreement and market share and concentration data suggest a likelihood of anticompetitive harm that is not sufficiently mitigated by any continuing competition identified through the analysis in Section 3.34, the Agencies inquire whether entry would be timely, likely, and sufficient in its magnitude, character and scope to deter or counteract the anticompetitive harm of concern. If so, the relevant agreement ordinarily requires no further analysis.

As a general matter, the Agencies assess timeliness, likelihood, and sufficiency of committed entry under principles set forth in Section 3 of the Horizontal Merger Guidelines.[50] However, unlike mergers, competitor collaborations often restrict only certain business activities, while preserving competition among participants in other respects, and they may be designed to terminate after a limited duration. Consequently, the extent to which an agreement creates opportunities that would induce entry and the conditions under which ease of entry may deter or counteract anticompetitive harms may be more complex and less direct than for mergers and will vary somewhat according to the nature of the relevant agreement. For example, the likelihood of entry may be affected by what potential entrants believe about the probable duration of an anticompetitive agreement. Other things being equal, the shorter the anticipated duration of an anticompetitive agreement, the smaller the profit opportunities for potential entrants, and the lower the likelihood that it will induce committed entry. Examples of other differences are set forth below.

For certain collaborations, sufficiency of entry may be affected by the possibility that entrants will participate in the anticompetitive agreement. To the extent that such participation raises the amount of entry needed to deter or counteract anticompetitive harms, and assets required for entry are not adequately available for entrants to respond fully to their sales opportunities, or otherwise renders entry inadequate in magnitude, character or scope, sufficient entry may be more difficult to achieve.[51]

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[50] Committed entry is defined as new competition that requires expenditure of significant sunk costs of entry and exit. See Section 3.0 of the Horizontal Merger Guidelines.

[51] Under the same principles applied to production and marketing collaborations, the exercise of monopsony power by a buying collaboration may be deterred or counteracted by the entry of new purchasers. To the extent that collaborators reduce their purchases, they may create

In the context of research and development collaborations, widespread availability of R&D capabilities and the large gains that may accrue to successful innovators often suggest a high likelihood that entry will deter or counteract anticompetitive reductions of R&D efforts. Nonetheless, such conditions do not always pertain, and the Agencies ask whether entry may deter or counteract anticompetitive R&D reductions, taking into account the following:

*Where market participants typically can observe the level and type of R&D efforts within a market, the principles of Section 3 of the Horizontal Merger Guidelines may be applied flexibly to determine whether entry is likely to deter or counteract a lessening of the quality, diversity, or pace of research and development. To be timely, entry must be sufficiently prompt to deter or counteract such harms. The Agencies evaluate the likelihood of entry based on the extent to which potential entrants have (1) core competencies (and the ability to acquire any necessary specialized assets) that give them the ability to enter into competing R&D and (2) incentives to enter into competing R&D in response to a post-collaboration reduction in R&D efforts. The sufficiency of entry depends on whether the character and scope of the entrants' R&D efforts are close enough to the reduced R&D efforts to be likely to achieve similar innovations in the same time frame or otherwise to render a collaborative reduction of R&D unprofitable.

*Where market participants typically cannot observe the level and type of R&D efforts by others within a market, there may be significant questions as to whether entry would occur in response to a collaborative lessening of the quality, diversity, or pace of research and development, since such effects would not likely be observed. In such cases, the Agencies may conclude that entry would not deter or counteract anticompetitive harms.

3.36 Identifying Procompetitive Benefits of the Collaboration

Competition usually spurs firms to achieve efficiencies internally. Nevertheless, as explained above, competitor collaborations have the potential to generate significant efficiencies that benefit consumers in a variety of ways. For example, a competitor collaboration may enable firms to offer goods or services that are cheaper, more valuable to consumers, or brought to market faster than would otherwise be possible. Efficiency gains from competitor collaborations often stem from combinations of different capabilities or resources. See supra Section 2.1.

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an opportunity for new buyers to make purchases without forcing the price of the input above pre-relevant agreement levels. Committed purchasing entry, defined as new purchasing competition that requires expenditure of significant sunk costs of entry and exit -- such as a new steel factory built in response to a reduction in the price of iron ore -- is analyzed under principles analogous to those articulated in Section 3 of the Horizontal Merger Guidelines. Under that analysis, the Agencies assess whether a monopsonistic price reduction is likely to attract committed purchasing entry, profitable at pre-relevant agreement prices, that would not have occurred before the relevant agreement at those same prices. (Uncommitted new buyers are identified as participants in the relevant market if their demand responses to a price decrease are likely to occur within one year and without the expenditure of significant sunk costs of entry and exit. See id. at Sections 1.32 and 1.41.)

Indeed, the primary benefit of competitor collaborations to the economy is their potential to generate such efficiencies.

Efficiencies generated through a competitor collaboration can enhance the ability and incentive of the collaboration and its participants to compete, which may result in lower prices, improved quality, enhanced service, or new products. For example, through collaboration, competitors may be able to produce an input more efficiently than any one participant could individually; such collaboration-generated efficiencies may enhance competition by permitting two or more ineffective (e.g., high cost) participants to become more effective, lower cost competitors. Even when efficiencies generated through a competitor collaboration enhance the collaboration's or the participants' ability to compete, however, a competitor collaboration may have other effects that may lessen competition and ultimately may make the relevant agreement anticompetitive.

If the Agencies conclude that the relevant agreement has caused, or is likely to cause, anticompetitive harm, they consider whether the agreement is reasonably necessary to achieve "cognizable efficiencies." "Cognizable efficiencies" are efficiencies that have been verified by the Agencies, that do not arise from anticompetitive reductions in output or service, and that cannot be achieved through practical, significantly less restrictive means. See infra Sections 3.36(a) and 3.36(b). Cognizable efficiencies are assessed net of costs produced by the competitor collaboration or incurred in achieving those efficiencies.

3.36(a) Cognizable Efficiencies Must Be Verifiable and Potentially Procompetitive

Efficiencies are difficult to verify and quantify, in part because much of the information relating to efficiencies is uniquely in the possession of the collaboration's participants. Moreover, efficiencies projected reasonably and in good faith by the participants may not be realized. Therefore, the participants must substantiate efficiency claims so that the Agencies can verify by reasonable means the likelihood and magnitude of each asserted efficiency; how and when each would be achieved; any costs of doing so; how each would enhance the collaboration's or its participants' ability and incentive to compete; and why the relevant agreement is reasonably necessary to achieve the claimed efficiencies (see Section 3.36 (b)). Efficiency claims are not considered if they are vague or speculative or otherwise cannot be verified by reasonable means.

Moreover, cognizable efficiencies must be potentially procompetitive. Some asserted efficiencies, such as those premised on the notion that competition itself is unreasonable, are insufficient as a matter of law. Similarly, cost savings that arise from anticompetitive output or service reductions are not treated as cognizable efficiencies. See Example 9.

3.36(b) Reasonable Necessity and Less Restrictive Alternatives

The Agencies consider only those efficiencies for which the relevant agreement is reasonably necessary. An agreement may be "reasonably necessary" without being essential. However, if the participants could have achieved or could achieve similar efficiencies by practical, significantly less restrictive means, then the Agencies conclude that the relevant agreement is not reasonably necessary to their achievement. In making this assessment, the Agencies consider only alternatives that are practical in the business situation faced by the

participants; the Agencies do not search for a theoretically less restrictive alternative that is not realistic given business realities.

The reasonable necessity of an agreement may depend upon the market context and upon the duration of the agreement. An agreement that may be justified by the needs of a new entrant, for example, may not be reasonably necessary to achieve cognizable efficiencies in different market circumstances. The reasonable necessity of an agreement also may depend on whether it deters individual participants from undertaking free riding or other opportunistic conduct that could reduce significantly the ability of the collaboration to achieve cognizable efficiencies. Collaborations sometimes include agreements to discourage any one participant from appropriating an undue share of the fruits of the collaboration or to align participants' incentives to encourage cooperation in achieving the efficiency goals of the collaboration. The Agencies assess whether such agreements are reasonably necessary to deter opportunistic conduct that otherwise would likely prevent the achievement of cognizable efficiencies. See Example 10.

3.37 Overall Competitive Effect

If the relevant agreement is reasonably necessary to achieve cognizable efficiencies, the Agencies assess the likelihood and magnitude of cognizable efficiencies and anticompetitive harms to determine the agreement's overall actual or likely effect on competition in the relevant market. To make the requisite determination, the Agencies consider whether cognizable efficiencies likely would be sufficient to offset the potential of the agreement to harm consumers in the relevant market, for example, by preventing price increases.[52]

The Agencies' comparison of cognizable efficiencies and anticompetitive harms is necessarily an approximate judgment. In assessing the overall competitive effect of an agreement, the Agencies consider the magnitude and likelihood of both the anticompetitive harms and cognizable efficiencies from the relevant agreement. The likelihood and magnitude of anticompetitive harms in a particular case may be insignificant compared to the expected cognizable efficiencies, or vice versa. As the expected anticompetitive harm of the agreement increases, the Agencies require evidence establishing a greater level of expected cognizable efficiencies in order to avoid the conclusion that the agreement will have an anticompetitive effect overall. When the anticompetitive harm of the agreement is likely to be particularly large, extraordinarily great cognizable efficiencies would be necessary to prevent the agreement from having an anticompetitive effect overall.

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[52] In most cases, the Agencies' enforcement decisions depend on their analysis of the overall effect of the relevant agreement over the short term. The Agencies also will consider the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market. Delayed benefits from the efficiencies (due to delay in the achievement of, or the realization of consumer benefits from, the efficiencies) will be given less weight because they are less proximate and more difficult to predict.

## SECTION 4: ANTITRUST SAFETY ZONES

### 4.1 Overview

Because competitor collaborations are often procompetitive, the Agencies believe that "safety zones" are useful in order to encourage such activity. The safety zones set out below are designed to provide participants in a competitor collaboration with a degree of certainty in those situations in which anticompetitive effects are so unlikely that the Agencies presume the arrangements to be lawful without inquiring into particular circumstances. They are not intended to discourage competitor collaborations that fall outside the safety zones.

The Agencies emphasize that competitor collaborations are not anticompetitive merely because they fall outside the safety zones. Indeed, many competitor collaborations falling outside the safety zones are procompetitive or competitively neutral. The Agencies analyze arrangements outside the safety zones based on the principles outlined in Section 3 above.

The following sections articulate two safety zones. Section 4.2 sets out a general safety zone applicable to any competitor collaboration.[53] Section 4.3 establishes a safety zone applicable to research and development collaborations whose competitive effects are analyzed within an innovation market. These safety zones are intended to supplement safety zone provisions in the Agencies' other guidelines and statements of enforcement policy.[54]

### 4.2 Safety Zone for Competitor Collaborations in General

Absent extraordinary circumstances, the Agencies do not challenge a competitor collaboration when the market shares of the collaboration and its participants collectively account for no more than twenty percent of each relevant market in which competition may be affected.[55] The safety zone, however, does not apply to agreements that are per se illegal, or that

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[53] See Sections 1.1 and 1.3 above.

[54] The Agencies have articulated antitrust safety zones in Health Care Statements 7 & 8 and the Intellectual Property Guidelines, as well as in the Horizontal Merger Guidelines. The antitrust safety zones in these other guidelines relate to particular facts in a specific industry or to particular types of transactions.

[55] For purposes of the safety zone, the Agencies consider the combined market shares of the participants and the collaboration. For example, with a collaboration among two competitors where each participant individually holds a 6 percent market share in the relevant market and the collaboration separately holds a 3 percent market share in the relevant market, the combined market share in the relevant market for purposes of the safety zone would be 15 percent. This collaboration, therefore, would fall within the safety zone. However, if the collaboration involved three competitors, each with a 6 percent market share in the relevant market, the combined market share in the relevant market for purposes of the safety zone would be 21 percent, and the collaboration would fall outside the safety zone. Including market shares of the participants takes into account possible spillover effects on competition within the relevant

would be challenged without a detailed market analysis,[56] or to competitor collaborations to which a merger analysis is applied.[57]

4.3 Safety Zone for Research and Development Competition Analyzed in Terms of Innovation Markets

Absent extraordinary circumstances, the Agencies do not challenge a competitor collaboration on the basis of effects on competition in an innovation market where three or more independently controlled research efforts in addition to those of the collaboration possess the required specialized assets or characteristics and the incentive to engage in R&D that is a close substitute for the R&D activity of the collaboration. In determining whether independently controlled R&D efforts are close substitutes, the Agencies consider, among other things, the nature, scope, and magnitude of the R&D efforts; their access to financial support; their access to intellectual property, skilled personnel, or other specialized assets; their timing; and their ability, either acting alone or through others, to successfully commercialize innovations. The antitrust safety zone does not apply to agreements that are per se illegal, or that would be challenged without a detailed market analysis,[58] or to competitor collaborations to which a merger analysis is applied.[59]

## APPENDIX

Section 1.3
Example 1 (Competitor Collaboration/Merger)
Facts

Two oil companies agree to integrate all of their refining and refined product marketing operations. Under terms of the agreement, the collaboration will expire after twelve years; prior to that expiration date, it may be terminated by either participant on six months' prior notice. The two oil companies maintain separate crude oil production operations.

Analysis

The formation of the collaboration involves an efficiency-enhancing integration of operations in the refining and refined product markets, and the integration eliminates all competition between the participants in those markets. The evaluating Agency likely would

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market among the participants and their collaboration.

[56] See supra notes 28-30 and accompanying text in Section 3.3.

[57] See Section 1.3 above.

[58] See supra notes 28-30 and accompanying text in Section 3.3.

[59] See Section 1.3 above.

conclude that expiration after twelve years does not constitute termination "within a sufficiently limited period." The participants' entitlement to terminate the collaboration at any time after giving prior notice is not termination by the collaboration's "own specific and express terms." Based on the facts presented, the evaluating Agency likely would analyze the collaboration under the Horizontal Merger Guidelines, rather than as a competitor collaboration under these Guidelines. Any agreements restricting competition on crude oil production would be analyzed under these Guidelines.

Section 2.3
Example 2 (Analysis of Individual Agreements/Set of Agreements)
Facts

Two firms enter a joint venture to develop and produce a new software product to be sold independently by the participants. The product will be useful in two areas, biotechnology research and pharmaceuticals research, but doing business with each of the two classes of purchasers would require a different distribution network and a separate marketing campaign. Successful penetration of one market is likely to stimulate sales in the other by enhancing the reputation of the software and by facilitating the ability of biotechnology and pharmaceutical researchers to use the fruits of each other's efforts. Although the software is to be marketed independently by the participants rather than by the joint venture, the participants agree that one will sell only to biotechnology researchers and the other will sell only to pharmaceutical researchers. The participants also agree to fix the maximum price that either firm may charge. The parties assert that the combination of these two requirements is necessary for the successful marketing of the new product. They argue that the market allocation provides each participant with adequate incentives to commercialize the product in its sector without fear that the other participant will free-ride on its efforts and that the maximum price prevents either participant from unduly exploiting its sector of the market to the detriment of sales efforts in the other sector.

Analysis

The evaluating Agency would assess overall competitive effects associated with the collaboration in its entirety and with individual agreements, such as the agreement to allocate markets, the agreement to fix maximum prices, and any of the sundry other agreements associated with joint development and production and independent marketing of the software. From the facts presented, it appears that the agreements to allocate markets and to fix maximum prices may be so intertwined that their benefits and harms "cannot meaningfully be isolated." The two agreements arguably operate together to ensure a particular blend of incentives to achieve the potential procompetitive benefits of successful commercialization of the new product. Moreover, the effects of the agreement to fix maximum prices may mitigate the price effects of the agreement to allocate markets. Based on the facts presented, the evaluating Agency likely would conclude that the agreements to allocate markets and to fix maximum prices should be analyzed as a whole.

Section 2.4
Example 3 (Time of Possible Harm to Competition)

Facts

A group of 25 small-to-mid-size banks formed a joint venture to establish an automatic teller machine network. To ensure sufficient business to justify launching the venture, the joint venture agreement specified that participants would not participate in any other ATM networks. Numerous other ATM networks were forming in roughly the same time period.

Over time, the joint venture expanded by adding more and more banks, and the number of its competitors fell. Now, ten years after formation, the joint venture has 900 member banks and controls 60% of the ATM outlets in a relevant geographic market. Following complaints from consumers that ATM fees have rapidly escalated, the evaluating Agency assesses the rule barring participation in other ATM networks, which now binds 900 banks.

Analysis

The circumstances in which the venture operates have changed over time, and the evaluating Agency would determine whether the exclusivity rule now harms competition. In assessing the exclusivity rule's competitive effect, the evaluating Agency would take account of the collaboration's substantial current market share and any procompetitive benefits of exclusivity under present circumstances, along with other factors discussed in Section 3.

Section 3.2
Example 4 (Agreement Not to Compete on Price)
Facts

Net-Business and Net-Company are two start-up companies. Each has developed and begun sales of software for the networks that link users within a particular business to each other and, in some cases, to entities outside the business. Both Net-Business and Net-Company were formed by computer specialists with no prior business expertise, and they are having trouble implementing marketing strategies, distributing their inventory, and managing their sales forces. The two companies decide to form a partnership joint venture, NET-FIRM, whose sole function will be to market and distribute the network software products of Net-Business and Net-Company. NET-FIRM will be the exclusive marketer of network software produced by Net-Business and Net-Company. Net-Business and Net-Company will each have 50% control of NET-FIRM, but each will derive profits from NET-FIRM in proportion to the revenues from sales of that partner's products. The documents setting up NET-FIRM specify that Net-Business and Net-Company will agree on the prices for the products that NET-FIRM will sell.

Analysis

Net-Business and Net-Company will agree on the prices at which NET-FIRM will sell their individually-produced software. The agreement is one "not to compete on price," and it is of a type that always or almost always tends to raise price or reduce output. The agreement to jointly set price may be challenged as per se illegal, unless it is reasonably related to, and reasonably necessary to achieve procompetitive benefits from, an efficiency-enhancing integration of economic activity.

Example 5 (Specialization without Integration)
Facts

Firm A and Firm B are two of only three producers of automobile carburetors. Minor engine variations from year to year, even within given models of a particular automobile manufacturer, require re-design of each year's carburetor and re-tooling for carburetor production. Firms A and B meet and agree that henceforth Firm A will design and produce carburetors only for automobile models of even-numbered years and Firm B will design and produce carburetors only for automobile models of odd-numbered years. Some design and re-tooling costs would be saved, but automobile manufacturers would face only two suppliers each year, rather than three.

Analysis

The agreement allocates sales by automobile model year and constitutes an agreement "not to compete on . . . output." The participants do not combine production; rather, the collaboration consists solely of an agreement not to produce certain carburetors. The mere coordination of decisions on output is not integration, and cost-savings without integration, such as the costs saved by refraining from design and production for any given model year, are not a basis for avoiding per se condemnation. The agreement is of a type so likely to harm competition and to have no significant benefits that particularized inquiry into its competitive effect is deemed by the antitrust laws not to be worth the time and expense that would be required. Consequently, the evaluating Agency likely would conclude that the agreement is per se illegal.

Example 6 (Efficiency-Enhancing Integration Present)
Facts

Compu-Max and Compu-Pro are two major producers of a variety of computer software. Each has a large, world-wide sales department. Each firm has developed and sold its own word-processing software. However, despite all efforts to develop a strong market presence in word processing, each firm has achieved only slightly more than a 10% market share, and neither is a major competitor to the two firms that dominate the word-processing software market.

Compu-Max and Compu-Pro determine that in light of their complementary areas of design expertise they could develop a markedly better word-processing program together than either can produce on its own. Compu-Max and Compu-Pro form a joint venture, WORD-FIRM, to jointly develop and market a new word-processing program, with expenses and profits to be split equally. Compu-Max and Compu-Pro both contribute to WORD-FIRM software developers experienced with word processing.
Analysis

Compu-Max and Compu-Pro have combined their word-processing design efforts, reflecting complementary areas of design expertise, in a common endeavor to develop new word-processing software that they could not have developed separately. Each participant has contributed significant assets - the time and know-how of its word-processing software

developers - to the joint effort. Consequently, the evaluating Agency likely would conclude that the joint word-processing software development project is an efficiency-enhancing integration of economic activity that promotes procompetitive benefits.

Example 7 (Efficiency-Enhancing Integration Absent)
Facts

Each of the three major producers of flashlight batteries has a patent on a process for manufacturing a revolutionary new flashlight battery -- the Century Battery -- that would last 100 years without requiring recharging or replacement. There is little chance that another firm could produce such a battery without infringing one of the patents. Based on consumer surveys, each firm believes that aggregate profits will be less if all three sold the Century Battery than if all three sold only conventional batteries, but that any one firm could maximize profits by being the first to introduce a Century Battery. All three are capable of introducing the Century Battery within two years, although it is uncertain who would be first to market.

One component in all conventional batteries is a copper widget. An essential element in each producers' Century Battery would be a zinc, rather than a copper widget. Instead of introducing the Century Battery, the three producers agree that their batteries will use only copper widgets. Adherence to the agreement precludes any of the producers from introducing a Century Battery.

Analysis

The agreement to use only copper widgets is merely an agreement not to produce any zinc-based batteries, in particular, the Century Battery. It is "an agreement not to compete on . . . output" and is "of a type that always or almost always tends to raise price or reduce output." The participants do not collaborate to perform any business functions, and there are no procompetitive benefits from an efficiency-enhancing integration of economic activity. The evaluating Agency likely would challenge the agreement to use only copper widgets as per se illegal.

Section 3.3
Example 8 (Rule-of-Reason: Agreement Quickly Exculpated)
Facts

Under the facts of Example 4, Net-Business and Net-Company jointly market their independently-produced network software products through NET-FIRM. Those facts are changed in one respect: rather than jointly setting the prices of their products, Net-Business and Net-Company will each independently specify the prices at which its products are to be sold by NET-FIRM. The participants explicitly agree that each company will decide on the prices for its own software independently of the other company. The collaboration also includes a requirement that NET-FIRM compile and transmit to each participant quarterly reports summarizing any comments received from customers in the course of NET-FIRM's marketing efforts regarding the desirable/undesirable features of and desirable improvements to (1) that participant's product and (2) network software in general. Sufficient provisions are included to prevent the company-

specific information reported to one participant from being disclosed to the other, and those provisions are followed. The information pertaining to network software in general is to be reported simultaneously to both participants.

Analysis

Under these revised facts, there is no agreement "not to compete on price or output." Absent any agreement of a type that always or almost always tends to raise price or reduce output, and absent any subsequent conduct suggesting that the firms did not follow their explicit agreement to set prices independently, no aspect of the partnership arrangement might be subjected to per se analysis. Analysis would continue under the rule of reason.

The information disclosure arrangements provide for the sharing of a very limited category of information: customer-response data pertaining to network software in general. Collection and sharing of information of this nature is unlikely to increase the ability or incentive of Net-Business or Net-Company to raise price or reduce output, quality, service, or innovation. There is no evidence that the disclosure arrangements have caused anticompetitive harm and no evidence that the prohibitions against disclosure of firm-specific information have been violated. Under any plausible relevant market definition, Net-Business and Net-Company have small market shares, and there is no other evidence to suggest that they have market power. In light of these facts, the evaluating Agency would refrain from further investigation.

Section 3.36(a)
Example 9 (Cost Savings from Anticompetitive Output or Service Reductions)
Facts

Two widget manufacturers enter a marketing collaboration. Each will continue to manufacture and set the price for its own widget, but the widgets will be promoted by a joint sales force. The two manufacturers conclude that through this collaboration they can increase their profits using only half of their aggregate pre-collaboration sales forces by (1) taking advantage of economies of scale -- presenting both widgets during the same customer call -- and (2) refraining from time-consuming demonstrations highlighting the relative advantages of one manufacturer's widgets over the other manufacturer's widgets. Prior to their collaboration, both manufacturers had engaged in the demonstrations.

Analysis

The savings attributable to economies of scale would be cognizable efficiencies. In contrast, eliminating demonstrations that highlight the relative advantages of one manufacturer's widgets over the other manufacturer's widgets deprives customers of information useful to their decision making. Cost savings from this source arise from an anticompetitive output or service reduction and would not be cognizable efficiencies.

Section 3.36(b)
Example 10 (Efficiencies from Restrictions on Competitive Independence)
Facts

Under the facts of Example 6, Compu-Max and Compu-Pro decide to collaborate on developing and marketing word-processing software. The firms agree that neither one will engage in R&D for designing word-processing software outside of their WORD-FIRM joint venture. Compu-Max papers drafted during the negotiations cite the concern that absent a restriction on outside word-processing R&D, Compu-Pro might withhold its best ideas, use the joint venture to learn Compu-Max's approaches to design problems, and then use that information to design an improved word-processing software product on its own. Compu-Pro's files contain similar documents regarding Compu-Max.

Compu-Max and Compu-Pro further agree that neither will sell its previously designed word-processing program once their jointly developed product is ready to be introduced. Papers in both firms' files, dating from the time of the negotiations, state that this latter restraint was designed to foster greater trust between the participants and thereby enable the collaboration to function more smoothly. As further support, the parties point to a recent failed collaboration involving other firms who sought to collaborate on developing and selling a new spread-sheet program while independently marketing their older spread-sheet software.

Analysis

The restraints on outside R&D efforts and on outside sales both restrict the competitive independence of the participants and could cause competitive harm. The evaluating Agency would inquire whether each restraint is reasonably necessary to achieve cognizable efficiencies. In the given context, that inquiry would entail an assessment of whether, by aligning the participants' incentives, the restraints in fact are reasonably necessary to deter opportunistic conduct that otherwise would likely prevent achieving cognizable efficiency goals of the collaboration.

With respect to the limitation on independent R&D efforts, possible alternatives might include agreements specifying the level and quality of each participant's R&D contributions to WORD-FIRM or requiring the sharing of all relevant R&D. The evaluating Agency would assess whether any alternatives would permit each participant to adequately monitor the scope and quality of the other's R&D contributions and whether they would effectively prevent the misappropriation of the other participant's know-how. In some circumstances, there may be no "practical, significantly less restrictive" alternative.

Although the agreement prohibiting outside sales might be challenged as per se illegal if not reasonably necessary for achieving the procompetitive benefits of the integration discussed in Example 6, the evaluating Agency likely would analyze the agreement under the rule of reason if it could not adequately assess the claim of reasonable necessity through limited factual inquiry. As a general matter, participants' contributions of marketing assets to the collaboration could more readily be monitored than their contributions of know-how, and neither participant may be capable of misappropriating the other's marketing contributions as readily as it could misappropriate know-how. Consequently, the specification and monitoring of each participant's marketing contributions could be a "practical, significantly less restrictive" alternative to prohibiting outside sales of pre-existing products. The evaluating Agency, however, would

examine the experiences of the failed spread-sheet collaboration and any other facts presented by the parties to better assess whether such specification and monitoring would likely enable the achievement of cognizable efficiencies.

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United States Court of Appeals,
Seventh Circuit.

TOYS "R" US, INC., Petitioner-Appellant,
v.
FEDERAL TRADE COMMISSION, Respondent-Appellee.

**No. 98-4107.**

Argued May 18, 1999
Decided Aug. 1, 2000

Before COFFEY, KANNE, and DIANE P. WOOD, Circuit Judges.

DIANE P. WOOD, Circuit Judge.

The antitrust laws, which aim to preserve and protect competition in economically sensible markets, have long drawn a sharp distinction between contractual restrictions that occur up and down a distribution chain--so-called vertical restraints--and restrictions that come about as a result of agreements among competitors, or horizontal restraints. Sometimes, however, it can be hard as a matter of fact to be sure what kind of agreement is at issue. This was the problem facing the Federal Trade Commission ("the Commission") when it brought under its antitrust microscope the large toy retailer Toys "R" Us (more properly Toys "R" Us, but to avoid debate we will abbreviate the company's name as TRU, in keeping with the parties' usage).

The Commission concluded, upon an extensive administrative record, that TRU had acted as the coordinator of a horizontal agreement among a number of toy manufacturers. The agreements took the form of a network of vertical agreements between TRU and the individual manufacturers, in each of which the manufacturer promised to restrict the distribution of its products to lowpriced warehouse club stores, on the condition that other manufacturers would do the same. This practice, the Commission found, violated § 5 of the Federal Trade Commission Act, 15 U.S.C. § 45. It also found that TRU had entered into a series of vertical agreements that flunked scrutiny under antitrust's rule of reason. TRU appealed that decision to us. It attacks both the sufficiency of the evidence supporting the Commission's conclusions and the scope of the Commission's remedial order. It is hard to prevail on either type of challenge: the former is fact-intensive and faces the hurdle of the substantial evidence standard of review, while the latter calls into question the Commission's exercise of its discretion to remedy an established violation of the law. We conclude that, while reasonable people could differ on the facts in this voluminous record, the Commission's decisions pass muster, and we therefore affirm.

## I

TRU is a giant in the toy retailing industry. The Commission found that it sells approximately 20% of all the toys sold in the United States, and that in some metropolitan areas its share of toy sales ranges between 35% and 49%. The variety of toys it sells is staggering: over the course of a year, it offers about 11,000 individual toy items, far more than any of its competitors. As one might suspect from these figures alone, TRU is a critical outlet for toy manufacturers. It buys about 30% of the large, traditional toy companies' total output and it is usually their most important customer. According to evidence before the Commission's administrative law judge, or ALJ, even a company as large as Hasbro felt that it could not find other retailers to replace TRU--and Hasbro, along with Mattel, is one of the two largest toy manufacturers in the country, accounting for approximately 12% of the market for traditional toys and 10% of a market that includes video games. Similar opinions were offered by Mattel and smaller manufacturers.

Toys are sold in a number of different kinds of stores. At the high end are traditional toy stores and department stores, both of which typically sell toys for 40 to 50% above their cost. Next are the specialized discount stores--a category virtually monopolized by TRU today--that sell at an average 30% markup. General discounters like Wal-Mart, KMart, and Target are next, with a 22% mark-up, and last are the stores that are the focus of this case, the warehouse clubs like Costco and Pace. The clubs sell toys at a slender mark-up of 9% or so.

The toys customers seek in all these stores are highly differentiated products. The little girl who wants Malibu Barbie is not likely to be satisfied with My First Barbie, and she certainly does not want Ken or Skipper. The boy who has his heart set on a figure of Anakin Skywalker will be disappointed if he receives Jar-Jar Binks, or a truck, or a baseball bat instead. Toy retailers naturally want to have available for their customers the season's hottest

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items, because toys are also a very faddish product, as those old enough to recall the mania over Cabbage Patch kids or Tickle Me Elmo dolls will attest.

What happened in this case, according to the Commission, was fairly simple. For a long time, TRU had enjoyed a strong position at the low price end for toy sales, because its only competition came from traditional toy stores who could not or did not wish to meet its prices, or from general discounters like Wal- Mart or K-Mart, which could not offer anything like the variety of items TRU had and whose prices were not too far off TRU's mark.

The advent of the warehouse clubs changed all that. They were a retail innovation of the late 1970s: the first one opened in 1976, and by 1992 there were some 600 individual club stores around the country. Rather than earning all of their money from their mark-up on products, the clubs sell only to their members, and they charge a modest annual membership fee, often about $30. As the word "warehouse" in the name suggests, the clubs emphasize price competition over service amenities. Nevertheless, the Commission found that the clubs seek to offer name-brand merchandise, including toys. During the late 1980s and early 1990s, warehouse clubs selected and purchased from the toy manufacturers' full array of products, just like everyone else. In some instances they bought specialized packs assembled for the "club" trade, but they normally preferred stocking conventional products so that their customers could readily compare the price of an item at the club against the price of the same item at a competing store.

To the extent this strategy was successful, however, TRU did not welcome it. By 1989, its senior executives were concerned that the clubs were a threat to TRU's low-price image and, more importantly, to its profits. A little legwork revealed that as of that year the clubs carried approximately 120-240 items in direct competition with TRU, priced as much as 25 to 30% below TRU's own price levels.

TRU put its President of Merchandising, a Mr. Goddu, to work to see what could be done. The response Goddu and other TRU executives formulated to beat back the challenge from the clubs began with TRU's decision to contact some of its suppliers, including toy manufacturing heavyweights Mattel, Hasbro, and Fisher Price. At the Toy Fair in 1992 (a major event at which the next Christmas season's orders are placed), Goddu informed the manufacturers of a new TRU policy, which was reflected in a memo of January 29, 1992. The policy set forth the following conditions and privileges for TRU:

. The clubs could have no new or promoted product unless they carried the entire line.
. All specials and exclusives to be sold to the clubs had to be shown first to TRU to see if TRU wanted the item.
. Old and basic product had to be in special packs.
. Clearance and closeout items were permissible provided that TRU was given the first opportunity to buy the product.
. There would be no discussion about prices.

TRU was careful to meet individually with each of its suppliers to explain its new policy. Afterwards, it then asked each one what it intended to do. Negotiations between TRU and the manufacturers followed, as a result of which each manufacturer eventually agreed that it would sell to the clubs only highly differentiated products (either unique individual items or combo packs) that were not offered to anything but a club (and thus of course not to TRU). As the Commission put it, "[t]hrough its announced policy and the related agreements discussed below, TRU sought to eliminate the competitive threat the clubs posed by denying them merchandise, forcing the clubs' customers to buy products they did not want, and frustrating customers' ability to make direct price comparisons of club prices and TRU prices." FTC opinion at 14.

The agreements between TRU and the various manufacturers were, of course, vertical agreements, because they ran individually from the supplier/manufacturer to the purchaser/retailer. The Commission found that TRU reached about 10 of these agreements. After the agreements were concluded, TRU then supervised and enforced each toy company's compliance with its commitment.

But TRU was not content to stop with vertical agreements. Instead, the Commission found, it decided to go further. It worked for over a year and a half to put the vertical agreements in place, but "the biggest hindrance TRU had to overcome was the major toy companies' reluctance to give up a new, fast- growing, and profitable channel of distribution." FTC opinion at 28. The manufacturers were also concerned that any of their rivals who broke ranks and sold to the clubs might gain sales at their expense, given the widespread and increasing popularity of the club format. To address this problem, the Commission found, TRU orchestrated a horizontal agreement among its key suppliers to

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boycott the clubs. The evidence on which the Commission relied showed that, at a minimum, Mattel, Hasbro, Fisher Price, Tyco, Little Tikes, Today's Kids, and Tiger Electronics agreed to join in the boycott "*on the condition that their competitors would do the same* ." FTC opinion at 28 (emphasis added).

The Commission first noted that internal documents from the manufacturers revealed that they were trying to expand, not to restrict, the number of their major retail outlets and to reduce their dependence on TRU. They were specifically interested in cultivating a relationship with the warehouse clubs and increasing sales there. Thus, the sudden adoption of measures under which they decreased sales to the clubs ran against their independent economic self- interest. Second, the Commission cited evidence that the manufacturers were unwilling to limit sales to the clubs without assurances that their competitors would do likewise. FTC opinion at 29. Goddu himself testified that TRU communicated the message "I'll stop if they stop" from manufacturer to competing manufacturer. FTC opinion at 30. He specifically mentioned having such conversations with Mattel and Hasbro, and he said more generally "We communicated to our vendors that we were communicating with all our key suppliers, and we did that I believe at Toy Fair 1992. We made a point to tell each of the vendors that we spoke to that we would be talking to our other key suppliers." *Id.* at 31.

Evidence from the manufacturers corroborated Goddu's account. A Mattel executive said that it would not sell the clubs the same items it was selling to TRU, and that this decision was "based on the fact ***933** that competition would do the same." *Id.* at 32. A Hasbro executive said much the same thing: "because our competitors had agreed not to sell loaded [that is, promoted] product to the clubs, that we would ... go along with this." *Id.* TRU went so far as to assure individual manufacturers that no one would be singled out.

Once the special warehouse club policy (or, in the Commission's more pejorative language, boycott) was underway, TRU served as the central clearinghouse for complaints about breaches in the agreement. The Commission gave numerous examples of this conduct in its opinion. See *id.* at 33-37.

Last, the Commission found that TRU's policies had bite. In the year before the boycott began, the clubs' share of all toy sales in the United States grew from 1.5% in 1991 to 1.9% in 1992. After the boycott took hold, that percentage slipped back by 1995 to 1.4%. Local numbers were more impressive. Costco, for example, experienced overall growth on sales of all products during the period 1991 to 1993 of 25%. Its toy sales increased during same period by 51%. But, after the boycott took hold in 1993, its toy sales decreased by 1.6% even while its overall sales were still growing by 19.5%. The evidence indicated that this was because TRU had succeeded in cutting off its access to the popular toys it needed. In 1989, over 90% of the Mattel toys Costco and other clubs purchased were regular (*i.e.* easily comparable) items, but by 1993 that percentage was zero. Once again, the Commission's opinion is chock full of similar statistics.

The Commission also considered the question whether TRU might have been trying to protect itself against free riding, at least with respect to its vertical agreements. It acknowledged that TRU provided several services that might be important to consumers, including "advertising, carrying an inventory of goods early in the year, and supporting a full line of products." FTC opinion at 41- 42. Nevertheless, it found that the manufacturers compensated TRU directly for advertising toys, storing toys made early in the year, and stocking a broad line of each manufacturer's toys under one roof. A 1993 TRU memorandum confirms that advertising is manufacturer-funded and is "essentially free." FTC opinion at 42. In 1994, TRU's net cost of advertising was a tiny 0.02% of sales, or $750,000, out of a total of $199 million it spent on advertising that year. As the Commission saw it, "[a]dvertising ... was a service the *toy manufacturers* provided for TRU and not the other way around." *Id.* (emphasis in original). TRU records also showed that manufacturers routinely paid TRU credits for warehousing services, and that they compensated it for full line stocking. In short, the Commission found, there was no evidence that club competition without comparable services threatened to drive TRU services out of the market or to harm customers. Manufacturers paid each retailer directly for the services they wanted the retailer to furnish.

Based on this record, the Commission drew three central conclusions of law: (1) the TRU-led manufacturer boycott of the warehouse clubs was illegal per se under the rule enunciated in *Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.*, 472 U.S. 284, 105 S.Ct. 2613, 86 L.Ed.2d 202 (1985); (2) the boycott was illegal

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under a full rule of reason analysis because its anticompetitive effects "clearly outweigh[ed] any possible business justification"; and (3) the vertical agreements between TRU and the individual toy manufacturers, "entered into *seriatim* with clear anticompetitive effect, violate section 1 of the Sherman Act." FTC opinion at 46. These antitrust violations in turn were enough to prove a violation of FTC Act § 5, which for present purposes tracks the prohibitions of the Sherman and Clayton Acts. After offering a detailed explanation of these conclusions (spanning 42 pages in its slip opinion), it turned to the question of remedy and affirmed the order the ALJ had entered.

In the Commission's words, its order:

> ... prohibits TRU from continuing, entering into, or attempting to enter into, vertical agreements with its suppliers to limit the supply of, or refuse to sell, toys to a toy discounter. *See* ¶ II.A. The order also prohibits TRU from facilitating, or attempting to facilitate, an agreement between or among its suppliers relating to the sale of toys to any retailer. *See* ¶ II.D. Additionally, TRU is enjoined from requesting information from suppliers about their sales to any toy discounter, and from urging or coercing suppliers to restrict sales to any toy discounter. *See* ¶ ¶ II.B, C. These four elements of relief are narrowly tailored to stop, and prevent the repetition of, TRU's illegal conduct.

FTC opinion at 88. TRU complained that the order trampled on its ability to exercise its rights under *United States v. Colgate & Co.,* 250 U.S. 300, 39 S.Ct. 465, 63 L.Ed. 992 (1919) , to choose unilaterally the companies with which it wanted to deal. The Commission rejected the point, because it found that TRU had repeatedly crossed the line from unilateral to concerted behavior in illegal ways, and that it was entitled to include remedial provisions that were necessary to prevent recurrence of the illegal behavior, citing *FTC v. National Lead Co.,* 352 U.S. 419, 430, 77 S.Ct. 502, 1 L.Ed.2d 438 (1957).

Commissioner Swindle concurred in part and dissented in part. He agreed with the majority's determination that TRU had engaged in a series of anticompetitive vertical agreements, and he thus agreed with the remedial provisions designed to proscribe those practices and their effects. He was unconvinced, however, that TRU had orchestrated a horizontal combination as well, believing that the evidence was too thin to support that conclusion. TRU appealed from the Commission's final order of October 13, 1998, to this court, under 15 U.S.C. § 45(c), as it carries on business in this circuit (as well as every other circuit, to the best of our knowledge).

## II

On appeal, TRU makes four principal arguments: (1) the Commission's finding of a horizontal conspiracy is contrary to the facts and impermissibly confuses the law of vertical restraints with the law of horizontal restraints; (2) whether the restrictions were vertical or horizontal, they were not unlawful because TRU has no market power, and thus the conduct can have no significant anticompetitive effect; (3) the TRU policy was a legitimate response to free riding; and (4) the relief ordered by the Commission goes too far. We review the Commission's legal conclusions *de novo,* but we must accept its findings of fact if they are supported by such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. *FTC v. Indiana Fed'n of Dentists,* 476 U.S. 447, 454, 106 S.Ct. 2009, 90 L.Ed.2d 445 (1986).

### A. *Horizontal Conspiracy*

As TRU correctly points out, the critical question here is whether substantial evidence supported the Commission's finding that there was a horizontal agreement among the toy manufacturers, with TRU in the center as the ringmaster, to boycott the warehouse clubs. It acknowledges that such an agreement may be proved by either direct or circumstantial evidence, under cases such as *Matsushita Electric Indus. Co. v. Zenith Radio Corp.,* 475 U.S. 574, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986) (horizontal agreements), *Monsanto Co. v. Spray-Rite Service Corp.,* 465 U.S. 752, 104 S.Ct. 1464, 79 L.Ed.2d 775 (1984) (vertical agreements), and *Interstate Circuit, Inc. v. United States,* 306 U.S. 208, 59 S.Ct. 467, 83 L.Ed. 610 (1939). When circumstantial evidence is used, there must be some evidence that "tends to exclude the possibility" that the alleged conspirators acted independently. *Monsanto,* 465 U.S. at 764, 104 S.Ct. 1464, *quoted in Matsushita,* 475 U.S. at 588, 106 S.Ct. 1348. This does not mean, however, that the Commission had to exclude *all* possibility that the manufacturers acted independently. As we pointed out in *In re Brand Name Prescription Drugs Antitrust Litigation,* 186 F.3d 781 (7th Cir.1999), that would amount to an absurd and legally unfounded burden to prove with 100% certainty that an antitrust violation occurred. *Id.* at 787. The test states only that there must be *some* evidence which, if believed, would support a finding of concerted behavior. In the context of an

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appeal from the Commission, the question is whether substantial evidence supports its conclusion that it is more likely than not that the manufacturers acted collusively.

In TRU's opinion, this record shows nothing more than a series of separate, similar vertical agreements between itself and various toy manufacturers. It believes that each manufacturer in its independent self-interest had an incentive to limit sales to the clubs, because TRU's policy provided strong unilateral incentives for the manufacturer to reduce its sales to the clubs. Why gain a few sales at the clubs, it asks, when it would have much more to gain by maintaining a good relationship with the 100-pound gorilla of the industry, TRU, and make far more sales?

We do not disagree that there was some evidence in the record that would bear TRU's interpretation. But that is not the standard we apply when we review decisions of the Federal Trade Commission. Instead, we apply the substantial evidence test, which we described as follows in another case in which the Commission's decision to stop a hospital merger was at issue:

> Our only function is to determine whether the Commission's analysis of the probable effects of these acquisitions on hospital competition in Chattanooga is so implausible, so feebly supported by the record, that it flunks even the deferential test of substantial evidence.

*Hospital Corp. of America v. F.T.C.*, 807 F.2d 1381, 1385 (7th Cir.1986) . There, as here, the Commission painstakingly explained in a long opinion exactly what evidence in the record supported its conclusion. We need only decide whether the inference the Commission drew of horizontal agreement was a permissible one from that evidence, not if it was the only possible one.

The Commission's theory, stripped to its essentials, is that this case is a modern equivalent of the old *Interstate Circuit* decision. That case too involved actors at two levels of the distribution chain, distributors of motion pictures and exhibitors. Interstate Circuit was one of the exhibitors; it had a stranglehold on the exhibition of movies in a number of Texas cities. The antitrust violation occurred when Interstate's manager, O'Donnell, sent an identical letter to the eight branch managers of the distributor companies, with each letter naming all eight as addressees, in which he asked them to comply with two demands: a minimum price for first-run theaters, and a policy against double features at night. The trial court there drew an inference of agreement from the nature of the proposals, from the manner in which they were made, from the substantial unanimity of action taken, and from the lack of evidence of a benign motive; the Supreme Court affirmed. The new policies represented a radical shift from the industry's prior business practices, and the Court rejected as beyond the range of probability that such unanimity of action was explainable only by chance.

The Commission is right. Indeed, as it argues in its brief, the TRU case if anything presents a more compelling case for inferring horizontal agreement than did *Interstate Circuit*, because not only was the manufacturers' decision to stop dealing with the warehouse clubs an abrupt shift from the past, and not only is it suspicious for a manufacturer to deprive itself of a profitable sales outlet, but the record here included the direct evidence of communications that was missing in *Interstate Circuit*. Just as in *Interstate Circuit*, TRU tries to avoid this result by hypothesizing independent motives. 306 U.S. at 223-24, 59 S.Ct. 467. If there were no evidence in the record tending to support concerted behavior, then we agree that *Matsushita* would require a ruling in TRU's favor. But there is. The evidence showed that the companies wanted to diversify from TRU, not to become more dependent upon it; it showed that each manufacturer was afraid to curb its sales to the warehouse clubs alone, because it was afraid its rivals would cheat and gain a special advantage in that popular new market niche. The Commission was not required to disbelieve the testimony of the different toy company executives and TRU itself to the effect that the only condition on which each toy manufacturer would agree to TRU's demands was if it could be sure its competitors were doing the same thing.

That is a horizontal agreement. As we explain further below in discussing TRU's free rider argument, it has nothing to do with enhancing efficiencies of distribution from the manufacturer's point of view. The typical story of a legitimate vertical transaction would have the manufacturer going to TRU and asking it to be the exclusive carrier of the manufacturer's goods; in exchange for that exclusivity, the manufacturer would hope to receive more effective promotion of its goods, and TRU would have a large enough profit margin to do the job well. But not all manufacturers think that exclusive dealing arrangements will maximize their profits. Some think, and are entitled to think, that using the greatest number of retailers possible is a

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better strategy. These manufacturers were in effect being asked by TRU to reduce their output (especially of the popular toys), and as is classically true in such cartels, they were willing to do so only if TRU could protect them against cheaters.

*Northwest Stationers* also demonstrates why the facts the Commission found support its conclusion that the essence of the agreement network TRU supervised was horizontal. There the Court described the cases that had condemned boycotts as "*per se*" illegal as those involving "joint efforts by a firm or firms to disadvantage competitors by either directly denying or persuading or coercing suppliers or customers to deny relationships the competitors need in the competitive struggle." 472 U.S. at 294, 105 S.Ct. 2613 (internal citations omitted). The boycotters had to have some market power, though the Court did not suggest that the level had to be as high as it would require in a case under Sherman Act § 2. Here, TRU was trying to disadvantage the warehouse clubs, its competitors, by coercing suppliers to deny the clubs the products they needed. It accomplished this goal by inducing the suppliers to collude, rather than to compete independently for shelf space in the different toy retail stores. See also *NYNEX Corp. v. Discon, Inc.*, 525 U.S. 128, 119 S.Ct. 493, 142 L.Ed.2d 510 (1998); *Klor's, Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207, 79 S.Ct. 705, 3 L.Ed.2d 741 (1959).

B. *Degree of TRU's Market Power*

TRU's efforts to deflate the Commission's finding of market power are pertinent only if we had agreed with its argument that the Commission's finding of a horizontal agreement was without support. Horizontal agreements among competitors, including group boycotts, remain illegal *per se* in the sense the Court used the term in *Northwest Stationers.* We have found that this case satisfies the criteria the Court used in *Northwest Stationers* for condemnation without an extensive inquiry into market power and economic pros and cons: (1) the boycotting firm has cut off access to a supply, facility or market necessary for the boycotted firm (*i.e.* the clubs) to compete; (2) the boycotting firm possesses a "dominant" position in the market (where "dominant" is an undefined term, but plainly chosen to stand for something different from antitrust's term of art "monopoly"); and (3) the boycott, as we explain further below, cannot be justified by plausible arguments that it was designed to enhance overall efficiency. 472 U.S. at 294, 105 S.Ct. 2613. We address the market power point here, therefore, only in the alternative.

TRU seems to think that anticompetitive effects in a market cannot be shown unless the plaintiff, or here the Commission, first proves that it has a large market share. This, however, has things backwards. As we have explained elsewhere, the share a firm has in a properly defined relevant market is only a way of estimating market power, which is the ultimate consideration. *Ball Memorial Hospital, Inc. v. Mutual Hospital Insurance*, 784 F.2d 1325, 1336 (7th Cir.1986) . The Supreme Court has made it clear that there are two ways of proving market power. One is through direct evidence of anticompetitive effects. *See FTC v. Indiana Fed'n of Dentists*, 476 U.S. 447, 460-61, 106 S.Ct. 2009, 90 L.Ed.2d 445 (1986) ("the finding of actual, sustained adverse effects on competition in those areas where IFD dentists predominated, viewed in light of the reality that markets for dental services tend to be relatively localized, is legally sufficient to support a finding that the challenged restraint was unreasonable even in the absence of elaborate market analysis."). The other, more conventional way, is by proving relevant product and geographic markets and by showing that the defendant's share exceeds whatever threshold is important for the practice in the case. See, *e.g.*, *United States v. E.I. duPont de Nemours & Co.*, 351 U.S. 377, 76 S.Ct. 994, 100 L.Ed. 1264 (1956); *United States v. Grinnell Corp.*, 384 U.S. 563, 86 S.Ct. 1698, 16 L.Ed.2d 778 (1966); *United States v. Aluminum Co. of America*, 148 F.2d 416 (2d Cir.1945) (suggesting that more than 90% is enough to constitute a monopoly for purposes of Sherman Act § 2 and 33% is not); *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U.S. 2, 104 S.Ct. 1551, 80 L.Ed.2d 2 (1984) (indicating that something more than 30% would be needed to show the kind of power over a tying product necessary for a violation of Sherman Act § 1).

The Commission found here that, however TRU's market power as a toy retailer was measured, it was clear that its boycott was having an effect in the market. It was remarkably successful in causing the 10 major toy manufacturers to reduce output of toys to the warehouse clubs, and that reduction in output protected TRU from having to lower its prices to meet the clubs' price levels. Price competition from conventional discounters like Wal- Mart and K-Mart, in contrast, imposed no such constraint on it, or so the Commission found. In addition, the Commission showed that the affected manufacturers accounted for some 40% of the traditional toy market, and that TRU had 20% of the national wholesale market and

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up to 49% of some local wholesale markets. Taking steps to prevent a price collapse through coordination of action among competitors has been illegal at least since *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 60 S.Ct. 811, 84 L.Ed. 1129 (1940). Proof that this is what TRU was doing is sufficient proof of actual anticompetitive effects that no more elaborate market analysis was necessary.

C. *Free Riding Explanation*

TRU next urges that its policy was a legitimate business response to combat free riding by the warehouse clubs. We think, however, that it has fundamentally misunderstood the theory of free riding. Briefly, that theory is as follows. The manufacturer of a product, say widgets, has an incentive to distribute as many widgets as it can, while keeping its costs of distribution down as low as possible. In many instances, this means that the manufacturer will want to sell its widgets for a particular wholesale price and it will want its retailer to apply as low a mark-up as possible (*i.e.* put the product on the market for as little extra expense as possible). Sometimes, however, the manufacturer will want the retailer to provide special services or amenities that cost money, such as attractive premises, trained salespeople, long business hours, full-line stocking, or fast warranty service. But the costs of providing some of those amenities (usually pre-sale services) are hard to pass on to customers unless some form of restricted distribution is available. What the manufacturer does *not* want is for the shopper to visit the attractive store with highly paid, intelligentsales help, learn all about the product, and then go home and order it from a discount warehouse or (today) on- line discounters. The shopper in that situation has taken a "free ride" on the retailer's efforts; the retailer never gets paid for them, and eventually it stops offering the services. *If* those services were genuinely useful, in the sense that the product plus service package resulted in greater sales for the manufacturer than the product alone would have enjoyed, there is a loss both for the manufacturer and the consumer. Hence, antitrust law permits nonprice vertical restraints that are designed to facilitate the provision of extra services, recognizing that a manufacturer in a competitive market who has guessed wrong will eventually be forced by the market to abandon the restrictions. See *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717, 724, 108 S.Ct. 1515, 99 L.Ed.2d 808 (1988), quoting *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 52 n. 19, 97 S.Ct. 2549, 53 L.Ed.2d 568 (1977).

Here, the evidence shows that the freeriding story is inverted. The manufacturers wanted a business strategy under which they distributed their toys to as many different kinds of outlets as would accept them: exclusive toy shops, TRU, discount department stores, and warehouse clubs. Rightly or wrongly, this was the distribution strategy that each one believed would maximize its individual output and profits. The *manufacturers* did not think that the alleged "extra services" TRU might have been providing were necessary. This is crucial, because the most important insight behind the free rider concept is the fact that, with respect to the cost of distribution services, the interests of the manufacturer and the *consumer* are aligned, and are basically adverse to the interests of the retailer (who would presumably like to charge as much as possible for its part in the process). See *Premier Electrical Construction Co. v. Nat'l Electrical Contractors Ass'n*, 814 F.2d 358, 369-70 (7th Cir.1987) ("[the rationale for permitting restricted distribution policies] depends on the alignment of interests between consumers and manufacturers. Destroy that alignment and you destroy the power of the argument.").

What TRU wanted or did not want is neither here nor there for purposes of the free rider argument. Its economic interest was in maximizing its own profits, not in keeping down its suppliers' cost of doing business. Furthermore, we note that the Commission made a plausible argument for the proposition that there was little or no opportunity to "free" ride on anything here in any event. The consumer is not taking a *free* ride if the cost of the service can be captured in the price of the item. As our earlier review of the facts demonstrated, the manufacturers were paying for the services TRU furnished, such as advertising, full-line product stocking, and extensive inventories. These expenses, we may assume, were folded into the price of the goods the manufacturers charged to TRU, and thus these services were not susceptible to free riding. On this record, in short, TRU cannot prevail on the basis that its practices were designed to combat free riding.

D. *Remedy*

Last, we consider TRU's challenge to the remedial provisions the Commission ordered. TRU's basic point here is that the Commission has commanded it to do things that it would have been free to refuse, and conversely to refrain from actions it would have been free to take, in the absence of its violation of FTC Act § 5. So that its arguments can be fully

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understood, we set forth Section II of the decree in its entirety here:

IT IS ORDERED that respondent, directly or indirectly, through any corporation, subsidiary, division or other device, in connection with the actual or potential purchase or distribution of toys and related products, in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, forthwith cease and desist from:

A. Continuing, maintaining, entering into, and attempting to enter into any agreement or understanding with any supplier to limit supply or to refuse to sell toys and related products to any toy discounter.

B. Urging, inducing, coercing, or pressuring, or attempting to urge, induce, coerce, or pressure, any supplier to limit supply or to refuse to sell toys and related products to any toy discounter.

C. Requiring, soliciting, requesting or encouraging any supplier to furnish information to respondent relating to any supplier's sales or actual or intended shipments to any toy discounter.

D. Facilitating or attempting to facilitate agreements or understandings between or among suppliers relating to limiting the sale of toys and related products to any retailer(s) by, among other things, transmitting or conveying complaints, intentions, plans, actions, or other similar information from one supplier to another supplier relating to sales to such retailer(s).

E. For a period of five years, (1) announcing or communicating that respondent will or may discontinue purchasing or refuse to purchase toys and related products from any supplier because that supplier intends to sell or sells toys and related products to any toy discounter, or (2) refusing topurchase toys and related products from a supplier because, in whole or in part, that supplier offered to sell or sold toys and related products to any toy discounter.

PROVIDED, however, that nothing in this order shall prevent respondent from seeking or entering into exclusive arrangements with suppliers with respect to particular toys.

TRU makes a perfunctory, one-paragraph argument that paragraphs II(B), II(C), II(D), and II(E)(1) impose a "gag order" that contravenes the Supreme Court's recognition in *Monsanto Co. v. Spray-Rite Corp., supra,* that manufacturers and distributors have a legitimate need for a free flow of information between them. This order, they claim, will create an irrational dislocation in the market to the detriment of toy suppliers, retailers, and consumers. With respect to paragraph II(E)(2), it argues that the five-year restriction on refusals to deal impermissibly cabins its *Colgate* rights to choose the suppliers with which it wants to deal. In effect, it claims, the decree will force it to purchase all toys that are offered to anyone, unless it can somehow prove that its refusal was because of a safety defect or other similar flaw.

We consider first TRU's challenges to parts II(B) through II(D) of the order. (It has not mentioned II(A) in its brief, and thus it has waived any challenge to that part of the order.) In general, if a retailer had some kind of restricted distribution arrangement with a manufacturer, *Monsanto* holds that it is permissible for the retailer to urge the manufacturer to respect the limits of that agreement. The retailer may communicate complaints about the provision of product to discounters, if that runs afoul of the promises in the distribution agreement. *Colgate* indicates that the retailer would also be within its rights to tell the manufacturer that it will no longer stock the manufacturer's product, if it is unhappy with the company it is keeping (*i.e.* if the manufacturer is sending too many goods to discounters, stores with a reputation for rude and sloppy service, or other undesirables).

Two facts distinguish these general rules from the situation in which TRU finds itself. First, unilateral actions of the sort protected by *Monsanto* and *Colgate* are not the same thing as a retailer's request to the manufacturer to change the latter's business practice. Under paragraph II(B) of the decree, TRU must not tell the manufacturer what to do; it is still permitted to decide which toys it wants to carry and which ones to drop, based on business considerations such as the expected popularity of the item. Second, to the extent paragraph II(B) might indirectly inhibit TRU from exercising its unilateral judgment, TRU must confront the fact that the FTC is not limited to restating the law in its remedial orders. Such orders can restrict the options for a company that has violated § 5, to ensure that the violation will cease and competition will be restored. See *National Lead Co., supra,* 352 U.S. at 430, 77 S.Ct. 502; *FTC v. Cement Institute,* 333 U.S. 683, 726-27, 68 S.Ct. 793, 92 L.Ed. 1010 (1948); *Corning Glass Works v. FTC,* 509 F.2d 293, 303 (7th Cir.1975). See also *FTC v. Colgate-Palmolive Co.,* 380 U.S. 374, 392, 85 S.Ct. 1035, 13 L.Ed.2d 904 (1965) (making the same point, in context of the Commission's deceptive practices authority).

The second point also applies to TRU's objections to paragraphs II(C) and II(D). In addition, we note that the retailer should not have any reason to obtain its

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suppliers' business records about shipments to the retailer's competitors. That is the supplier's concern. TRU is protected as long as it can ensure that it receives what was promised to it. Also, of course, the decree preserves TRU's right to enter into exclusive arrangements with respect to particular toys. In so doing, it also implicitly allows TRU to engage in communications that are necessary for the implementation and enforcement of such agreements. Paragraph II(D) directly addresses the Commission's finding of a horizontal agreement, and it orders TRU not to go out and create a new one. The Commission was certainly acting within the bounds of its discretion when it included these provisions.

Paragraph II(E) appears to be the one that causes the greatest concern to TRU. This strikes us as a closer call, but in this connection the standard of review becomes important. The Commission has represented in its brief to this court that the decree "leaves [TRU] free to make stocking decisions based on a wide range of business reasons; it must simply make those decisions--for a period of five years--independent of whether clubs or other discounters are carrying the same item." FTC Brief at 58. The attempt to use its market clout to harm the warehouse clubs lies at the heart of this case, and so it is easy to see why the Commission chose to prohibit reliance on the supplier's practices vis ... vis the clubs as a reason for TRU's own purchasing decisions. At bottom, TRU is really just worried that it will be difficult to prove that any particular purchasing decision was free from the prohibited taint. It will be easy to refrain from announcements or communications about refusals to deal, which is what II(E)(1) prohibits. With respect to II(E)(2), if TRU implements adequate internal procedural safeguards, it should be possible to demonstrate that its buying decisions were not influenced by anything the manufacturers were doing with discounters like the clubs. These refusals to deal were the means TRU used to accomplish the unlawful result, and as such, they are subject to regulation by the Commission. See *National Lead,* 352 U.S. at 425, 77 S.Ct. 502. Under the abuse of discretion standard that governs our review of the Commission's choice of remedy, see *Siegel Co. v. FTC,* 327 U.S. 608, 612-13, 66 S.Ct. 758, 90 L.Ed. 888 (1946), this does not appear to be a remedy that "has no reasonable relation to the unlawful practices found to exist." We therefore have no warrant to set it aside. If, however, it becomes clear in practice that this provision is unworkable, TRU is free to return to the Commission to petition for a modification of the order.

**III**

We conclude that the Commission's decision is supported by substantial evidence on the record, and that its remedial decree falls within the broad discretion it has been granted under the FTC Act. The decision is hereby Affirmed.

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Supreme Court of the United States

BUSINESS ELECTRONICS CORPORATION,
Petitioner
v.
SHARP ELECTRONICS CORPORATION.

**No. 85-1910.**

Argued Jan. 19, 1988.
Decided May 2, 1988.

SCALIA, J., delivered the opinion of the Court, in which REHNQUIST, C.J., and BRENNAN, MARSHALL, BLACKMUN, and O'CONNOR, JJ., joined. STEVENS, J., filed a dissenting opinion, in which WHITE, J., joined, *post,* p. ----. KENNEDY, J., took no part in the consideration or decision of the case.

Justice SCALIA delivered the opinion of the Court.

Petitioner Business Electronics Corporation seeks review of a decision of the United States Court of Appeals for the Fifth Circuit holding that a vertical restraint is *per se* illegal under § 1 of the Sherman Act, 26 Stat. 209, as amended, 15 U.S.C. § 1, only if there is an express or implied agreement to set resale prices at some level. 780 F.2d 1212, 1215-1218 (1986). We granted certiorari, 482 U.S. 912, 107 S.Ct. 3182, 96 L.Ed.2d 671 (1987), to resolve a conflict in the Courts of Appeals regarding the proper dividing line between the rule that vertical price restraints are illegal *per se* and the rule that vertical nonprice restraints are to be judged under the rule of reason. [FN1] [omitted]

I

In 1968, petitioner became the exclusive retailer in the Houston, Texas, area of electronic calculators manufactured by respondent Sharp Electronics Corporation. In 1972, respondent appointed Gilbert Hartwell as a second retailer in the Houston area. During the relevant period, electronic calculators were primarily sold to business customers for prices up to $1,000. While much of the evidence in this case was conflicting--in particular, concerning whether petitioner was "free riding" on Hartwell's provision of presale educational and promotional services by providing inadequate services itself--a few facts are undisputed. Respondent published a list of suggested minimum retail prices, but its written dealership agreements with petitioner and Hartwell did not obligate either to observe them, or to charge any other specific price. Petitioner's retail prices were often below respondent's suggested retail prices and generally below Hartwell's retail prices, even though Hartwell too sometimes priced below respondent's suggested retail prices. Hartwell complained to respondent on a number of occasions about petitioner's prices. In June 1973, Hartwell gave respondent the ultimatum that Hartwell would terminate his dealership unless respondent ended its relationship with petitioner within 30 days. Respondent terminated petitioner's dealership in July 1973.

Petitioner brought suit in the United States District Court for the Southern District of Texas, alleging that respondent and Hartwell had conspired to terminate petitioner and that such conspiracy was illegal *per se* under § 1 of the Sherman Act. The case was tried to a jury. The District Court submitted a liability interrogatory to the jury that asked whether "there was an agreement or understanding between Sharp Electronics Corporation and Hartwell to terminate Business Electronics as a Sharp dealer because of Business Electronics' price cutting." Record, Doc. No. 241. The District Court instructed the jury at length about this question:

> "The Sherman Act is violated when a seller enters into an agreement or understanding with one of its dealers to terminate another dealer because of the other dealer's price cutting. Plaintiff contends that Sharp terminated Business Electronics in furtherance of Hartwell's desire to eliminate Business Electronics as a price-cutting rival.
>
> "If you find that there was an agreement between Sharp and Hartwell to terminate Business Electronics because of Business Electronics' price cutting, you should answer yes to Question Number 1.
>
> * * *
>
> "A combination, agreement or understanding to terminate a dealer because of his price cutting unreasonably restrains trade and cannot be justified for any reason. Therefore, even though the combination, agreement or understanding may have been formed or engaged in ... to eliminate any alleged evils of price cutting, it is still unlawful....
>
> "If a dealer demands that a manufacturer terminate a price cutting dealer, and the manufacturer agrees to do so, the agreement is illegal if the manufacturer's purpose is to eliminate the price cutting." App. 18-19.

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The jury answered Question 1 affirmatively and awarded $600,000 in damages. The District Court rejected respondent's motion for judgment notwithstanding the verdict or a new trial, holding that the jury interrogatory and instructions had properly stated the law. It entered judgment for petitioner for treble damages plus attorney's fees.

The Fifth Circuit reversed, holding that the jury interrogatory and instructions were erroneous, and remanded for a new trial. It held that, to render illegal *per se* a vertical agreement between a manufacturer and a dealer to terminate a second dealer, the first dealer "must expressly or impliedly agree to set its prices at some level, though not a specific one. The distributor cannot retain complete freedom to set whatever price it chooses." 780 F.2d, at 1218.

II

A

Section 1 of the Sherman Act provides that "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal." 15 U.S.C. § 1. Since the earliest decisions of this Court interpreting this provision, we have recognized that it was intended to prohibit only unreasonable restraints of trade. *National Collegiate Athletic Assn. v. Board of Regents of University of Oklahoma,* 468 U.S. 85, 98, 104 S.Ct. 2948, 2958-59, 82 L.Ed.2d 70 (1984); see, *e.g., Standard Oil Co. v. United States,* 221 U.S. 1, 60, 31 S.Ct. 502, 515-16, 55 L.Ed. 619 (1911) . Ordinarily, whether particular concerted action violates § 1 of the Sherman Act is determined through case-by-case application of the so-called rule of reason--that is, "the factfinder weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition." *Continental T.V., Inc. v. GTE Sylvania Inc.,* 433 U.S. 36, 49, 97 S.Ct. 2549, 2557, 53 L.Ed.2d 568 (1977). Certain categories of agreements, however, have been held to be *per se* illegal, dispensing with the need for case-by-case evaluation. We have said that *per se* rules are appropriate only for "conduct that is manifestly anticompetitive," *id.,* at 50, 97 S.Ct., at 2557, that is, conduct " 'that would always or almost always tend to restrict competition and decrease output,' " *Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.,* 472 U.S. 284, 289-290, 105 S.Ct. 2613, 2617, 86 L.Ed.2d 202 (1985), quoting *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.,* 441 U.S. 1, 19-20, 99 S.Ct. 1551, 1562, 60 L.Ed.2d 1 (1979). See also *FTC v. Indiana Federation of Dentists,* 476 U.S. 447, 458-459, 106 S.Ct. 2009, 2017- 2018, 90 L.Ed.2d 445 (1986) ("[W]e have been slow ... to extend *per se* analysis to restraints imposed in the context of business relationships where the economic impact of certain practices is not immediately obvious"); *National Collegiate Athletic Assn. v. Board of Regents of University of Oklahoma, supra,* 433 U.S., at 103-104, 104 S.Ct., at 2961 ("*Per se* rules are invoked when surrounding circumstances make the likelihood of anticompetitive conduct so great as to render unjustified further examination of the challenged conduct"); *National Society of Professional Engineers v. United States,* 435 U.S. 679, 692, 98 S.Ct. 1355, 1365, 55 L.Ed.2d 637 (1978) (agreements are *per se* illegal only if their "nature and necessary effect are so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality").

Although vertical agreements on resale prices have been illegal *per se* since *Dr. Miles Medical Co. v. John D. Park & Sons Co.,* 220 U.S. 373, 31 S.Ct. 376, 55 L.Ed. 502 (1911), we have recognized that the scope of *per se* illegality should be narrow in the context of vertical restraints. In *Continental T.V., Inc. v. GTE Sylvania Inc., supra,* we refused to extend *per se* illegality to vertical nonprice restraints, specifically to a manufacturer's termination of one dealer pursuant to an exclusive territory agreement with another. We noted that especially in the vertical restraint context "departure from the rule-of-reason standard must be based on demonstrable economic effect rather than ... upon formalistic line drawing." *Id.,* 433 U.S., at 58-59, 97 S.Ct., at 2562. We concluded that vertical nonprice restraints had not been shown to have such a " 'pernicious effect on competition' " and to be so " 'lack[ing] [in] ... redeeming value' " as to justify *per se* illegality. *Id.,* at 58, 97 S.Ct., at 2561, quoting *Northern Pacific R. Co. v. United States,* 356 U.S. 1, 5, 78 S.Ct. 514, 518, 2 L.Ed.2d 545 (1958) . Rather, we found, they had real potential to stimulate interbrand competition, "the primary concern of antitrust law," 433 U.S., at 52, n. 19, 97 S.Ct., at 2558 n. 19:

> "[N]ew manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer. Established manufacturers can use them to induce retailers to

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> engage in promotional activities or to provide service and repair facilities necessary to the efficient marketing of their products. Service and repair are vital for many products.... The availability and quality of such services affect a manufacturer's goodwill and the competitiveness of his product. Because of market imperfections such as the so-called 'free-rider' effect, these services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the services than if none did." *Id.*, at 55, 97 S.Ct., at 2560.

Moreover, we observed that a rule of *per se* illegality for vertical nonprice restraints was not needed or effective to protect *intra* brand competition. First, so long as interbrand competition existed, that would provide a "significant check" on any attempt to exploit intrabrand market power. *Id.*, at 52, n. 19, 97 S.Ct., at 2558, n. 19; see also *id.*, at 54, 97 S.Ct., at 2559-60. In fact, in order to meet that interbrand competition, a manufacturer's dominant incentive is to lower resale prices. *Id.*, at 56, and n. 24, 97 S.Ct., at 2560, and n. 24. Second, the *per se* illegality of vertical restraints would create a perverse incentive for manufacturers to integrate vertically into distribution, an outcome hardly conducive to fostering the creation and maintenance of small businesses. *Id.*, at 57, n. 26, 97 S.Ct., at 2561, n. 6.

Finally, our opinion in *GTE Sylvania* noted a significant distinction between vertical nonprice and vertical price restraints. That is, there was support for the proposition that vertical price restraints reduce *inter* brand price competition because they " 'facilitate cartelizing.' " *Id.*, at 51, n. 18, 97 S.Ct., at 2558, n. 18, quoting Posner, Antitrust Policy and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions, 75 Colum.L.Rev. 282, 294 (1975). The authorities cited by the Court suggested how vertical price agreements might assist horizontal price fixing at the manufacturer level (by reducing the manufacturer's incentive to cheat on a cartel, since its retailers could not pass on lower prices to consumers) or might be used to organize cartels at the retailer level. See R. Posner, Antitrust: Cases, Economic Notes and Other Materials 134 (1974); E. Gellhorn, Antitrust Law and Economics 252, 256 (1976); Note, Vertical Territorial and Customer Restrictions in the Franchising Industry, 10 Colum.J.L. & Soc.Prob. 497, 498, n. 12 (1974). Similar support for the cartel-facilitating effect of vertical nonprice restraints was and remains lacking.

We have been solicitous to assure that the market-freeing effect of our decision in *GTE Sylvania* is not frustrated by related legal rules. In *Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752, 763, 104 S.Ct. 1464, 1470, 79 L.Ed.2d 775 (1984), which addressed the evidentiary showing necessary to establish vertical concerted action, we expressed concern that "[i]f an inference of such an agreement may be drawn from highly ambiguous evidence, there is considerable danger that the doctrin[e] enunciated in *Sylvania* ... will be seriously eroded." See also *id.*, at 761, n. 6, 104 S.Ct., at 1469, n. 6. We eschewed adoption of an evidentiary standard that "could deter or penalize perfectly legitimate conduct" or "would create an irrational dislocation in the market" by preventing legitimate communication between a manufacturer and its distributors. *Id.*, at 763, 764, 104 S.Ct., at 1470.

Our approach to the question presented in the present case is guided by the premises of *GTE Sylvania* and *Monsanto:* that there is a presumption in favor of a rule-of-reason standard; that departure from that standard must be justified by demonstrable economic effect, such as the facilitation of cartelizing, rather than formalistic distinctions; that interbrand competition is the primary concern of the antitrust laws; and that rules in this area should be formulated with a view towards protecting the doctrine of *GTE Sylvania.* These premises lead us to conclude that the line drawn by the Fifth Circuit is the most appropriate one.

There has been no showing here that an agreement between a manufacturer and a dealer to terminate a "price cutter," without a further agreement on the price or price levels to be charged by the remaining dealer, almost always tends to restrict competition and reduce output. Any assistance to cartelizing that such an agreement might provide cannot be distinguished from the sort of minimal assistance that might be provided by vertical nonprice agreements like the exclusive territory agreement in *GTE Sylvania,* and is insufficient to justify a *per se* rule. Cartels are neither easy to form nor easy to maintain. Uncertainty over the terms of the cartel, particularly the prices to be charged in the future, obstructs both formation and adherence by making cheating easier. Cf. *Maple Flooring Mfrs. Assn. v. United States,* 268 U.S. 563, 45 S.Ct. 578, 69 L.Ed. 1093 (1925); *Cement Mfrs. Protective Assn. v. United States,* 268 U.S. 588, 45 S.Ct. 586, 69 L.Ed. 1104 (1925); see generally *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 590, 106 S.Ct. 1348,

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1358, 89 L.Ed.2d 538 (1986). Without an agreement with the remaining dealer on price, the manufacturer both retains its incentive to cheat on any manufacturer-level cartel (since lower prices can still be passed on to consumers) and cannot as easily be used to organize and hold together a retailer-level cartel. [FN2]

FN2. The dissent's principal fear appears to be not cartelization at either level, but Hartwell's assertion of dominant retail power. This fear does not possibly justify adopting a rule of *per se* illegality. Retail market power is rare, because of the usual presence of interbrand competition and other dealers, see *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 54, 97 S.Ct. 2549, 2559-60, 53 L.Ed.2d 568 (1977), and it should therefore not be assumed but rather must be proved. Cf. Baxter, The Viability of Vertical Restraints Doctrine, 75 Calif.L.Rev. 933, 948-949 (1987). Of course this case was not prosecuted on the theory, and therefore the jury was not asked to find, that Hartwell possessed such market power.

The District Court's rule on the scope of *per se* illegality for vertical restraints would threaten to dismantle the doctrine of *GTE Sylvania.* Any agreement between a manufacturer and a dealer to terminate another dealer who happens to have charged lower prices can be alleged to have been directed against the terminated dealer's "price cutting." In the vast majority of cases, it will be extremely difficult for the manufacturer to convince a jury that its motivation was to ensure adequate services, since price cutting and ***728** some measure of service cutting usually go hand in hand. Accordingly, a manufacturer that agrees to give one dealer an exclusive territory and terminates another dealer pursuant to that agreement, or even a manufacturer that agrees with one dealer to terminate another for failure to provide contractually obligated services, exposes itself to the highly plausible claim that its real motivation was to terminate a price cutter. Moreover, even vertical restraints that do not result in dealer termination, such as the initial granting of an exclusive territory or the requirement that certain services be provided, can be attacked as designed to allow existing dealers to charge higher prices. Manufacturers would be likely to forgo legitimate and competitively useful conduct rather than risk treble damages and perhaps even criminal penalties.

We cannot avoid this difficulty by invalidating as illegal *per se* only those agreements imposing vertical restraints that contain the word "price," or that affect the "prices" charged by dealers. Such formalism was explicitly rejected in *GTE Sylvania.* As the above discussion indicates, all vertical restraints, including the exclusive territory agreement held not to be *per se* illegal in *GTE Sylvania,* have the potential to allow dealers to increase "prices" and can be characterized as intended to achieve just that. In fact, vertical nonprice restraints only accomplish the benefits identified in *GTE Sylvania* because they reduce intrabrand price competition to the point where the dealer's profit margin permits provision of the desired services. As we described it in *Monsanto:* "The manufacturer often will want to ensure that its distributors earn sufficient profit to pay for programs such as hiring and training additional salesmen or demonstrating the technical features of the product, and will want to see that 'free-riders' do not interfere." 465 U.S., at 762-763, 104 S.Ct., at 1470. See also *GTE Sylvania,* 433 U.S., at 55, 97 S.Ct., at 2560.

The dissent erects a much more complex analytic structure, which ultimately rests, however, upon the same discredited premise that the only function this nonprice vertical restriction can serve is restraint of dealer-level competition. Specifically, the dissent's reasoning hinges upon its perception that the agreement between Sharp and Hartwell was a "naked" restraint--that is, it was not "ancillary" to any other agreement between Sharp and Hartwell. *Post,* at 1526-1528, 1530-1531. But that is not true, unless one assumes, contrary to *GTE Sylvania* and *Monsanto,* and contrary to our earlier discussion, that it is not a quite plausible purpose of the restriction to enable Hartwell to provide better services under the sales franchise agreement. [FN3] From its faulty conclusion that what we have before us is a "naked" restraint, the dissent proceeds, by reasoning we do not entirely follow, to the further conclusion that it is therefore a horizontal rather than a vertical restraint. We pause over this only to note that in addition to producing what we think the wrong result in the present case, it introduces needless confusion into antitrust terminology. Restraints imposed by agreement between competitors have traditionally been denominated as horizontal restraints, and those imposed by agreement between firms at different levels of distribution as vertical restraints. [FN4]

FN3. The conclusion of "naked" restraint

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could also be sustained on another assumption, namely, that an agreement is not "ancillary" unless it is designed to enforce a contractual obligation of one of the parties to the contract. The dissent appears to accept this assumption. See *post,* at 1527-1528, and n. 3, 1530-1531. It is plainly wrong. The classic "ancillary" restraint is an agreement by the seller of a business not to compete within the market. See *Mitchel v. Reynolds,* 1 P. Wms. 181, 24 Eng.Rep. 347 (1711); Restatement (Second) of Contracts § 188(2)(a) (1981). That is not ancillary to any other contractual obligation, but, like the restraint here, merely enhances the value of the contract, or permits the "enjoyment of [its] fruits." *United States v. Addyston Pipe & Steel Co.,* 85 F. 271, 282 (CA6 1898), aff'd, 175 U.S. 211, 20 S.Ct. 96, 44 L.Ed. 136 (1899); cf. Restatement (Second) of Contracts § § 187, 188 (1981) (restraint may be ancillary to a "transaction *or relationship* ") (emphasis added); R. Bork, The Antitrust Paradox 29 (1978) (hereinafter Bork) (vertical arrangements are ancillary to the "transaction of supplying and purchasing").
More important than the erroneousness of the dissent's common-law analysis of "naked" and "ancillary" restraints are the perverse economic consequences of permitting nonprice vertical restraints to avoid *per se* invalidity only through attachment to an express contractual obligation. Such an approach is contrary to the express views of the principal scholar on whom the dissent relies. See 7 P. Areeda, Antitrust Law § 1457c, p. 170 (1986) (hereinafter Areeda) (legality of terminating price cutter should not depend upon formal adoption of service obligations that termination is assertedly designed to protect). In the precise case of a vertical agreement to terminate other dealers, for example, there is no conceivable reason why the existence of an exclusivity commitment by the manufacturer to the one remaining dealer would render anticompetitive effects less likely, or the procompetitive effects on services more likely--so that the dissent's line for *per se* illegality fails to meet the requirement of *Continental T.V., Inc. v. GTE Sylvania Inc., supra,* 433 U.S., at 59, 97 S.Ct., at 2562, that it be based on "demonstrable economic effect." If anything, the economic effect of the dissent's approach is perverse, encouraging manufacturers to agree to otherwise inefficient contractual provisions for the sole purpose of attaching to them efficient nonprice vertical restraints which, only by reason of such attachment, can avoid *per se* invalidity as "naked" restraints. The dissent's approach would therefore create precisely the kind of "irrational dislocation in the market" that legal rules in this area should be designed to avoid. *Monsanto Co. v. Spray-Rite Service Corp.,* 465 U.S. 752, 764, 104 S.Ct. 1464, 1470-71, 79 L.Ed.2d 775 (1984).

FN4. The dissent apparently believes that whether a restraint is horizontal depends upon whether its anticompetitive *effects* are horizontal, and not upon whether it is the product of a horizontal agreement. *Post,* at 1530-1531, and n. 10. That is of course a conceivable way of talking, but if it were the language of antitrust analysis there would be no such thing as an unlawful vertical restraint, since all anticompetitive effects are by definition horizontal effects. The dissent quotes a statement of Professor Areeda as supposed adoption of its definition of horizontal restraint. *Post,* at 1530, n. 10, quoting Areeda § 1457d, p. 174. That statement seems to us to be, to the contrary, Professor Areeda's attempt to explain a peculiar usage of the term "horizontal" in *Cernuto, Inc. v. United Cabinet Corp.,* 595 F.2d, at 168, noting that (even though *Cernuto* did not involve a horizontal restraint) the use of the term "horizontal" was "appropriate to capture the fact that dealer interests opposed to those of the manufacturer were being served." Areeda § 1457d, p. 174. The dissent also seeks to associate Judge Bork with its terminological confusion. See *post,* at 1531, n. 10, quoting Bork 288. What thequoted passage says, however, is that a facially vertical restraint imposed by a manufacturer only because it has been coerced by a "horizontal carte[l]" agreement among his distributors is in reality a horizontal restraint. That says precisely what we say: that a restraint is horizontal not because it has horizontal effects, but because it is the product of a horizontal agreement.

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Finally, we do not agree with petitioner's contention that an agreement on the remaining dealer's price or price levels will so often follow from terminating another dealer "because of [its] price cutting" that prophylaxis against resale price maintenance warrants the District Court's *per se* rule. Petitioner has provided no support for the proposition that vertical price agreements generally underlie agreements to terminate a price cutter. That proposition is simply incompatible with the conclusion of *GTE Sylvania* and *Monsanto* that manufacturers are often motivated by a legitimate desire to have dealers provide services, combined with the reality that price cutting is frequently made possible by "free riding" on the services provided by other dealers. The District Court's *per se* rule would therefore discourage conduct recognized by *GTE Sylvania* and *Monsanto* as beneficial to consumers.

B

In resting our decision upon the foregoing economic analysis, we do not ignore common-law precedent concerning what constituted "restraint of trade" at the time the Sherman Act was adopted. But neither do we give that pre-1890 precedent the dispositive effect some would. The term "restraint of trade" in the statute, like the term at common law, refers not to a particular list of agreements, but to a particular economic consequence, which may be produced by quite different sorts of agreements in varying times and circumstances. The changing content of the term "restraint of trade" was well recognized at the time the Sherman Act was enacted. See *Gibbs v. Consolidated Gas Co.*, 130 U.S. 396, 409, 9 S.Ct. 553, 557, 32 L.Ed. 979 (1889) (noting that English case laying down the common-law rule that contracts in restraint of trade are invalid "was made under a condition of things, and a state of society, different from those which now prevail, [and therefore] the rule laid down is not regarded as inflexible, and has been considerably modified"); see also *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S., at 406, 31 S.Ct., at 384 ("With respect to contracts in restraint of trade, the earlier doctrine of the common law has been substantially modified in adaptation to modern conditions"); B. Cardozo, The Nature of the Judicial Process 94-96 (1921).

The Sherman Act adopted the term "restraint of trade" along with its dynamic potential. It invokes the common law itself, and not merely the static content that the common law had assigned to the term in 1890. See *GTE Sylvania*, 433 U.S., at 53, n. 21, 97 S.Ct., at 2559, n. 21; *Standard Oil Co. v. United States*, 221 U.S., at 51-60, 31 S.Ct., at 512-16; see also *McNally v. United States*, 483 U.S. 350, 372-373, 107 S.Ct. 2875, 2888-2889, 97 L.Ed.2d 292 (1987) (STEVENS, J., joined by O'CONNOR J., dissenting); *Associated General Contractors of California, Inc. v. Carpenters*, 459 U.S. 519, 533, n. 28, 539-540, and n. 43, 103 S.Ct. 897, 906, n. 28, 909, and n. 43 (1983); Bork 37. If it were otherwise, not only would the line of *per se* illegality have to be drawn today precisely where it was in 1890, but also case-by-case evaluation of legality (conducted where *per se* rules do not apply) would have to be governed by 19th-century notions of reasonableness. It would make no sense to create out of the single term "restraint of trade" a chronologically schizoid statute, in which a "rule of reason" evolves with new circumstances and new wisdom, but a line of *per se* illegality remains forever fixed where it was.

Of course the common law, both in general and as embodied in the Sherman Act, does not lightly assume that the economic realities underlying earlier decisions have changed, or that earlier judicial perceptions of those realities were in error. It is relevant, therefore, whether the common law of restraint of trade ever prohibited as illegal *per se* an agreement of the sort made here, and whether our decisions under § 1 of the Sherman Act have ever expressed or necessarily implied such a prohibition.

With respect to this Court's understanding of pre-Sherman Act common law, petitioner refers to our decision in *Dr. Miles Medical Co. v. John D. Park & Sons Co., supra.* Though that was an early Sherman Act case, its holding that a resale price maintenance agreement was *per se* illegal was based largely on the perception that such an agreement was categorically impermissible at common law. *Id.*, 220 U.S., at 404-408, 31 S.Ct., at 383- 85. As the opinion made plain, however, the basis for that common-law judgment was that the resale restriction was an unlawful restraint on alienation. See *ibid.* As we explained in *Boston Store of Chicago v. American Graphophone Co.*, 246 U.S. 8, 21-22, 38 S.Ct. 257, 259, 62 L.Ed. 551 (1918), "*Dr. Miles* ... decided that under the general law the owner of movables ... could not sell the movables and lawfully by contract fix a price at which the product should afterwards be sold, because to do so would be at one and the same time to sell and retain, to part with and yet to hold, to project the will of the seller so as to cause it to control the movable parted with when it

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was not subject to his will because owned by another." In the present case, of course, no agreement on resale price or price level, and hence no restraint on alienation, was found by the jury, so the common-law rationale of *Dr. Miles* does not apply. Cf. United States v. General Electric Co., 272 U.S. 476, 486-488, 47 S.Ct. 192, 195-96, 71 L.Ed. 362 (1926) (*Dr. Miles* does not apply to restrictions on price to be charged by one who is in reality an agent of, not a buyer from, the manufacturer).

Petitioner's principal contention has been that the District Court's rule on *per se* illegality is compelled not by the old common law, but by our more recent Sherman Act precedents. First, petitioner contends that since certain horizontal agreements have been held to constitute price fixing (and thus to be *per se* illegal) though they did not set prices or price levels, see, e.g., Catalano, Inc. v. Target Sales, Inc., 446 U.S. 643, 647- 650, 100 S.Ct. 1925, 1927-29, 64 L.Ed.2d 580 (1980) (*per curiam* ), it is improper to require that a vertical agreement set prices or price levels before it can suffer the same fate. This notion of equivalence between the scope of horizontal *per se* illegality and that of vertical *per se* illegality was explicitly rejected in GTE Sylvania, supra, 433 U.S., at 57, n. 27, 97 S.Ct., at 2561, n. 27 --as it had to be, since a horizontal agreement to divide territories is *per se* illegal, see United States v. Topco Associates, Inc., 405 U.S. 596, 608, 92 S.Ct. 1126, 1133-34, 31 L.Ed.2d 515 (1972), while *GTE Sylvania* held that a vertical agreement to do so is not. See also United States v. Arnold, Schwinn & Co., 388 U.S. 365, 390-391, 87 S.Ct. 1856, 1871-72, 18 L.Ed.2d 1249 (1967) (Stewart, J., joined by Harlan, J., concurring in part and dissenting in part); White Motor Co. v. United States, 372 U.S. 253, 263, 83 S.Ct. 696, 702, 9 L.Ed.2d 738 (1963).

Second, petitioner contends that *per se* illegality here follows from our two cases holding *per se* illegal a group boycott of a dealer because of its price cutting. See United States v. General Motors Corp., 384 U.S. 127, 86 S.Ct. 1321, 16 L.Ed.2d 415 (1966); Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207, 79 S.Ct. 705, 3 L.Ed.2d 741 (1959). This second contention is merely a restatement of the first, since both cases involved horizontal combinations--*General Motors, supra,* 384 U.S., at 140, 143-145, 86 S.Ct., at 1327-28, 1329-31, at the dealer level, [FN5] and *Klor's, supra,* 359 U.S., at 213, 79 S.Ct., at 710, at the manufacturer and wholesaler levels. Accord, GTE Sylvania, supra, at 58, n. 28; United States v. Arnold, Schwinn & Co., 388 U.S., at 373, 378, 87 S.Ct., at 1862, 1865; *id.*, 388 U.S., at 390, 87 S.Ct., at 1871, (Stewart, J., joined by Harlan, J., concurring in part and dissenting in part); White Motor Co. v. United States, supra, 372 U.S., at 263, 83 S.Ct., at 702.

FN5. Contrary to the dissent, *post,* at 1529, 1531, *General Motors* does not differ from the present case merely in that it involved a three- party rather than a two-party agreement. The agreement was among competitors in *General Motors;* it was betweennoncompetitors here. Cf. Bork 330 (defining "boycotts" as "agreements among competitors to refuse to deal").

Third, petitioner contends, relying on Albrecht v. Herald Co., 390 U.S. 145, 88 S.Ct. 869, 19 L.Ed.2d 998 (1968), and United States v. Parke, Davis & Co., 362 U.S. 29, 80 S.Ct. 503, 4 L.Ed.2d 505 (1960), that our vertical price-fixing cases have already rejected the proposition that *per se* illegality requires setting a price or a price level. We disagree. In *Albrecht,* the maker of the product formed a combination to force a retailer to charge the maker's advertised retail price. See 390 U.S., at 149, 88 S.Ct., at 871. This combination had two aspects. Initially, the maker hired a third party to solicit customers away from the noncomplying retailer. This solicitor "was aware that the aim of the solicitation campaign was to force [the noncomplying retailer] to lower his price" to the suggested retail price. *Id.*, at 150, 88 S.Ct., at 872. Next, the maker engaged another retailer who "undertook to deliver [products] at the suggested price" to the noncomplying retailer's customers obtained by the solicitor. *Ibid.* This combination of maker, solicitor, and new retailer was held to be *per se* illegal. *Id.*, at 150, 153, 88 S.Ct., at 872, 873. It is plain that the combination involved both an explicit agreement on resale price and an agreement to force another to adhere to the specified price.

In *Parke, Davis,* a manufacturer combined first with wholesalers and then with retailers in order to gain the "retailers' adherence to its suggested minimum retail prices." 362 U.S., at 45-46, and n. 6, 80 S.Ct., at 512-13 and n. 6. The manufacturer also brokered an agreement among its retailers not to advertise prices below its suggested retail prices, which agreement was held to be part of the *per se* illegal combination. This holding also does not support a rule that an agreement on price or price level is not required for a vertical restraint to be *per se* illegal--first, because the agreement not to advertise prices

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was part and parcel of the combination that contained the price agreement, *id.*, at 35-36, 80 S.Ct., at 507, and second because the agreement among retailers that the manufacturer organized was a *horizontal* conspiracy among competitors. *Id.*, at 46-47, 80 S.Ct., at 513.

In sum, economic analysis supports the view, and no precedent opposes it, that a vertical restraint is not illegal *per se* unless it includes some agreement on price or price levels. Accordingly, the judgment of the Fifth Circuit is

*Affirmed.*

Justice KENNEDY took no part in the consideration or decision of this case.

Justice STEVENS, with whom Justice WHITE joins, dissenting.

In its opinion the majority assumes, without analysis, that the question presented by this case concerns the legality of a "vertical nonprice restraint." As I shall demonstrate, the restraint that results when one or more dealers threaten to boycott a manufacturer unless it terminates its relationship with a price-cutting retailer is more properly viewed as a "horizontal restraint." Moreover, an agreement to terminate a dealer because of its price cutting is most certainly not a "nonprice restraint." The distinction between "vertical nonprice restraints" and "vertical price restraints," on which the majority focuses its attention, is therefore quite irrelevant to the outcome of this case. Of much greater importance is the distinction between "naked restraints" and "ancillary restraints" that has been a part of our law since the landmark opinion written by Judge (later Chief Justice) Taft in *United States v. Addyston Pipe & Steel Co.*, 85 F. 271 (CA6 1898), aff'd, 175 U.S. 211, 20 S.Ct. 96, 44 L.Ed. 136 (1899).

I

The plain language of § 1 of the Sherman Act prohibits "every" contract that restrains trade. [FN1] Because such a literal reading of the statute would outlaw the entire body of private contract law, and because Congress plainly intended *737 the Act to be interpreted in the light of its common- law background, the Court has long held that certain "ancillary" restraints of trade may be defended as reasonable. As we recently explained without dissent:

> FN1. Section 1 of the Sherman Act, as set forth in 15 U.S.C. § 1, provides:
> "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal."

> "The Rule of Reason suggested by *Mitchel v. Reynolds* [1 P. Wms. 181, 24 Eng.Rep. 347 (1711) ] has been regarded as a standard for testing the enforceability of covenants in restraint of trade which are ancillary to a legitimate transaction, such as an employment contract or the sale of a going business. Judge (later Mr. Chief Justice) Taft so interpreted the Rule in his classic rejection of the argument that competitors may lawfully agree to sell their goods at the same price as long as the agreed-upon price is reasonable. *United States v. Addyston Pipe & Steel Co....*" *National Society of Professional Engineers v. United States*, 435 U.S. 679, 689, 98 S.Ct. 1355, 1364, 55 L.Ed.2d 637 (1978).

Judge Taft's rejection of an argument that a price-fixing agreement could be defended as reasonable was based on a detailed examination of common-law precedents. He explained that in England there had been two types of objection to voluntary restraints on one's ability to transact business. "One was that by such contracts a man disabled himself from earning a livelihood with the risk of becoming a public charge, and deprived the community of the benefit of his labor. The other was that such restraints tended to give to the covenantee, the beneficiary of such restraints, a monopoly of the trade, from which he had thus excluded one competitor, and by the same means might exclude others." 85 F., at 279. Certain contracts, however, such as covenants not to compete in a particular business, for a certain period of time, within a defined geographical area, hadalways been considered reasonable when necessary to carry out otherwise procompetitive contracts, such as the sale of a business. *Id.*, at 280-282 . The difference between ancillary covenants that may be justified as reasonable and those that are "void" because there is "nothing to justify or excuse the restraint," *id.*, at 282-283, was described in the opinion's seminal discussion:

> "[T]he contract must be one in which there is a main purpose, to which the covenant in restraint of

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trade is merely ancillary. The covenant is inserted only to protect one of the parties from the injury which, in the execution of the contract or enjoyment of its fruits, he may suffer from the unrestrained competition of the other. The main purpose of the contract suggests the measure of protection needed, and furnishes a sufficiently uniform standard by which the validity of such restraints may be judicially determined. In such a case, if the restraint exceeds the necessity presented by the main purpose of the contract, it is void for two reasons: First, because it oppresses the covenantor, without any corresponding benefit to the covenantee; and, second, because it tends to a monopoly. But where the sole object of both parties in making the contract as expressed therein is merely to restrain competition, and enhance or maintain prices, it would seem that there was nothing to justify or excuse the restraint, that it would necessarily have a tendency to monopoly, and therefore would be void. In such a case there is no measure of what is necessary to the protection of either party, except the vague and varying opinion of judges as to how much, on principles of political economy, men ought to be allowed to restrain competition. There is in such contracts no main lawful purpose, to subserve which partial restraint is permitted, and by which its reasonableness is measured, but the sole object is to restrain trade in order to avoid the competition which it has always been the policy of the common law to foster." *Ibid.*

Although Judge Taft was writing as a Circuit Judge, his opinion is universally accepted as authoritative. We affirmed his decision without dissent, we have repeatedly cited it with approval, [FN2] [omitted] and it is praised by a respected scholar as "one of the greatest, if not the greatest, antitrust opinions in the history of the law." R. Bork, The Antitrust Paradox 26 (1978). In accordance with the teaching in that opinion, it is therefore appropriate to look more closely at the character of the restraint of trade found by the jury in this case.

II

It may be helpful to begin by explaining why the agreement in this case does not fit into certain categories of agreement that are frequently found in antitrust litigation. First, despite the contrary implications in the majority opinion, this is not a case in which the manufacturer is alleged to have imposed any vertical nonprice restraints on any of its dealers. The term "vertical nonprice restraint," as used in *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 97 S.Ct. 2549, 53 L.Ed.2d 568 (1977), and similar cases, refers to a contractual term that a dealer must accept in order to qualify for a franchise. Typically, the dealer must agree to meet certain standards in its advertising, promotion, product display, and provision of repair and maintenance services in order to protect the goodwill of the manufacturer's product. Sometimes a dealer must agree to sell only to certain classes of customers--for example, wholesalers generally may only sell to retailers and may be required not to sell directly to consumers. In *Sylvania*, to take another example, we examined agreements between a manufacturer and its dealers that included "provisions barring the retailers from selling franchised products from locations other than those specified in agreements." *Id.*, 433 U.S., at 37, 97 S.Ct., at 2551. Restrictions of that kind, which are a part of, or ancillary to, the basic franchise agreement, are perfectly lawful unless the "rule of reason" is violated. Although vertical nonprice restraints may have some adverse effect on competition, as long as they serve the main purpose of a procompetitive distribution agreement, the ancillary restraints may be defended under the rule of reason. And, of course, a dealer who violates such a restraint may properly be terminated by the manufacturer. [FN3] [omitted]

In this case, it does not appear that respondent imposed any vertical nonprice restraints upon either petitioner or Hartwell. Specifically, respondent did not enter into any "exclusive" agreement, as did the defendant in *Sylvania*. It is true that before Hartwell was appointed and after petitioner was terminated, the manufacturer was represented by only one retailer in the Houston market, but there is no evidence that respondent ever made any contractual commitment to give either of them any exclusive rights. This therefore is not a case in which a manufacturer's right to grant exclusive territories, or to change the identity of the dealer in an established exclusive territory, is implicated. The case is one in which one of two competing dealers entered into an agreement with the manufacturer to terminate a particular competitor without making any promise to provide better or more efficient services and without receiving any guarantee of exclusivity in the future. The contractual relationship between respondent and Hartwell was exactly the same after petitioner's termination as it had been before that termination.

Second, this case does not involve a typical vertical price restraint. As the Court of Appeals noted, there is some evidence in the record that may support the

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conclusion that respondent and Hartwell implicitly agreed that Hartwell's prices would be maintained at a level somewhat higher than petitioner had been charging before petitioner was terminated. 780 F.2d 1212, 1219 (CA5 1986) . The illegality of the agreement found by the jury does not, however, depend on such evidence. For purposes of analysis, we should assume that no such agreement existed and that respondent was perfectly willing to allow its dealers to set prices at levels that would maximize their profits. That seems to have been the situation during the period when petitioner was the only dealer in Houston. Moreover, after respondent appointed Hartwell as its second dealer, it was Hartwell, rather than respondent, who objected to petitioner's pricing policies.

Third, this is not a case in which the manufacturer acted independently. Indeed, given the jury's verdict, it is not even a case in which the termination can be explained as having been based on the violation of any distribution policy adopted by respondent. The termination was motivated by the ultimatum that respondent received from Hartwell and that ultimatum, in turn, was the culmination of Hartwell's complaints about petitioner's competitive price cutting. The termination was plainly the product of coercion by the stronger of two dealers rather than an attempt to maintain an orderly and efficient system of distribution. [FN4]

> FN4. "When a manufacturer acts on its own, in pursuing its own market strategy, it is seeking to compete with other manufacturers by imposing what may be defended as reasonable vertical restraints. This would appear to be the rationale of the *GTE Sylvania* decision. However, if the action of a manufacturer or other supplier is taken at the direction of its customer, the restraint becomes primarily horizontal in nature in that one customer is seeking to suppress its competition by utilizing the power of a common supplier. Therefore, although the termination in such a situation is, itself, a vertical restraint, the desired impact is horizontal and on the dealer, not the manufacturer, level." *Cernuto, Inc. v. United Cabinet Corp.*, 595 F.2d 164, 168 (CA3 1979).

In sum, this case does not involve the reasonableness of any vertical restraint imposed on one or more dealers by a manufacturer in its basic franchise agreement. What the jury found was a simple and naked " 'agreement between Sharp and Hartwell to terminate Business Electronics because of Business Electronics' price cutting.' " *Ante,* at 1518.

III

Because naked agreements to restrain the trade of third parties are seldom identified with such stark clarity as in this case, there appears to be no exact precedent that determines the outcome here. There are, however, perfectly clear rules that would be decisive if the facts were changed only slightly.

Thus, on the one hand, if it were clear that respondent had acted independently and decided to terminate petitioner because respondent, for reasons of its own, objected to petitioner's pricing policies, the termination would be lawful. See *United States v. Parke, Davis & Co.*, 362 U.S. 29, 43- 45, 80 S.Ct. 503, 511-12, 4 L.Ed.2d 505 (1960) . On the other hand, it is equally clear that if respondent had been represented by three dealers in the Houston market instead of only two, and if two of them had threatened to terminate their dealerships "unless respondent ended its relationship with petitioner within 30 days," *ante,* at 1518, an agreement to comply with the ultimatum would be an obvious violation of the Sherman Act. See, *e.g., United States v. General Motors Corp.*, 384 U.S. 127, 86 S.Ct. 1321, 16 L.Ed.2d 415 (1966); *Klor's, Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207, 79 S.Ct. 705, 3 L.Ed.2d 741 (1959). [FN5] [omitted] The question then is whether the two-party agreement involved in this case is more like an illegal three-party agreement or a legal independent decision. For me, the answer is plain.

The distinction between independent action and joint action is fundamental in antitrust jurisprudence. [FN6] [omitted] Any attempt to define the boundaries of *per se* illegality by the number of parties to different agreements with the same anticompetitive consequences can only breed uncertainty in the law and confusion for the businessman.

More importantly, if instead of speculating about irrelevant vertical nonprice restraints, we focus on the precise character of the agreement before us, we can readily identify its anticompetitive nature. Before the agreement was made, there was price competition in the Houston retail market for respondent's

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products. The stronger of the two competitors was unhappy about that competition; it wanted to have the power to set the price level in the market and therefore it "complained to respondent on a number of occasions about petitioner's prices." *Ante,* at 1518. Quite obviously, if petitioner had agreed with either Hartwell or respondent to discontinue its competitive pricing, there would have been no ultimatum from Hartwell and no termination by respondent. It is equally obvious that either of those agreements would have been illegal *per se.* [FN7] [omitted] Moreover, it is also reasonable to assume that if respondent were to replace petitioner with another price-cutting dealer, there would soon be more complaints and another ultimatum from Hartwell. Although respondent has not granted Hartwell an exclusive dealership--it retains the right to appoint multiple dealers--its agreement has protected Hartwell from price competition. Indeed, given the jury's finding and the evidence in the record, that is the *sole function* of the agreement found by the jury in this case. It therefore fits squarely within the category of "naked restraints of trade with no purpose except stifling of competition." *White Motor Co. v. United States,* 372 U.S. 253, 263, 83 S.Ct. 696, 702, 9 L.Ed.2d 738 (1963).

This is the sort of agreement that scholars readily characterize as "inherently suspect." [FN8] When a manufacturer responds to coercion from a dealer, instead of making an independent decision to enforce a predetermined distribution policy, the anticompetitive character of the response is evident. [FN9] As Professor Areeda has correctly noted, the fact that the agreement is between only one complaining dealer and the manufacturer does not prevent it from imposing a "horizontal" restraint. [FN10] If two critical facts are present--a naked purpose to eliminate price competition as such and coercion of the manufacturer [FN11]--the conflict with antitrust policy is manifest. [FN12]

FN8. "[S]cenarios that involve a firm or firms at one level of activity using vertical restraints deliberately to confer market power on firms at an adjacent level are inherently suspect. To do so is, typically, to inflict self-injury, just as it would be for consumers to confer market power on the retailers from whom they buy." Baxter, The Viability of Vertical Restraints Doctrine, 75 Calif.L.Rev. 933, 938 (1987).

FN9. "Termination responses reflecting the manufacturer's own distribution policy differ greatly from those imposed upon him by a complaining dealer. In the latter case, the manufacturer's compliance with the complainer's demand is more likely to be anticompetitive. There is a superficial resemblance to *Parke Davis* in that three parties are involved, but my earlier analysis suggested that the key to that case was 'complex enforcement,' which is absent where a complaining dealer simply threatens to abandon the manufacturer who continues selling to discounting dealers." 7 P. Areeda, Antitrust Law § 1457, p. 166 (1986).

FN10. Commenting on Judge Adams' opinion in *Cernuto,* see nn. 4 and 5, *supra,* Professor Areeda wrote:
"That the complainer was a single firm did not weaken the 'horizontal' characterization. Because the elimination of price competition was the purpose of the complaint and the termination, the court declared that per se illegality would be appropriate. However, the court made clear that no illegal agreement would be found if United was implementing its own unilaterally chosen distribution policy. Thus, the court's implicit theory was that an agreement arose when the manufacturer bowed to the complainer's will. In that situation, the 'horizontal' characterization is appropriate to capture the fact that dealer interests opposed to those of the manufacturer were being served." Areeda, *supra,* at 174 (footnotes omitted).
See also R. Bork, The Antitrust Paradox 288 (1978):
"A restraint--whether on price, territory, or any other term--is vertical, according to the usage employed here, when a firm operating at one level of an industry places restraints upon rivalry at another level for its own benefit. (This definition excludes restraints, vertical in form only, that are actually imposed by horizontal cartels at any level of the industry, e.g., resale price maintenance that is compelled not by the manufacturer but by the pressure of organized retailers.)"

FN11. The two critical facts that had not yet been determined by a jury in the *Cernuto*

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case are perfectly plain in this case. As Professor Areeda explained:

"The *Cernuto* case was decided on summary judgment which accepted the plaintiff's view of the facts. But two facts critical for the court will often be obscure. *First,* was it the manufacturer's purpose to eliminate price competition as such? Let us assume that termination was not based on such completely independent grounds as non-payment of bills. Even so, the existence of an inevitable price effect does not establish a purpose to control prices in a forbidden way. A purpose to facilitate point-of-sale services or to protect minimum economies of scale could induce a manufacturer to limit intrabrand competition. Notwithstanding price effects, such limitations are lawful when reasonable and not subject to automatic condemnation. Indeed, termination of one dealer in order to grant another exclusive distribution rights in an area is generally lawful. Nevertheless, so long as the manufacturer is not implementing his own interest but that of the complainer, the vice of eliminating 'horizontal' competition with the complainer's rivals seems equally present when the complainer thereby succeeds in eliminating horizontal competition with respect to customers or territories. *Second,* was the manufacturer coerced or was he indulging his own preferences? As we have seen, this question cannot be answered in the abstract. The court correctly acknowledged that the manufacturer might also be implementing his own unilateral vision of optimal distribution without regard to the complainer's desires and held that no illegal agreement would arise if that were the case." Areeda, *supra,* at 174-175 (footnotes omitted).

FN12. "Let us defer for the moment problems of proof and assume that a manufacturer does not wish to terminate the plaintiff dealer but does so to placate the complaining dealer, who would otherwise cease handling the product. This manufacturer would rather keep both dealers but, when forced to choose between them, concludes that terminating the plaintiff hurts him less (considering sales lost, transaction costs in finding and perhaps training a replacement, and any spillover effects upon his relations with other dealers) than losing the complainer's patronage.

"The present situation is *Colgate* in reverse. In *Colgate,* it was the supplier who was controlling the dealer's behavior. Here a dealer is conditioning his patronage in a way that controls the manufacturer's behavior. The agreement concept seems parallel. But the economic effects can be very different. From the policy viewpoint, it can matter greatly whether manufacturer or dealer interests are being served. The former is more likely to seek efficient distribution, which stimulates interbrand competition; the latter is more likely to seek excess profits, which dampen interbrand competition. Accordingly, antitrust policy can be more hospitable toward manufacturer efforts to control dealer prices, customers, or territories than toward the efforts of dealers to control *their* competitors through the manufacturer.

"Of course, manufacturer and dealer interests are not necessarily antagonistic. Like the manufacturer, dealers might also believe that restricted distribution increases dealer services and sales and thus strengthens interbrand competition. However, this objective seems unlikely when the manufacturer is forced to violate the distribution policy he thinks best. Although he might be mistaken about what his optimal distribution policy ought to be, he should be presumed a better judge of that than coercing dealers who always desire excess profits unnecessary for efficient distribution." Areeda, *supra,* at 167-168 (footnotes omitted).

Indeed, since the economic consequences of Hartwell's ultimatum to respondent are identical to those that would result from a comparable ultimatum by two of three dealers in a market--and since a two-party price- fixing agreement is just as unlawful as a three-party price-fixing agreement-- it is appropriate to employ the term "boycott" to characterize this agreement. In my judgment the case is therefore controlled by our decision in *United States v. General Motors Corp.,* 384 U.S. 127, 86 S.Ct. 1321, 16 L.Ed.2d 415 (1966).

The majority disposes quickly of both *General Motors* and *Klor's, Inc. v. Broadway-Hale Stores,*

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*Inc.*, 359 U.S. 207, 79 S.Ct. 705, 3 L.Ed.2d 741 (1959), by concluding that "both cases involved horizontal combinations." *Ante,* at 1525. But this distinction plainly will not suffice. In *General Motors,* a group of Chevrolet dealers conspired with General Motors to eliminate sales from the manufacturer to discounting dealers. We held that "[e]limination, by joint collaborative action, of discounters from access to the market is a *per se* violation of the Act," 384 U.S., at 145, 86 S.Ct., at 1330, and explained that "inherent in the success of the combination in this case was a substantial restraint upon price competition--a goal unlawful *per se* when sought to be effected by combination or conspiracy." *Id.,* at 147, 86 S.Ct., at 1331. Precisely the same goal was sought and effected in this case--the elimination of price competition at the dealer level. Moreover, the method of achieving that goal was precisely the same in both cases--the manufacturer's refusal to sell to discounting dealers. The difference between the two cases is not a difference between horizontal and vertical agreements-- in both cases the critical agreement was between market actors at the retail level on the one hand and the manufacturer level on the other. Rather, the difference is simply a difference in the number of conspirators. Hartwell's coercion of respondent in order to eliminate petitioner because of its same- level price competition is not different in kind from the Chevrolet dealers' coercion of General Motors in order to eliminate other, price-cutting dealers; the only difference between the two cases--one dealer seeking a naked price- based restraint in today's case, many dealers seeking the same end in *General Motors* --is merely a difference in degree. Both boycotts lack any efficiency justification--they are simply naked restraints on price competition, rather than integral, or ancillary, parts of the manufacturers' predetermined distribution policies.

IV

What is most troubling about the majority's opinion is its failure to attach any weight to the value of intrabrand competition. In *Continental T.V., Inc. v. GTE Sylvania Inc.,* 433 U.S. 36, 97 S.Ct. 2549, 53 L.Ed.2d 568 (1977) , we correctly held that a demonstrable benefit to interbrand competition will outweigh the harm to intrabrand competition that is caused by the imposition of vertical nonprice restrictions on dealers. But we also expressly reaffirmed earlier cases in which the illegal conspiracy affected only intrabrand competition. [FN13] [omitted] Not a word in the *Sylvania* opinion implied that the elimination of intrabrand competition could be justified as reasonable without any evidence of a purpose to improve interbrand competition.

In the case before us today, the relevant economic market was the sale at retail in the Houston area of calculators manufactured by respondent. [FN14] [omitted] There is no dispute that an agreement to fix prices in that market, either horizontally between petitioner and Hartwell or vertically between respondent and either or both of the two dealers, would violate the Sherman Act. The "quite plausible" assumption, see *ante,* at 1522, that such an agreement might enable the retailers to provide better services to their customers would not have avoided the strict rule against price fixing that this Court has consistently enforced in the past.

Under petitioner's theory of the case, an agreement between respondent and Hartwell to terminate petitioner because of its price cutting was just as indefensible as any of those price-fixing agreements. At trial the jury found the existence of such an agreement to eliminate petitioner's price competition. Respondent had denied that any agreement had been made and asked the jury to find that it had independently decided to terminate petitioner because of its poor sales performance, [FN15] but after hearing several days of testimony, the jury concluded that this defense was pretextual.

FN15. The court instructed the jury:
"Sharp, on the other hand, contends that it terminated Business Electronics unilaterally, not as a result of any agreement or understanding with Hartwell, but because of Business Electronics' sales performance. If you find that Sharp did not terminate Business Electronics pursuant to an agreement or understanding with Hartwell to eliminate price cutting by Business Electronics, then you should answer 'no' to question number 1." 22 Record 1587.
See also nn. 18-19, *infra.*

Neither the Court of Appeals nor the majority questions the accuracy of the jury's resolution of the factual issues in this case. Nevertheless, the rule the majority fashions today is based largely on its concern that in other cases juries will be unable to tell the difference between truthful and pretextual defenses. Thus, it opines that "even a manufacturer that agrees with one dealer to terminate another for failure to provide contractually obligated services,

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exposes itself to the highly plausible claim that its real motivation was to terminate a price cutter." *Ante,* at 9. But such a "plausible" concern in a hypothetical case that is so different from this one should not be given greater weight than facts that can be established by hard evidence. If a dealer has, in fact, failed to provide contractually obligated services, and if the manufacturer has, in fact, terminated the dealer for that reason, both of those objective facts should be provable by admissible evidence. [FN16] [omitted] Both in its disposition of this case and in its attempt to justify a new approach to agreements to eliminateprice competition, the majority exhibits little confidence in the judicial process as a means of ascertaining the truth. [FN17] [omitted]

The majority fails to consider that manufacturers such as respondent will only be held liable in the rare case in which the following can be proved: First, the terminated dealer must overcome the high hurdle of *Monsanto Co. v. Spray-Rite Service Corp.,* 465 U.S. 752, 104 S.Ct. 1464, 79 L.Ed.2d 775 (1984). A terminated dealer must introduce "evidence that tends to exclude the possibility that the manufacturer and nonterminated distributors were acting independently." *Id.,* at 764, 104 S.Ct., at 1471. Requiring judges to adhere to the strict test for agreement laid down in *Monsanto,* in their jury instructions or own findings of fact, goes a long way toward ensuring that many legitimate dealer termination decisions do not succumb improperly to antitrust liability. [FN18]

FN18. Although at trial respondent had asked the jury to find that it had acted independently, see n. 15, *supra,* and accompanying text, respondent has not disputed, either in the Court of Appeals or here, the jury's finding of an agreement. (Respondent has, of course, contended that no agreement was reached requiring some level of resale price maintenance. As I have argued, though, such an agreement is not needed to invoke the *per se* rule in a case such as this.) Respondent did argue before the District Court for an instruction explaining that "it must be shown that the manufacturer agreed with the complaining dealer to terminate the existing dealer and that, in so agreeing, the manufacturer shared with the complaining dealer the same desire of eliminating price competition for the complaining dealer." 1 Record 151. Respondent later objected to the court's decision not to give this instruction, *id.,* at 54, 22 Record 1599, but the court in fact had quite carefully explained to the jury that "[w]hat a preponderance ... of the evidence in the case must show in order to establish the existence of the required combination, agreement, or understanding is that Sharp and Hartwell knowingly came to a common and mutual understanding to accomplish or to attempt to accomplish an unlawful purpose." *Id.,* at 1584-1585.

Second, the terminated dealer must prove that the agreement was based on a purpose to terminate it because of its price cutting. Proof of motivation is another commonplace in antitrust litigation of which the majority appears apprehensive, but as we have explained or demonstrated many times, see, *e.g., Aspen Skiing Co. v. Aspen Highlands Skiing Corp.,* 472 U.S. 585, 610-611, 105 S.Ct. 2847, 2861-62, 86 L.Ed.2d 467 (1985); *McLain v. Real Estate Board of New Orleans, Inc.,* 444 U.S. 232, 243, 100 S.Ct. 502, 509-510, 62 L.Ed.2d 441 (1980) ; *United States v. Socony-Vacuum Oil Co.,* 310 U.S. 150, 224-226, n. 59, 60 S.Ct. 811, 845-46, n. 59 (1940) ; *Chicago Board of Trade v. United States,* 246 U.S. 231, 238, 38 S.Ct. 242, 62 L.Ed. 683 (1918); see also Piraino, The Case for Presuming the Legality of Quality Motivated Restrictions on Distribution, 63 Notre Dame L.Rev. 1, 4, 16-19 (1988) , in antitrust, as in many other areas of the law, motivation matters and factfinders are able to distinguish bad from good intent.

Third, the manufacturer may rebut the evidence tending to prove that the sole purpose of the agreement was to eliminate a price cutter by offering evidence that it entered the agreement for legitimate, nonprice-related reasons.

Although in this case the jury found a naked agreement to terminate a dealer because of its price cutting, *ante,* at 1518-1519, the majority boldly characterizes the same agreement as "this nonprice vertical restriction." *Ante,* at 1522. That characterization is surely an oxymoron when applied to the agreement the jury actually found. Nevertheless, the majority proceeds to justify it as "ancillary" to a "quite plausible purpose ... to enable Hartwell to provide better services under the sales franchise agreement." *Ibid.* There are two significant reasons why that justification is unacceptable.

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First, it is not supported by the jury's verdict. Although it did not do so with precision, the District Court did instruct the jury that in order to hold respondent liable it had to find that the agreement's purpose was to eliminate petitioner because of its price cutting and that no valid vertical nonprice restriction existed to which the motivation to eliminate price competition at the dealership level was merely ancillary. [FN19]

FN19. The Court instructed the jury:
"The Sherman Act is violated when a seller enters into an agreement or understanding with one of its dealers to terminate another dealer because of the other dealer's price cutting. Plaintiff contends that Sharp terminated Business Electronics in furtherance of Hartwell's desire to eliminate Business Electronics as a price-cutting rival.
"If you find that there was an agreement between Sharp and Hartwell to terminate Business Electronics because of Business Electronics' price cutting, you should answer 'yes' to question number 1.
"Sharp, on the other hand, contends that it terminated Business Electronics unilaterally, not as a result of any agreement or understanding with Hartwell, but because of Business Electronics' sales performance. If you find that Sharp did not terminate Business Electronics pursuant to an agreement or understanding with Hartwell to eliminate price cutting by Business Electronics, then you should answer 'no' to question number 1." 22 Record 1587.
Respondent had asked for an instruction requiring the jury to consider circumstantial evidence as proof of a motivation to eliminate price competition only if such evidence could not "equally be interpreted to show that Sharp terminated Business Electronics Corporation for other business reasons and not pursuant to any agreement with Mr. Hartwell to fix resale prices of calculators." 1 Record 148. Respondent objected to the failure to give this instruction, *id.*, at 54, and also objected, more specifically, to the instruction that was given on the ground that "it allows the jury to find against the defendant even if they do not believe that Sharp cared about [Business Electronics'] price cutting or if they believe that Sharp had a dual motive in making the termination." 22 Record 1599. The instruction quoted above, though, makes it highly unlikely that the jury would have found for petitioner although finding respondent's motives to be mixed ones.

Second, the "quite plausible purpose" the majority hypothesizes as salvation for the otherwise anticompetitive elimination of price competition--"to enable Hartwell to provide better services under the sales franchise agreement," *ibid.* is simply not the type of concern we sought to protect in *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 97 S.Ct. 2549, 53 L.Ed.2d 568 (1977). I have emphasized in this dissent the difference between restrictions imposed in pursuit of a manufacturer's structuring of its product distribution, and those imposed at the behest of retailers who care less about the general efficiency of a product's promotion than their own profit margins. *Sylvania* stressed the importance of the former, not the latter; we referred to the use that *manufacturers* can make of vertical nonprice restraints, see *id.*, at 54-57, 97 S.Ct., at 2559-61, and nowhere did we discuss the benefits of permitting dealers to structure intrabrand competition at the retail level by coercing manufacturers into essentially anticompetitive agreements. Thus, while Hartwell may indeed be able to provide better services under the sales franchise agreement with petitioner out of the way, one would not have thought, until today, that the mere possibility of such a result--at the expense of the elimination of price competition and absent the salutary overlay of a manufacturer's distribution decision with the entire product line in mind--would be sufficient to legitimate an otherwise purely anticompetitive restraint. See n. 14, *supra.* In fact, given the majority's total reliance on "economic analysis," see *ante,* at 1525, it is hard to understand why, if such a purpose were sufficient to avoid the application of a *per se* rule in this context, the same purpose should not also be sufficient to trump the *per se* rule in all other price-fixing cases that arguably permit cartel members to "provide better services."

If, however, we continue to accept the premise that competition in the relevant market is worthy of legal protection--that we should not rely on competitive pressures exerted by sellers in other areas and purveyors of similar but not identical products--and if we are faithful to the competitive philosophy that has animated our antitrust jurisprudence since Judge Taft's opinion in *Addyston Pipe,* we can agree that the elimination of price competition will produce wider gross profit margins for retailers, but we may not assume that the retailer's self-interest will result

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in a better marketplace for consumers.

"The Sherman Act reflects a legislative judgment that ultimately competition will produce not only lower prices, but also better goods and services. 'The heart of our national economic policy long has been faith in the value of competition.' *Standard Oil Co. v. FTC*, 340 U.S. 231, 248, 71 S.Ct. 240, 249, 95 L.Ed. 239. The assumption that competition is the best ***757** method of allocating resources in a free market recognizes that all elements of a bargain--quality, service, safety, and durability--and not just the immediate cost, are favorably affected by the free opportunity to select among alternative offers. Even assuming occasional exceptions to the presumed consequences of competition, the statutory policy precludes inquiry into the question whether competition is good or bad." *National Society of Professional Engineers v. United States*, 435 U.S., at 695, 98 S.Ct., at 1367.

The "plausible purpose" posited by the majority as its sole justification for this mischaracterized "nonprice vertical restriction" is inconsistent with the legislative judgment that underlies the Sherman Act itself. Under the facts as found by the jury in this case, the agreement before us is one whose "sole object is to restrain trade in order to avoid the competition which it has always been the policy of the common law to foster." *United States v. Addyston Pipe & Steel Co.*, 85 F., at 283.

V

In sum, this simply is not a case in which procompetitive vertical nonprice restraints have been imposed; in fact, it is not a case in which *any* procompetitive agreement is at issue. [FN20] The sole purpose of the agreement between respondent and Hartwell was to eliminate price competition at Hartwell's level. As Judge Bork has aptly explained:

> "Since the naked boycott is a form of predatory behavior, there is little doubt that it should be a per se violation of the Sherman Act." Bork, The Antitrust Paradox, at 334.

I respectfully dissent.

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FN20. Thus, the Courts of Appeals decisions cited by the majority as supporting its view, see *ante*, at 1517, n. 1, are, in fact, consistent with the rule that a naked intent to eliminate price competition is *per se* invalid. Each of the opinions contains a discussion that distinguishes between, on the one hand, an agreement between manufacturer and dealer to eliminate a price-cutting competitor based solely on an intent to eliminate price competition, and, on the other hand, an agreement between manufacturer and dealer to eliminate a price-cutting competitor that is grounded not only in an antipathy to price competition, but also in a purpose to implement a procompetitive system of vertical nonprice restraints. See *McCabe's Furniture, Inc. v. La-Z-Boy Chair Co.*, 798 F.2d, at 329-330; *Morrison v. Murray Biscuit Co.*, 797 F.2d, at 1439-1440; *Westman Commission Co. v. Hobart Int'l, Inc.*, 796 F.2d 1216, 1223 (CA10 1986). Moreover, none of these opinions proposes the rule that the majority sanctions today: that an agreement as to some level of resale price maintenance is necessary for invocation of the *per se* rule in these situations.

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**H**

United States Court of Appeals,
Seventh Circuit.

PADDOCK PUBLICATIONS, INC., doing business as The Daily Herald, Plaintiff-Appellant,
v.
CHICAGO TRIBUNE COMPANY, et al., Defendants-Appellees.

**No. 96-2058.**

Argued Nov. 8, 1996.
Decided Dec. 16, 1996.
Rehearing and Suggestion for Rehearing En Banc Denied Jan. 21, 1997. [FN*]

FN* Judge Cummings took no part in consideration of the suggestion for rehearing en banc.

Before EASTERBROOK, MANION, and ROVNER, Circuit Judges.

EASTERBROOK, Circuit Judge.

Newspapers' content has many sources. To the work of their own staff, papers add dispatches from syndicated news services such as the Associated Press and Reuters that station reporters or stringers across the globe. Leading newspapers such as the *New York Times, the Los Angeles Times, the Washington Post, the Chicago Tribune*, and the *Wall Street Journal* have set up supplemental news services. The New York Times News Service carries that paper's stories; the Los Angeles Times/Washington Post News Service combines stories from those papers; the Knight-Ridder/Tribune Information Service pools stories from the *Tribune* and the Knight-Ridder chain's papers. Subscribers can reprint the originating paper's stories (and those of other papers that contribute to the supplemental service) in the subscribers' home markets. Cartoons, op-ed pieces, book reviews, chess columns, puzzles, and other features are available from syndicators such as United Press Syndicate, United Features Syndicate, King Features Syndicate, Creators Syndicate, and Tribune Media Services.

Supplemental news services and features syndicators offer exclusive contracts to subscribers in each metropolitan area. Because the *Chicago Tribune* subscribes to the New York Times News Service, stories from the Times are unavailable to the *Chicago Sun-Times* and smaller newspapers in the Chicago area; the *Sun-Times* subscribes to the Los Angeles Times/Washington Post News Service, which therefore is unavailable to the *Tribune* and smaller papers. News services and features syndicates charge by the circulation of the subscribing paper, and they therefore strive to sign up the largest paper in each market. Exclusivity is one valuable feature the service offers, for a paper with exclusive rights to a service or feature is both more attractive to readers and more distinctive from its rivals. When selling to smaller papers, however, the supplemental news services and features syndicates generally do not offer exclusivity--for they still hope to interest the larger, and therefore more lucrative, papers in the market (which can sign up later with exclusive rights against all but the original customer).

As a rule, the larger papers subscribe to the more popular services and features; or perhaps it is the very fact that a feature runs in a market's larger papers that makes it "more popular." Causation need not concern us. No matter which way it runs, smaller papers perceive that they get the crumbs. This suit, by the *Daily Herald,* the number three general- interest paper in the Chicago area (with 6.7 percent of average weekly readership), contends that the pattern of exclusive distribution rights violates § 1 of the Sherman Antitrust Act, 15 U.S.C. § 1, by making it harder for small papers to grow. Like the district court, we assume without deciding that "general-interest-newspaper readership in the Chicago SMSA" is a market. According to the complaint, the *Chicago Tribune* and the *Chicago Sun- Times* have locked up the "most popular" or "best" supplemental services and features, injuring consumers by frustrating competition. (We assume that "the best" services and features can constitute a market, although it sounds more like an aesthetic judgment; no one would say that "the best film of 1996" has a monopoly of any market just because there can be only one "best" film.) The *Daily Herald* views theKnight-Ridder/Tribune Information Service as a distant third to the supplemental news services the *Tribune* and *Sun-Times* use, and even it is unavailable because the *Tribune* will not license its stories to a competitor in its home market. The Herald concedes that the Associated Press, Reuters, and many quality comics and features are available to it (for example, it publishes *Dilbert* , one of today's most-followed comic strips) but insists that the best

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ones are committed to its larger rivals. After assuming that all of the *Herald's* allegations are true, the district court dismissed the complaint for failure to state a claim on which relief may be granted. 1995-2 Trade Cas. ¶ 71,255.

The *Herald* does not contend that the *Tribune* has conspired with the *Sun- Times* to bring about this state of affairs. Compare *Associated Press v. United States*, 326 U.S. 1, 65 S.Ct. 1416, 89 L.Ed. 2013 (1945) (holding that the Associated Press, a consortium of newspapers, must eliminate an exclusivity feature that could be traced to agreement among horizontal rivals). Nor does it contend that the supplemental news services and features syndicators (or their contributing papers and authors) have agreed among themselves. It concedes that each has adopted its method of doing business independently; they take the same approach to distribution because each has discovered that it is the most profitable way to do business. All of the contracts between services and newspapers are terminable at will or on short notice (usually 30 days, although some features require a year's notice). Instead of seeing whether money could persuade a supplemental news service to cut off one of the larger papers--the *Herald* has never tried to outbid the *Tribune* or *Sun-Times* , either on a total compensation basis or a per-subscriber basis--it asked the district court to declare that the antitrust laws entitle it to receive the leading supplemental news services and features without regard to the contractual exclusivity that the *Tribune* and *Sun-Times* currently enjoy. At times the *Herald* suggests that it would be happy with rights to articles from the *New York Times, Los Angeles Times*, and *Washington Post* that the *Tribune* and *Sun-Times* do not reprint; "there's plenty for all" is a theme of its brief. But this won't work well for news (must the *Tribune* give the *Herald* advance notice of its contents?) or at all for features, which are sold one at a time. For example, King Features Syndicate does not sell its entire portfolio to one paper per market; the *Tribune, Sun-Times*, and *Herald* each publish some of its comics and columns. So the *Herald* necessarily argues that it is entitled to run *Peanuts* and *Dick Tracy* even though these comic strips also appear in the *Tribune*.

This is fundamentally an "essential facilities" claim-but without any essential facility. There are three supplemental news services that the *Herald* is willing to acknowledge as major competitors (and others besides, though the *Herald* denigrates them). There are hundreds, if not thousands, of opinion and entertainment features; a newspaper deprived of access to the *New York Times* crosswords puzzles can find others, even if the *Times* has the best known one. Unlike *United States v. Terminal RailroadAss'n*, 224 U.S. 383, 32 S.Ct. 507, 56 L.Ed. 810 (1912), the granddaddy of these cases, in which the Court held that a bottleneck facility that could not feasibly be duplicated must be shared among rivals, this case does not involve a single facility that monopolizes one level of production and creates a potential to extend the monopoly to others. We have, instead, competition at each level of production; no one can "take over" another level of production by withholding access from disfavored rivals. *Flip Side Productions, Inc. v. Jam Productions, Ltd.*, 843 F.2d 1024, 1032-34 (7th Cir.1988) , holds that the existence of three competing facilities not only means that none is an "essential facility" but also means that each of the three is entitled to sign an exclusive contract with a favored user. Other firms that want to enter the market can do so by competing at intervals for these contracts.

Competition-for-the-contract is a form of competition that antitrust laws protect rather than proscribe, and it is common. Every year or two, General Motors, Ford, and Chrysler invite tire manufacturers to bid for exclusive rights to have their tires used in the manufacturers' cars. Exclusive contracts make the market hard to enter in mid-year but cannot stifle competition over the longer run, and competition of this kind drives down the price of tires, to the ultimate benefit of consumers. Just so in the news business--if smaller newspapers are willing to bid with cash rather than legal talent. In the meantime, exclusive stories and features help the newspapers differentiate themselves, the better to compete with one another. A market in which every newspaper carried the same stories, columns, and cartoons would be a less vigorous market than the existing one. And a market in which the creators of intellectual property (such as the *New York Times* ) could not decide how best to market it for maximum profit would be a market with less (or less interesting) intellectual property created in the first place. No one can take the supply of well researched and written news as a given; legal rulings that diminish the incentive to find and explicate the news (by reducing the return from that business) have little to commend them.

In what way could the news services' practices harm consumers? Tacit collusion (economists' term for "shared monopoly") could be a source of monopoly profits and injury to consumers even if none of the stages of production is monopolized.

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Some distribution arrangements might be objectionable because they facilitate tacit collusion. But collusion, tacit or express, requires some horizontal cooperation, or at least forbearance from vigorous competition among rivals. See Herbert Hovenkamp, *Federal Antitrust Policy* § 4.4 (1994). Compare Richard A. Posner, *Antitrust Law: An Economic Perspective* 42-77 (1976), with Donald F. Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal* , 75 Harv.L.Rev. 655 (1962). Although the newspaper market is concentrated on the readers' side, the inputs to newspaper production are unconcentrated and therefore do not facilitate tacit collusion in the more concentrated market. The New York Times News Service competes for column inches of ink not only with other supplemental news services but also with the Associated Press, Reuters, and the reporters of the subscribing papers. Markets here are less concentrated, and use fewer of the devices that facilitate oligopolistic interdependence, than the markets in *E.I. Du Pont de Nemours & Co. v. FTC,* 729 F.2d 128 (2d Cir.1984), where an antitrust claim was nonetheless rejected. The *Herald* does not argue that the practices at hand facilitate tacit collusion.

What the *Herald* does argue is that a mixture of fewness of firms, exclusive contracts, and relations between suppliers and users of news that endure despite short contract terms, hampers the growth of small rivals even though each market is competitive. Such an argument does not come within any of the economic approaches to tacit collusion--but it does, the *Herald* insists, come within the holding of *FTC v. Motion Picture Advertising Service Co.,* 344 U.S. 392, 73 S.Ct. 361, 97 L.Ed. 426 (1953). The *Herald* relies as well on *Standard Oil Co. v. United States,* 337 U.S. 293, 69 S.Ct. 1051, 93 L.Ed. 1371 (1949) (*Standard Stations*), and *United States v. Loew's, Inc.,* 371 U.S. 38, 83 S.Ct. 97, 9 L.Ed.2d 11 (1962), but rightly treats *Motion Picture Advertising Service* as its best case.

Four companies signed approximately 75 percent of the nation's motion picture theaters to exclusive-dealing contracts for advertisements to be displayed along with the films. Having signed with one supplier of ads, a theater could not display ads furnished by another. The Federal Trade Commission concluded that these arrangements, in the aggregate, stifled competition by firms that wanted to enter the business of furnishing advertising to theaters, and therefore violated § 5 of the Federal Trade Commission Act, 15 U.S.C. § 45: as the Supreme Court phrased the FTC's conclusion, "due to the exclusive contracts, respondent and the three other major companies have foreclosed to competitors 75 percent of all available outlets for this business throughout the United States." 344 U.S. at 395, 73 S.Ct. at 363-64. According to the *Herald*, the same kind of thing now has occurred in the news industry, making it equally appropriate to aggregate the market shares of the firms without proof of horizontal collaboration (for there was none in *Motion Picture Advertising Service*). The district court was not impressed, for the approach of *Motion Picture Advertising Service*--which depends on "foreclosure" of sales to competitors without proof of injury to consumers--reflects a bygone day in antitrust analysis. But the district court properly did not rely entirely on a belief that the opinion is a derelict. See *Khan v. State Oil Co.,* 93 F.3d 1358, 1362-64 (7th Cir.1996) (implementing another antique antitrust opinion that is unlikely to be reaffirmed if the Supreme Court revisits the subject). It held that *Motion Picture Advertising Service* is not controlling even if it remains authoritative.

First, *Motion Picture Advertising Service* was decided under § 5 of the FTC Act. The Commission has the authority under that provision to forbid practices that pose risks to effective competition, even when they do not violate the Sherman Act. The Court remarked on this in *Motion Picture Advertising Service:* "The 'unfair methods of competition,' which are condemned by § 5(a) of the Act, are not confined to those that were illegal at common law or that were condemned by the Sherman Act." 344 U.S. at 394, 73 S.Ct. at 363. A district court lacks the FTC's power to go beyond the limits of the Sherman Act. Similarly, *Standard Stations* was decided under § 3 of the Clayton Act, 15 U.S.C. § 14, and does not assist the plaintiff in a Sherman Act case that cannot be characterized as involving tie-in sales. Granted, the Court remarked in *Motion Picture Advertising Service* that "a device which has sewed up a market so tightly for the benefit of a few falls within the prohibitions of the Sherman Act", 344 U.S. at 395, 73 S.Ct. at 364, but this bald and unreasoned assertion is not conclusive. Poorly reasoned holdings bind the inferior courts; unreasoned dictum does not--and this statement was obiter dictum, for the Court had emphasized only a paragraph before that it was deferring to the FTC's findings as § 5 of the FTC Act requires. No subsequent case has read *Motion Picture Advertising Service* to abolish the requirement of concerted action under § 1 of the Sherman Act.

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Second, *Motion Picture Advertising Service* involved exclusive *dealing,* while this case involves exclusive *distributorships.* Despite the similarity in nomenclature, there is a difference--one vital to the theory of *Motion Picture Advertising Service* itself. See generally Hovenkamp, *Federal Antitrust Policy* § 10.8. An exclusive dealing contract obliges a firm to obtain its inputs from a single source. Each of the theaters was committed to one distributor for all of its ads. This was the genesis of the concern about foreclosure. A new advertising distributor could not find outlets. An exclusive distributorship, by contrast, does not restrict entry at either level. None of the newspapers in Chicago (or anywhere else) has promised by contract to obtain all of its news from a single source--and the sources have not locked all of their output together (unlike the "block booking" involved in *Loew's* ). A new entrant to the supplemental news service business could sell to every newspaper in the United States, if it chose to do so. Existing features syndicates sell to multiple firms in the same market (although most features go to one paper per city; this is the exclusive distribution aspect of the contracts). So vendors can and do sell news and features to multiple customers, and customers can and do buy news and features from multiple vendors. "Foreclosure" of the kind about which *Motion Picture Advertising Service* was concerned does not occur under exclusive distribution contracts.

Third, the FTC and the Supreme Court concluded that even exclusive dealing contracts are lawful if limited to a year's duration. 344 U.S. at 395-96, 73 S.Ct. at 363-64. The Commission saw that exclusivity can promote competition by making it feasible for firms to invest in promoting their products--for these costs would not be recoverable if the contracts were of very short terms, or if rivals could exhibit the same films and obtain the benefit of this promotional activity. Moreover, with year-long contracts, the entire market is up for grabs. A new entrant can sell to a twelfth of the theaters in the first month, a sixth of all theaters by the end of the second month, and so on; competition for the contract makes it possible to have the benefits of exclusivity and rivalry simultaneously. Things work similarly in the newspaper business. Contract terms are short, so competition for the contract can flourish. Meanwhile, exclusive distribution of news or features through a single paper in a city helps the paper distinguish itself from, and compete with, its rivals. The *SunTimes* will not promote a readership for a particular columnist if the *Tribune* and the *Herald* carry the same column; free-riding would spoil the investment and thwart this aspect of competition.

Contracts in the news business, unlike those in the motion picture advertising business, are of indefinite duration, and either side may terminate after giving the required advance notice. According to the *Herald* , this makes all the difference, but we don't see why. A termination clause works just like a stated time limit in facilitating competition for the contract. The FTC did not insist that dealings between a distributor and a theater *cease* after a year; the parties were free to renew their arrangement for successive years; it was enough that there be an option to change distributors or renegotiate once a year. That option exists in the newspaper business. Both sides to these contracts enjoy an annual (or more frequent) right to negotiate new terms or change partners. To this the *Herald* responds, in essence: The contracts aren't terminated in fact, so the legal terms do not matter; the contracts should be treated as perpetual. Yet for all we can tell renewal was (and remains) the norm in the motion picture business. As long as arrangements serve the interests of both parties, they will continue, whether that means signing another in a series of one-year contracts or declining to exercise an annual option to cancel a contract. Enduring exclusive distribution contracts characterize markets that are recognized as competitive: for example, *Babylon 5* appears exclusively on WPWR-TV (Channel 50) in Chicago, and almost all other shows are exhibited exclusively on one channel per locale, sticking with that station for their entire original production run, even though no one thinks that individual stations or producers have market power. Cf. *Schurz Communications, Inc. v. FCC,* 982 F.2d 1043 (7th Cir.1992); *Capital Cities/ABC, Inc. v. FCC,* 29 F.3d 309 (7th Cir.1994). The FTC and the Supreme Court in *Motion Picture Advertising Service* wanted to ensure that dealings continued only while they remained in the interests of both distributors and theaters--which meant that someone else could come along with a better deal and get the business. Likewise someone with a better offer can get or sell news on short notice. The *Herald* has never tried to make a better offer, and we conclude that it has come to the wrong forum. It should try to outbid the *Tribune* and *Sun-Times* in the marketplace, rather than to outmaneuver them in court.

AFFIRMED.

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## IV – THE BURDEN AND STANDARD OF PROOF

91. This is the first appeal under the Act against an infringement decision, so we address at the outset the issue of the burden and standard of proof where penalties are imposed under section 36 of the Act.

92. Article 6 of the European Convention on Human Rights and Fundamental Freedoms (ECHR) which is given further effect in domestic law under the Human Rights Act 1998, provides:
"Right to a Fair Trial

1. In the determination of his civil rights and obligations or of any criminal charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law. Judgment shall be pronounced publicly ...

2. Everyone charged with a criminal offence shall be presumed innocent until proved guilty according to law.

3. Everyone charged with a criminal office has the following minimum rights:
(a) to be informed promptly, in a language which he understands and in detail, of the nature and cause of the accusation against him;

(b) to have adequate time and facilities for the preparation of his defence;

(c) to defend himself in person or through legal assistance of his own choosing or, if he has not sufficient means to pay for legal assistance, to be given it free when the interests of justice so require;

(d) to examine or have examined witnesses against him and to obtain the attendance and examination of witnesses on his behalf under the same conditions as witnesses against him;
..."

93. Both parties accept that proceedings under the prohibitions imposed by the Act which may lead to the imposition of a penalty under section 36 involve a "criminal charge" or a "criminal offence" for the purposes of Article 6 of the ECHR.

94. From that starting point, Napp argues that it is entitled to the presumption of innocence in proceedings before the Tribunal, which represent the first occasion upon which the "criminal charge" against Napp falls to be determined by an independent and impartial tribunal within the meaning of Article 6(1). Napp further argues that the Director must rebut the presumption of innocence and discharge the burden of proof to the criminal standard: see Clayton & Tomlinson *The Law of Human Rights* (2000) paragraphs 11.115 to 11.119.

95. The Director argues that the fact that the present proceedings involve a criminal charge for the purpose of the ECHR does not mean that they are to be equated with criminal proceedings under English law, or that the rights that apply in criminal proceedings automatically apply to a case under the Act: see the decision of the Court of Appeal in *Han v Commissioners of Customs and Excise,* [2001] 4 All ER 687. As regards the burden of proof, the Director accepts that it is incumbent upon him to establish the infringement, and that the persuasive burden of proof remains. on him throughout. However, that does not necessarily prevent the operation of certain evidential presumptions for example, that sales below direct cost are presumed to be abusive: see *R v Lambert*

[UKHL] 37 [2001] 3 WLR 206, paragraphs 34, 87 et seq, and 150 et seq.

96. As regards the standard of proof, the Director argues that the appropriate standard is the balance of probabilities. There is no requirement, under the ECHR, of proof beyond reasonable doubt: Sir Richard Buxton, *The Human Rights Act and the Substantive Criminal Law* [2000] Crim LR 331. The balance of probabilities is a sufficiently flexible standard to require that the Tribunal (or Director) should be more sure before finding serious allegations proved than when deciding less serious matters: per Lord Nicholls in *In re H* [1996] AC 563 at 586-587. The criminal standard of proof beyond reasonable doubt would not be appropriate in relation to the kind and range of issues this Tribunal has to determine under the Act.

97. At the Tribunal's request, counsel for the Director dealt with the position as regards the standard of proof in Scots Law, citing *1 st Indian Cavalry Club Ltd and Chowdhury v Customs and Excise Commissioners* [1998] STC 293 and *Mullan v Anderson* [1993] SLT 835. He also dealt with the standard of proof before the European Courts under Articles 81 and 82 of the EC Treaty, citing notably Case T-7/89 *Hercules Chemicals NV v Commission* [1991] ECR II-1711, at paragraph 59, Cases 29-30/83 *Compagnie Royale Asturienne des Mines SA and Rheinzink v Commission* [1984] ECR 1679 at paragraph 20, and the opinion of Judge Vesterdorf, acting as Advocate General, in Cases T 1-15/89 *Rhône-Poulenc and others v Commission* [1991] ECR II-867 at p.954.

98. As we have already stated in our interim judgment of 8 August 2001, we agree that the Director's concession that these proceedings are "criminal", for the purposes of Article 6 of the ECHR, is properly made: see Case C-235/92P *Montecatini v Commission* [1999] ECR I-4575, paragraphs 175 and 176. That is particularly so since penalties under the Act are intended to be severe and to have a deterrent effect: see the Director's statutory *Guidance as to the appropriate amount of the penalty*, (OFT 423, March 2000) issued under section 38(1) of the Act.

99. The fact that these proceedings may be classified as "criminal" for the purposes of the ECHR gives Napp the protection of Article 6, and in particular the right to "a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law" (Article 6(1)), to the presumption of innocence (Article 6(2)), and to the minimum rights envisaged by Article 6(3) including the right "to examine or have examined witnesses against him and to obtain the. attendance and examination of witnesses on his behalf under the same conditions as witnesses against him" (Article 6(3)(d)).

100. In our view it follows from Article 6(2) that the burden of proof rests throughout on the Director to prove the infringements alleged.

101. However, as the Court of Appeal held in *Han,* cited above, to which we referred in our judgment of 8 August 2001, the fact that Article 6 applies does not of itself lead to the conclusion that these proceedings must be subject to the procedures and rules that apply to the investigation and trial of offences classified as criminal offences for the purposes of domestic law: see Potter LJ at paragraph 84, and Mance LJ at paragraph 88 of that judgment.

102. Neither the ECHR itself nor the European Court of Human Rights has laid down a particular standard of proof that must be applied in proceedings to which Articles 6(2) or (3) apply, and still less that the standard should be that of "proof beyond reasonable doubt", which is not a concept to be found in the domestic systems of many of the signatory States (see Sir Richard Buxton, cited above, at pp. 338 and 339).

103. In our view it follows that neither Article 6, nor the Human Rights Act 1998, in themselves oblige

us to apply the criminal standard of proof as established in domestic law in cases where the Director seeks to impose a financial penalty in respect of alleged infringements of the Chapter I or Chapter II prohibitions under the Act.

104. In our view the standard of proof to be applied under the Act is to be decided in accordance with the normal rules of the United Kingdom domestic legal systems. Neither party has cited to us any decided domestic cases which suggest that, in circumstances such as these, the criminal standard should be applied, nor invited us to apply by analogy certain civil situations where traditionally the criminal standard of proof is required (e.g. committal proceedings).

105. Infringements of the Chapter I and Chapter II prohibitions imposed by sections 2 and 18 of the Act are not classified as criminal offences in domestic law, in contrast, for example, to the criminal offences created under sections 42 to 44. Under section 38(8), penalties are recoverable by the Director as a civil debt. Directions are enforceable by civil proceedings under section 34. In our view the structure of the Act points to the conclusion that under domestic law the standard of proof. we must apply in deciding whether infringements of the Chapter I or Chapter II prohibitions are proved is the civil standard, commonly known as the preponderance or balance of probabilities, notwithstanding that the civil penalties imposed may be intended by the Director to have a deterrent effect.

106. We add that in many cases under the Act the factual issues before this Tribunal will often relate to such matters as determining the relevant market, whether dominance exists, and assessing whether conduct characterised as an "abuse" is economically justified. Issues of that kind involve a more or less complex assessment of mainly economic data and perhaps conflicting expert evidence. It seems to us more likely that Parliament would have intended us to apply the civil standard of proof to issues of this kind, rather than the time-honoured criminal standard of "proof beyond reasonable doubt".

107. In our view it follows from the speech of Lord Nicholls (with whom Lord Goff and Lord Mustill agreed) in *Re* H, cited above, at pp.586 to 587, that under the law of England and Wales there are only two standards of proof, the criminal standard and the civil standard; there is no 'intermediate' standard. The position is the same in the law of Scotland and Northern Ireland. Within the civil standard, however, the more serious the allegation, the more cogent should be the evidence before the court concludes that the allegation is established on the preponderance of probability: see Lord Nicholls speech in *Re* H, citing notably *In re Dellow's Will Trusts* [1964] 1 WLR 451, 455 and *Hornal v Neuberger Products Ltd* [1957] 1 QB 247, 266.

108. Since cases under the Act involving penalties are serious matters, it follows from *Re H* that strong and convincing evidence will be required before infringements of the Chapter I and Chapter II prohibitions can be found to be proved, even to the civil standard. Indeed, whether we are, in technical terms, applying a civil standard on the basis of strong and convincing evidence, or a criminal standard of beyond reasonable doubt, we think in practice the result is likely to be the same. We find it difficult to imagine, for example, this Tribunal upholding a penalty if there were a reasonable doubt in our minds, or if we were anything less than sure that the Decision was soundly based.

109. In those circumstances the conclusion we reach is that, formally speaking, the standard of proof in proceedings under the Act involving penalties is the civil standard of proof, but that standard is to be applied bearing in mind that infringements of the Act are serious matters attracting severe. financial penalties. It is for the Director to satisfy us in each case, on the basis of strong and compelling evidence, taking account of the seriousness of what is alleged, that the infringement is

duly proved, the undertaking being entitled to the presumption of innocence, and to any reasonable doubt there may be.

110. That approach does not in our view preclude the Director, in discharging the burden of proof, from relying, in certain circumstances, from inferences or presumptions that would, in the absence of any countervailing indications, normally flow from a given set of facts, for example that dominance may be inferred from very high market shares (Case 85/76 *Hoffman-La Roche v Commission* [1979] ECR 461, paragraph 41); that sales below average variable costs may, in the absence of rebuttal, be presumed to be predatory (see the opinion of Advocate General Fennelly in Cases C-395/96P and 396/96P *Compagnie Maritime Belge v Commission* [2000] ECR I-1442 at paragraph 127); or that an undertaking's presence at a meeting with a manifestly anti-competitive purpose implies, in the absence of explanation, participation in the cartel alleged: *Montecatini v Commission*, cited above, at paragraphs 177 to 181.

111. Presumptions of this kind simply reflect inferences that can, in normal circumstances, be drawn from the evidence: they do not reverse the burden of proof or set aside the presumption of innocence: *Montecatini* at paragraph 181. Being essentially evidential in character, such presumptions are hardly equivalent to statutory 'reverse onus' provisions of the kind considered in *R v Lambert*, cited above. But even in the case of such a statutory provision, Article 6(2) of the ECHR does not prohibit a permissive or evidentiary presumption from which a trier of fact may (as opposed to must) draw an inference of guilt: see again *R v Lambert*, notably Lord Steyn at paragraph 40, Lord Hope at paragraphs 87 to 91 and Lord Clyde at paragraphs 150 to 158. If a defendant undertaking seeks to rebut the presumption in question, the legal burden of proof remains on the Director to show that an abuse is established.

112. Whether or not section 60 of the Act is to be construed as requiring us to follow the case law of the Court of Justice and the Court of First Instance on issues such as the burden and standard of proof, we believe that the approach we have outlined above is in line with the approach of those Courts. There is no doubt that in proceedings under Articles 81 and 82 of the Treaty, the burden of proof rests on the Commission (see *Montecatini* at paragraph 179). As far as the standard of proof is concerned, the European Courts, faced with the different traditions of the Member States, have simply indicated that the infringement should be demonstrated to the "requisite legal standard" (à. suffisance de droit), but there is no doubt that, in general, those Courts require convincing proof that the alleged infringements have been committed in the form of a "firm, precise and consistent body of evidence": see Cases 29 and 30/83 *CRAM and Rheinzink v Commission* cited above, paragraphs 16 to 20; Cases C-89/85 etc *Ahlström Osakeyhtiö and others v Commission* [1993] ECR I-1307, paragraph 127. We have no reason to suppose that the standard of proof we propose to follow is any different from that followed in practice by the courts in Luxembourg.

113. We observe, finally, that in the present case, much of the above discussion is somewhat academic. As appears in more detail from our findings below, we do not think that it makes any material difference to the outcome in this particular case whether we apply the domestic civil standard in the way described above, or the domestic criminal standard as traditionally expressed.

## V – OTHER PROCEDURAL ISSUES

*The Director's witness statements*

114. In paragraphs 64 to 92 of our judgment of 8 August 2001 we pointed out that the Act and the Tribunal's Rules envisage that further evidence could be given and documents produced before the Tribunal, and that there was no absolute bar, under the ECHR or otherwise, to that being done in a

proper case. While indicating that, in general, the discretion to take account of new evidence relied on by the Director should be exercised sparingly, we held that the interests of fairness may well indicate that such new evidence should be allowed, particularly where it consists, in essence, of matters going to rebut allegations made by an applicant in the notice of appeal. We therefore declined to exclude at that stage the evidence of five of the Director's witnesses, although we excluded one statement, and a further statement was withdrawn by the Director.

115. Napp has, however, contended that the Tribunal should only take account of the five remaining witness statements in so far as they are favourable to Napp, and not take into account material to Napp's detriment which could have been, but was not, made available in the administrative procedure. Otherwise, says Napp, the administrative procedure envisaged by the Act can be circumvented and Napp's rights of defence jeopardised.

116. As we indicated in our judgment of 8 August 2001 (paragraphs 72 to 79) it is of obvious importance that, in the administrative procedure, the provisions of Rule 14 of the Director's Rules (see paragraphs 24 and 25 above) are properly observed.

117. If and when a matter moves to the judicial stage before this Tribunal, what was previously an administrative procedure, in which the Director combines the rôles of "prosecutor" and "decision maker", becomes a judicial proceeding. There is, at that stage, no inhibition on the applicant attacking the Decision on any ground he chooses, including new evidence, whether or not that ground or evidence was put before the Director. The Tribunal, for its part, is not limited to the traditional rôle of judicial review but is required by paragraph 3(1) of Schedule 8 of the Act to decide the case "on the merits" and may, if necessary and appropriate, "make any other decision which the Director could have made": paragraph 3(2)(e). If confirming a decision, the Tribunal may nonetheless set aside a finding of fact by the Director: paragraph 3(4) of Schedule 8. Unlike the normal practice in judicial review proceedings, the Act and the Tribunal Rules envisage that the Tribunal may order the production of documents, hear witnesses and appoint experts (see Schedule 8, paragraph 9 of the Act, and Rule 17 of the Tribunal's Rules) and may do so even if the evidence was not available to the Director when he took the decision: see Rule 20(2) of the Tribunal's Rules.

118. In elucidation of these provisions, we refer to the statement made in the House of Commons by the then Minister for Competition and Consumer Affairs (Mr Griffiths) during the passage of the Competition Bill on 18 June 1998 (Hansard Col 496):

> "It is our intention that the tribunal should be primarily concerned with the correctness or otherwise of the conclusions contained in the appealed decision and not with how the decision was reached or the reasoning expressed in it. That will apply unless defects in how the decision was reached or the reasoning make it impracticable for the tribunal fairly to determine the correctness or otherwise of the conclusions or of any directions contained in the decision. Wherever possible, we want the tribunal to decide a case on the facts before it, even where there has been a procedural error, and to avoid remitting the case to the director general. We intend to reflect that policy in the tribunal rules.
>
> This is an important aspect of our policy, and I shall explain the rationale behind our approach. The Bill provides for a full appeal on the merits of the case, which is an essential part of ensuring the fairness and transparency of the new regime. It enables undertakings to appeal the substance of the decision including in those cases where it is believed that a failure on the part of the director general to follow proper procedures has led him to reach an incorrect conclusion. The fact that the tribunal will be

reconsidering the decision on the merits will enable it to remedy the consequences of any defects in the director general's procedures."

119. As we have already said in our judgment of 8 August 2001, if, at the judicial stage, an applicant launches an attack which places under close scrutiny particular aspects of the Decision, in principle we do not think that the Director should be denied a reasonable opportunity to reply by adducing rebuttal evidence in support of the points already made in the Decision. Thus we do not accept. Napp's principal submission that nothing may be relied on before the Tribunal unless it was relied on in the administrative procedure.

120. Nor do we accept Napp's submission that it (Napp) is entitled to rely on the Director's new evidence but that we (the Tribunal) must close our eyes and ears if the witness on whom Napp relies states something unfavourable to Napp's case. Napp has had the opportunity to cross-examine the Director's witnesses, and/or apply for orders for disclosure. In four days of argument before the Tribunal Napp has had every opportunity to make any point it wishes as to the evidence in question and has itself relied strongly on the evidence of Messrs Hartley and Penrose, and to a lesser extent that of Mr Blake. We do not see any ground on which Napp should be permitted to "have its cake and eat it".

121. As regards the individual witness statements in question, Mr John Brownlee is head of the PPRS branch in the Department of Health. His evidence goes to rebut certain assertions made by Napp in the notice of appeal as to the position of the Department in this case and the way the PPRS is said to work. We see no grounds for excluding this evidence.

122. Mr John Hartley is Head of Sales and Marketing at Link. The essence of Mr Hartley's statement is to rebut various assertions made by Napp in the notice of appeal regarding the factors Link would take into account in its decisions on prices to hospitals, the importance to Link of the hospital sector, and the effect on Link of Napp's pricing in the hospital segment. Having initially sought to exclude Mr Hartley's evidence, in the event counsel for Napp relied upon it strongly. In addition, Mr Hartley supports Napp's case as regards the Directions. In our view Mr Hartley's evidence and the documents he produces are fairly introduced and relevant to a number of issues in the case.

123. Mr Mark Connolly is the Marketing Director of the Prescription Medicine Division for BIL. His evidence is relevant mainly to the reasons for BIL's withdrawal from the market, which are relied on by the Director at paragraphs 173 to 176 of the Decision, but contested by Napp. We think this evidence is fairly introduced as rebuttal evidence but the point is academic since, as will be seen below, we do not need to express a view on the matters dealt with by Mr Connolly.

124. Mr Roger Penrose is the NHS and Development Manager for BIL. His evidence rebuts Napp's attack on BIL's competence, deals with the importance to BIL of the hospital sector, explains the history of discounting in the market from 1994 until BIL's withdrawal in 2000, and comments on. the follow-on effect alleged by Napp. Although largely relating to events before the alleged period of infringement, Napp relies strongly on Mr Penrose's evidence on at least one point, namely that it was BIL rather than Napp which initiated price cutting after 1994. We see no proper basis for excluding Mr Penrose's evidence, although it is not essential to our analysis of Napp's conduct during the period of infringement.

125. Mr Stephen Blake is a solicitor working for the Legal Division of the OFT. As far as relevant, his evidence updates the Tribunal on potential new entrants to the market, and is not seriously contested.

126. In all these circumstances, we see no reason not to take the Director's five witness statements into account in deciding this case on the merits, whether in Napp's favour or otherwise, to the extent that those witness statements are relevant to the issues which we have to decide.

*The documents disclosed following the Tribunal's request of 31 August 2001*

127. Napp argues that the documents disclosed by Napp following the Tribunal's request of 31 August 2001 are inadmissible, save to the extent that they support Napp's case. Napp argues that they are not relied on in the Decision and relate to a period prior to the infringement alleged. In addition Napp questions the inferences to be drawn from these documents: see Napp's letter of 5 October 2001.

128. The Tribunal Rules, particularly Rule 17, give this Tribunal wide powers to make directions to secure the just, expeditious and economical conduct of the proceedings (see Rule 17(1)). Rules 17(2)(d) and (k) provide for the production and disclosure of documents, while Rule 17(3) provides that the Tribunal may do certain things of its own motion, in particular putting questions, inviting further submissions and asking for further material, including asking, under Rule 17(3)(d), "for documents or any papers relating to the case to be produced". As is, we believe, well known, the Tribunal's Rules are modelled on the Rules of Procedure of the Court of First Instance of the European Communities (OJ 2001 C34/39): see Articles 64 and 65 of those Rules.

129. We decided to ask for our attention to be drawn to the documents referred to in the Tribunal's request of 31 August 2001 in view of the fact that, in its notice of appeal, Napp was asserting to us the factors that were or would be taken into account by Napp in setting its pricing policy, but as far. as we could see without referring to any documents tending to show what matters Napp had actually taken into account at the material time. We therefore asked for documents relating to the objectives, strategy or policy considerations taken into account by Napp in setting its prices in the periods referred to in the Decision to be drawn to our attention. The documents concerned were promptly supplied without objection on Napp's part.

130. The Tribunal having requested the documents pursuant to its powers under the Tribunal Rules we cannot see that the documents are "inadmissible" solely by virtue of the fact that they did not figure in the administrative procedure. Rule 20(2) of the Tribunal Rules provides expressly that documents may be submitted whether or not they were available to the respondent when the disputed decision was taken. Whether it would be proper or fair to permit the Director to rely on those documents is in our view a matter for the Tribunal's discretion, which we discuss later in this judgment: see paragraphs 311 et seq, below.

*The "Ermakov" issue*

131. At the stage of our interim judgment of 8 August 2001, Napp argued, and has since continued to argue, that the Director's case during those proceedings has shifted significantly away from the case as made in the Decision. This is particularly so, says Napp, in respect of the Director's case on excess pricing but other matters are complained of as well. In our interim judgment we held that it was not a matter for striking out, but an issue to be decided in our final judgment.

132. Napp now argues on the basis of *R v Westminster City Council ex parte Ermakov* [1996] 2 All ER 302 (CA), followed for example in *Nash v Chelsea Royal College of Art* (Burnton J, [2001] EWHC Admin 538), that the Director should not be permitted to change the reasons for his Decision before the Tribunal, nor add supplementary reasons, given in particular that the Director is a specialist decision maker. In *Ermakov*, the Court of Appeal decided that, in certain proceedings under the

Housing Act 1996, the decision maker should be held to the reasons given in his original decision, in the interests of fairness and efficient decision making: see Hutchison LJ at pp. 315 to 317.

133. On this point, for the same reasons that we consider that our discretion to allow the Director to submit further evidence should be exercised only sparingly, we accept Napp's basic submission that, in principle, the Director should not be permitted to advance a wholly new case at the judicial stage, nor rely on new reasons. To decide otherwise would make the administrative procedure, and the safeguards it provides, largely devoid of purpose; the function of this Tribunal is not to try a wholly new case. If the Director wishes to make a new case, the proper course is for the Director to withdraw the decision and adopt a new decision, or for this Tribunal to remit.

134. However, given the powers of this Tribunal, it seems to us the analogy with *Ermakov* does not go as far as Napp submits. In those circumstances it is virtually inevitable that, at the judicial stage, certain aspects of the Decision are explored in more detail than during the administrative procedure and are, in consequence, further elaborated upon by the Director. As already indicated, these are not purely judicial review proceedings. Before this Tribunal, it is the merits of the Decision which are in issue. It may also be appropriate for this Tribunal to receive further evidence and hear witnesses. Under the Act, Parliament appears to have intended that this Tribunal should be equipped to take its own decision, where appropriate, in substitution for that of the Director. For these reasons, while we accept the force of the general principle that lies behind *Ermakov*, the analogy is not exact.

135. In the present case, for the reasons given in more detail below (see paragraphs 428 to 442), we have reached the view that Napp's allegations as to the Director's alleged "change of case" do not in fact have the significance that Napp alleges as far as the Director's findings of infringement are concerned. As will be seen, we do not think that there is anything in the *Ermakov* line of reasoning which precludes us from determining this appeal on the merits in the light of all the material now before us.

*Human Rights and general issues of unfairness*

136. Napp argues, in an amended version of paragraphs 5.61 to 5.72 of the notice of appeal, which was submitted after the Tribunal had sought clarification of Napp's case on this aspect, that the Director's conduct of the investigation was unfair and failed to observe the requirements of Article 6 of the ECHR. Napp submits that the Director acted as both prosecutor and judge in investigating and reaching the Decision, and in deciding what evidence, including exculpatory evidence, might be disclosed to Napp; that the Director failed to disclose to Napp all the evidence available to him which he should, or could, have obtained; that the Director failed to collect sufficient evidence, or relied on material having no evidential value, or ignored relevant evidence; and that the Director failed to accord Napp the possibility of testing the evidence by cross-examination.

137. As we have just indicated, we accept that both Article 6(1) and (2) of the ECHR apply to proceedings potentially involving a penalty imposed for a breach of the Chapter I and Chapter II prohibitions. We also accept that there is force in the argument that the administrative procedure before the Director does not in itself comply with Article 6(1), notably because the Director himself combines the roles of investigator, prosecutor and decision maker. However, as we have already indicated in paragraph 74 of our judgment of 8 August 2001, that in itself involves no breach of Article 6 because the Director's administrative Decision is subject to full judicial control on the merits by this Tribunal: see also now the decision of the House of Lords in *Magill v Porter* [2001] UKHL 67, judgment of 13 December 2001, per Lord Hope at paragraphs 87 to 94. In those circumstances we do not find that the procedure, taken as a whole, is unfair. It has not been

suggested that this Tribunal is not "an independent and impartial tribunal" for the purposes of Article 6(1) of the ECHR.

138. As to the procedural requirements governing the administrative stage, we have already drawn attention to Rule 14 of the Director's Rules, which provides, in effect, for the "right to be heard" and for "access to the file". Under these provisions the Director must put to the defendant undertaking the essential facts and matters on which he relies. It goes without saying that the Director may not rely, in establishing his case, on anything that has not been disclosed to the defendant undertaking. It is also well established that, subject to the protection of internal documents (Rule 30(1)(f)) and confidential information as defined by Rule 30(1)(c) – essentially business secrets and information relating to the private affairs of an individual – the whole of the Director's file must be available for inspection by the undertakings concerned: see Case T-30/91 *Solvay v Commission* [1995] ECR II-1775, appeal dismissed Case C-288/95P [2000] ECR I-2391. The availability of the file enables the undertaking to defend itself, notably by seeking exculpatory material.

139. In the revised version of its notice of appeal, Napp complains of the Director's failure to disclose documents relating to the conduct of other firms who are or were supplying sustained release morphine in the United Kingdom; the views of the Department of Health on the case; evidence of discounts offered on other pharmaceutical products; and documents relating to the chronology of the discounting of oral sustained release morphine.

140. As we understand it, very extensive disclosure took place during the administrative proceedings, albeit that certain documents – not relied on by the Director – were not disclosed to Napp because. commercial confidentiality had been claimed by third parties pursuant to Rule 14(6)(a) and Rule 30(1)(c) of the Director's Rules. A Schedule listing all the documents in the Director's possession, identifying those which had not been disclosed in whole or part, was supplied to Napp. Upon the lodging of the appeal, the Director disclosed further documents to named external advisers of Napp, who gave undertakings to observe the confidentiality of the documents in question. Material relating to the discounting of products other than oral sustained release morphine was disclosed by the Director in the defence. The witness statements of Mr Hartley and Mr Penrose before the Tribunal contained a great deal of further material about the commercial strategies pursued in relation to Zomorph and Oramorph, respectively.

141. We understand that these further steps have largely resolved any dispute there may have been as regards disclosure. Despite having the opportunity during these proceedings to apply to the Tribunal for the disclosure of further documents, or classes of documents, Napp has made no such application. Nor was any specific complaint made, during argument at the hearing, that material documents were still being withheld, or that Napp's defence was being hampered as a result.
142. In these circumstances, we are wholly unable to find either that any documents were wrongfully withheld from Napp in breach of Rule 14 of the Director's Rules, or that Napp has suffered any prejudice as a result of the application of Rules 14(6)(a) and 30(1)(c) in this case. In particular, given the very full argument that Napp has advanced by reference to the relatively vast amount of material now before the Tribunal, we see no grounds for suggesting that there has been any breach of Napp's right to 'a fair trial' for the purposes of Article 6(1), as far as the disclosure of material documents is concerned.

143. It is true that where, in the course of the administrative procedure, the Director refuses disclosure under Rules 14(6)(a) and 30(1)(c), there is no provision under the Act which permits that issue to be adjudicated upon until the matter reaches the judicial stage before the Tribunal. The same is true of proceedings before the Court of First Instance. However, once the matter does reach the

Tribunal, the case is fully argued "on the merits", the Tribunal having the power to take its own decision, or remit the matter to the Director. It is at that stage that the Tribunal is in a position, by the exercise of its powers under Rules 17 to 21 of the Tribunal Rules, to ensure that the rights of the defence are respected as regards the disclosure of documents. That is, in effect, what has occurred in the present case, as far as documents are concerned.

144. In our view the same approach applies to the cross-examination of witnesses. The Director's Rules do not envisage the cross-examination of witnesses during the administrative stage. However, there is power to apply to cross-examine at the judicial stage before the Tribunal. In the present case, Napp did not apply to cross-examine any witness under Rule 17 or seek any witness summons under Rule 21. In those circumstances we see no basis for arguing that Napp's rights of defence have been breached by the absence of cross-examination during the administrative stage.

145. We do not accept that the Director had any duty to collect, and make available to Napp, any further material, nor did Napp make any application to the Tribunal in that regard during the appeal.

146. We add, generally, that the three evidential issues to which Napp's submissions on this part of the case are principally directed are (a) whether hospital discounting was, as Napp suggests, initiated by Farmitalia and BIL; (b) why BIL left the market in 2000; and (c) Mr Mountain's view of the competitive strategy of Link. As will be seen below, neither (a) nor (b) are matters upon which we need to make specific findings. As regards (c), Mr Mountain was available, at the Tribunal's request, at the oral hearing and Napp could have cross-examined him then had they wished to do so.

147. The remaining arguments advanced by Napp in this part of the case seem to us to go to the weight of the evidence rather than to issues of procedure. We therefore turn to deal with the merits.

**IN THE COMPETITION COMMISSION**

**APPEAL TRIBUNAL**

Case No. 1001/1/1/01

New Court
Carey Street
London WC2A 2JT

15 January 2002

Before:

SIR CHRISTOPHER BELLAMY
(President)
MR BARRY COLGATE
PROFESSOR PETER GRINYER

BETWEEN:

NAPP PHARMACEUTICAL HOLDINGS LIMITED AND SUBSIDIARIES

Applicant

and

DIRECTOR GENERAL OF FAIR TRADING

Respondent

Mr Nicholas Green QC (instructed by Messrs Herbert Smith) appeared for the Applicant

Mr Peter Roth QC and Mr Jon Turner (instructed by The Director of Legal Services, Office of Fair Trading) appeared for the Respondent

**JUDGMENT (Non-confidential version):**

Note: Excisions in this judgment relate to commercially confidential information: Section 56 and Schedule 8, paragraph 4(3) of the Competition Act 1998.

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**Note:** For simplicity, this judgment will refer throughout to Articles 81 and 82 of the EC Treaty, whether in citations from judgments or otherwise, notwithstanding that the original citation referred to Articles 85 and 86 of the EC Treaty which were renumbered as Articles 81 and 82 by the Treaty of Amsterdam with effect from 1 May 1999.



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## I – INTRODUCTION

1. This is the judgment of the Tribunal on the substantive appeal by Napp Pharmaceutical Holdings Limited and subsidiaries ("Napp") against:

   (i) the decision by the Director General of Fair Trading ("the Director") dated 30 March 2001 ("the Decision") which found that Napp had abused a dominant position in the supply of sustained release morphine tablets and capsules in the United Kingdom, contrary to the Chapter II prohibition of the Competition Act 1998, and imposed a penalty of £3.21 million; and

   (ii) the directions made by the Director dated 4 May 2001 ("the Directions") regulating the prices at which Napp's sustained release morphine products are to be sold.

   Earlier decisions of this Tribunal on 22 May, 10 July and 8 August 2001 have previously dealt with interim relief and various interlocutory matters: see [2001] CompAR 1, 21 and 33.

### *The statutory framework*

2. The Competition Act 1998 ("the Act") came into force on 1 March 2000. This case concerns section 18 of the Act which provides, so far as material:

> "18.–(1) … [A]ny conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom.
>
> (2) Conduct may, in particular, constitute such an abuse if it consists in–
>
> (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
>
> (b) limiting production, markets or technical development to the prejudice of consumers;
>
> (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
>
> (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contracts.
>
> (3) In this section–
>
> "dominant position" means a dominant position within the United Kingdom; and
>
> "the United Kingdom" means the United Kingdom or any part of it.
>
> (4) The prohibition imposed by subsection (1) is referred to in this Act as "the Chapter II prohibition"."



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3. Following an investigation under the powers contained in Chapter III of the Act, the Director may, pursuant to section 31(1)(b), make a decision that the Chapter II prohibition has been infringed.

4. Section 33(1) of the Act provides that, if the Director has made a decision that conduct infringes the Chapter II prohibition, he may give "such directions as he considers appropriate to bring the infringement to an end." Such directions may be enforced by the Director on an application to the Court: section 34

5. Section 36(2) provides that on making a decision that conduct has infringed the Chapter II prohibition, the Director may require the undertaking concerned to pay him a penalty in respect of the infringement. Under section 36(3), such a penalty may be imposed only if the Director is satisfied that the infringement has been committed intentionally or negligently. By virtue of section 36(8), no penalty fixed by the Director may exceed 10 per cent of the turnover of the undertaking as determined in accordance with the Competition Act 1998 (Determination of Turnover for Penalties) Order 2000 (SI 2000 No. 309). Any penalty so imposed is recoverable as a civil debt following the expiry of the period for appealing to this Tribunal, or the determination of any such appeal: section 37.

6. Section 38(1) of the Act requires the Director to publish guidance as to the appropriate amount of any penalty. Under section 38(8) the Director must have regard to that guidance when setting the amount of the penalty. The Director has published such guidance entitled *Director General of Fair Trading's Guidance as to the Appropriate Amount of Penalty* (OFT 423, March 2000).

7. The foregoing provisions of the Act are closely modelled on Article 82 of the Treaty establishing the European Community ("the Treaty") and Council Regulation no. 17 OJ 1959-62, p. 87 as amended. So far as possible and appropriate, the Act is to be interpreted and applied in a manner consistent with the principles of European Community law regarding competition: section 60.

8. A person in respect of whose conduct the Director has made a decision may appeal to this Tribunal against, or with respect to, that decision: sections 46(2) and 48(1).

9. The powers of this Tribunal to determine appeals under section 46 are set out in paragraph 3 of Schedule 8 of the Act, which provides:

> "3.–(1) The tribunal must determine the appeal on the merits by reference to the grounds of appeal set out in the notice of appeal.

(2) The tribunal may confirm or set aside the decision which is the subject of the appeal, or any part of it, and may–

(a) remit the matter to the Director,

(b) impose or revoke, or vary the amount of, a penalty,

(c) grant or cancel an individual exemption or vary any conditions or obligations imposed in relation to the exemption by the Director,

(d) give such directions, or take such other steps, as the Director could himself have given or taken, or

(e) make any other decision which the Director could himself have made.

(3) Any decision of the tribunal on an appeal has the same effect, and may be enforced in the same manner, as a decision of the Director.

(4) If the tribunal confirms the decision which is the subject of the appeal it may nevertheless set aside any finding of fact on which the decision was based."

10. The procedure governing such appeals is set out in the Competition Commission Appeal Tribunal Rules 2000, S.I. 2000 No. 261 ("the Tribunal Rules"). Rules 17, 20 and 21 (directions, witnesses and evidence) and Rule 27 (interest on penalties) are relevant to certain issues arising in these proceedings.

***General Background***

11. Napp, a pharmaceutical company based in Cambridge, is an associate of the Purdue Pharma group of companies which is owned ultimately by the Sackler family. Napp had a United Kingdom turnover of approximately £51.2 million in 2000, of which some £[...] million was derived from sustained release morphine.

12. Morphine is a strong opioid analgesic used to treat moderate and severe pain, particularly in cancer patients. Napp states that there is evidence of growing use of opioid analgesics to treat non-cancer patients such as, for example, those with chronic arthritis. Sustained release morphine extends the duration of action of a morphine preparation and is used when the pain is constant.

13. In 1980 Napp launched the first sustained release morphine product to appear on the market under the name MST CONTINUS ("MST"). According to Napp, the advantage of MST is that the active ingredient is released gradually over a 12 hour period so as to achieve a continuous and uniform level of analgesia. Napp states that it is a mark of the success of MST that, even some 20 years after its launch, it remains "the gold standard for the treatment of severe chronic pain".

14. Napp held a patent on MST between 1980 and 1992. The patent protected the sustained release formulation rather than the morphine sulphate itself. From 1980 to 1991 MST was the only orally administered sustained release morphine product on the market in the United Kingdom.

15. In 1991 Farmitalia launched a rival brand of oral sustained release morphine tablets under the name SRM-Rhotard and later assigned its rights to Boehringer Ingelheim Limited ("BIL"). BIL re-launched the product under the name Oramorph SR in 1994. BIL withdrew Oramorph SR from the market in September 2000 having taken the decision to do so in February of that year.

16. Napp has around 95 per cent of the total market for oral sustained release morphine tablets and capsules in the United Kingdom. Apart from MST, which is supplied in tablets, there are currently two other brands of oral sustained release morphine on the market, namely Morcap SR, launched in 1996 and supplied by Sanofi-Winthrop; and Zomorph, launched in 1997 and supplied by Link Pharmaceuticals Limited ("Link"). Link's total turnover in all products in the year to March 2001 was £6.7 million. Link's product Zomorph is supplied in capsules which can either be swallowed or broken open and sprinkled on food. There are no generic – i.e. unbranded – sustained release morphine products on the market. Morcap SR has a negligible market share and has hardly figured in the argument in this case.

17. About 86 to 90 per cent of the supply of oral sustained release morphine is to the community segment of the market – i.e. to patients under the care of their GP. Where a GP prescribes by brand name the community pharmacist is obliged to dispense that brand of drug. Napp's market share in the community segment is and has remained for many years around 96 per cent.

18. In the community segment of the market, Napp's NHS list price for MST has remained the same since its launch, subject to periodic reductions negotiated by the pharmaceutical industry as a whole in the context of the Pharmaceutical Price Regulation Scheme ("the PPRS"). The PPRS, of which Napp is a member, is a voluntary price regulation scheme, agreed between the Secretary of State for Health and the Association of the British Pharmaceutical Industry, which operates to control the overall profits of participating pharmaceutical companies and, in some instances, to limit the initial launch price, or subsequent price increases, of branded medicines. The current PPRS, which came into force in 1999 and expires in 2004, is backed by various statutory powers under the Health Act 1999.

19. The remaining 10 to 14 per cent of supply is to the hospital segment of the market. Sustained release morphine is purchased directly from manufacturers by hospitals, where it is prescribed to patients by hospital doctors or specialists. The hospital pharmacist will dispense the branded drug prescribed by the hospital doctor but may have discretion to substitute an equivalent branded drug carried in the hospital formulary. A number of hospital regions purchase by competitive tender through the NHS Purchasing and Supplies Agency (NHS PASA), or its equivalent in Scotland and Northern Ireland, but a separate contract is negotiated for each region. Other regions seek tenders directly without using the NHS PASA. The regional contracts are framework contracts, which mean that an individual hospital may choose to negotiate an individual contract on different terms, possibly with another supplier.

20. In the hospital segment, the purchasing authorities are much more price sensitive than GPs in the community segment of the market. After the launch of SRM Rhotard by Farmitalia in 1991, discounts to hospitals increased, and continued to do so after the re-launch of that product as Oramorph SR by BIL in 1994. Since the mid 1990s Napp has offered discounts off the NHS list price of up to [...] [in excess of 90] per cent on hospital tenders on certain strengths of MST tablets. Napp's market share in the hospital segment is in excess of 90 per cent.

21. As seen below, the hospital segment is not only important in its own right but is a strategic "gateway" for any new supplier who wishes to establish himself in the community segment of the market.

22. In addition to the scheme of voluntary price regulation under the PPRS, the Health Act 1999 makes provision for the establishment of Primary Care Groups and Primary Care Trusts ("PCGs/PCTs") which are being progressively established with effect from 1 April 1999. One of the purposes of this reform is to encourage greater price sensitivity in prescribing by GPs, and to promote a greater awareness of the cost implications, for the community segment of the market, of purchasing decisions made by hospitals.

## II – THE DECISION AND DIRECTIONS

### *The Administrative procedure*

23. Following a complaint, the Director's investigation began under the Competition Act 1980 and continued under the Competition Act 1998 after 1 March 2000. A notice dated 6 July 2000, sent to

Napp under section 26 of the Act, required notably the production of minutes of meetings of directors of members of the Napp group and all documents prepared for those meetings relating to the pricing of MST tablets for the period from 1 January 1997, as well as a great deal of other specified documents and information.

24. The Director issued Napp with a notice under Rule 14 of the rules made by the Competition Act 1998 (Director's rules) Order 2000 SI 2000 No. 293 ("the Director's Rules") on 25 August 2000 ("the first Rule 14 Notice"). In that Notice the Director stated his intention to take a decision that the Chapter II prohibition had been infringed, and setting out the facts and matters relied on, as required by Rule 14(3). Napp replied to that notice orally and in writing. A supplementary notice ("the second Rule 14 notice") was served on Napp on 2 February 2001, to which Napp also replied orally and in writing. A third notice under Rule 14 relating to directions the Director proposed to make under section 33 of the Act was served on 15 March 2001. Napp replied in writing on 27 March 2001 and made certain later submissions.

25. Pursuant to Rule 14(5), Napp was afforded an opportunity to inspect the documents in the Director's file, subject to the protection of confidentiality requested by third parties and of internal documents under Rule 14(6). It appears that the Director kept under review the question of disclosure, and subsequently disclosed to Napp a number of further documents

26. The Decision was notified to Napp on 30 March 2001, and the Directions were notified on 4 May 2001.

***The Director's findings on dominance***

27. In the Decision the Director finds that the relevant market for the purposes of his analysis is the market for sustained release morphine tablets and capsules in the United Kingdom (paragraphs 45 to 93), and that Napp has a dominant position in that market (paragraphs 94 to 108). Napp contests very few of the primary facts on which the Director relies, without necessarily accepting the conclusions which he draws.

28. On the issue of dominance, in the Decision the Director first relies on Napp's market shares (paragraphs 96 to 100). According to Tables 2 to 4 of the Decision (as revised and updated to 31 March 2001 in the course of these proceedings) the uncontested market shares are as follows:

**Table 2: Napp's market share (unit volumes) of sustained release morphine tablets/capsules 1997-2000**

| Hospital and Community sales (unit volumes) | 1997 | 1998 | 1999 | 2000 | Q1 2001 |
|---|---|---|---|---|---|
| MST CONTINUS | 89.2 | 89.6 | 90.6 | 91.0 | 91.6 |
| MXL | 5.2 | 5.9 | 5.1 | 4.2 | 3.9 |
| Napp total | 94.4 | 95.5 | 95.7 | 95.2 | 95.5 |
| ORAMORPH SR | 4.9 | 3.6 | 3.0 | 2.0 | 0.0 |
| MORCAP | 0.6 | 0.7 | 0.5 | 0.5 | 0.6 |
| ZOMORPH | 0.1 | 0.2 | 0.8 | 2.3 | 3.9 |
| TOTAL | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

**Table 3: Shares of supply (unit volumes) of sustained release morphine tablets/capsules to the community 1997-2000**

| Community sales (unit volumes) | 1997 | 1998 | 1999 | 2000 | Q1 2001 |
|---|---|---|---|---|---|
| MST CONTINUS | 91.7 | 91.0 | 91.4 | 91.5 | 92.0 |
| MXL | 5.0 | 5.6 | 5.1 | 4.2 | 4.0 |
| Napp total | 96.7 | 96.6 | 96.5 | 95.7 | 96.0 |
| ORAMORPH SR | 2.6 | 2.4 | 2.3 | 1.8 | 0.0 |
| MORCAP | 0.7 | 0.8 | 0.5 | 0.5 | 0.6 |
| ZOMORPH | 0.0 | 0.2 | 0.7 | 2.0 | 3.4 |
| TOTAL | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

**Table 4: Shares of supply (unit volumes) of sustained release morphine tablets/capsules to hospitals 1997-2000**

| Hospital sales (unit volumes) | 1997 | 1998 | 1999 | 2000 | Q1 2001 |
|---|---|---|---|---|---|
| MST CONTINUS | 71.5 | 77.2 | 83.2 | 87.2 | 89.0 |
| MXL | 6.2 | 8.0 | 6.8 | 4.7 | 3.7 |
| Napp total | 77.7 | 85.2 | 90.0 | 91.9 | 92.7 |
| ORAMORPH SR | 22.0 | 14.4 | 8.1 | 3.6 | 0.0 |
| MORCAP | 0.3 | 0.4 | 0.2 | 0.2 | 0.0 |
| ZOMORPH | 0.0 | 0.0 | 1.7 | 4.3 | 7.3 |
| TOTAL | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

29. In addition to Napp's market shares, the Director relies in the Decision on three further factors to establish dominance:

(i) regulatory barriers to entry, that is to say the need for any new competitor to obtain the necessary manufacturing, marketing or import authorisations required under the Medicines Act 1968 and other legislation governing medicinal products (paragraphs 102 and 103);

(ii) what the Director describes as Napp's "strong and persistent first mover advantage" (paragraphs 104 to 113); and

(iii) what the Director describes as "the strategic barrier to entry in hospital sales" created by the pricing behaviour of Napp in the hospital segment of the market (paragraphs 114 to 118).

30. In respect of Napp's "first mover" advantage, the Director stresses first, MST's firmly established reputation among GP's, notably as "synonymous with the treatment of chronic severe pain". This reputation is very strong, since Napp has 96 per cent of the community segment of the market. Secondly, GPs are reluctant to experiment with a new strong opioid product of which they have no direct experience, and are extremely wary of possible side-effects and lack of efficacy. Thirdly, there is a lack of price sensitivity among GPs, particularly since the amount of money spent by an individual GP on morphine is relatively low. Fourthly, the costs of promotion to GPs are high, and it is difficult and expensive for later entrants to challenge early entrants to the market. None of these factors is disputed by Napp. According to the Director, the cumulative effect of these factors is to create significant barriers to entry into the community segment of the market, although that does not apply to the hospital segment where purchasers are price sensitive, and hospital specialists are less reluctant to assess the relative efficacy of different brands (see paragraphs 104 to 113 of the Decision).

31. In the Decision the Director also finds that neither the buying power of the NHS (paragraphs 119 and 120), nor the effects of PCGs/PCTs (paragraph 121), nor the system of price regulation under the PPRS (paragraphs 122 to 137), prevented Napp from holding a dominant position.

***The Director's findings on abuse***

32. As regards abuse, in paragraph 142 of the Decision (and again at paragraph 236) the Director states that Napp has:

> "(a) while charging high prices to customers in the community segment of the market, supplied sustained release morphine tablets and capsules to hospitals at discounts which have the object and effect of hindering competition in the market for the supply of sustained release morphine tablets and capsules in the UK. The pricing behaviour of Napp has to be considered as a whole, but the particular aspects in



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which, in the circumstances of the present case, its discounting behaviour is abusive under section 18 of the Act are as follows:

(i) selectively supplying sustained release morphine tablets and capsules to customers in the hospital segment at lower prices than to customers in the community segment;

(ii) more particularly, targeting competitors, both by supplying at higher discounts to hospitals where it faced (or anticipated) competition and by supplying at higher discounts on those strengths of sustained release morphine tablets and capsules where it faced competition; and

(iii) supplying sustained release morphine tablets and capsules to hospitals at excessively low prices.

Moreover Napp has engaged in the above conduct with the intention of eliminating competition.

(b) charged excessive prices to customers in the community segment of the market for the supply of sustained release morphine tablets and capsules in the UK.

In doing so, Napp has abused its dominant position in the market for the supply of sustained release morphine tablets and capsules in the UK."

*Discounts to hospitals*

33. Napp does not dispute the primary facts regarding its discounts to hospitals. It is thus common ground that Napp supplies hospitals at a discount of up to [...] [in excess of 90] per cent off the NHS list prices for sustained release morphine tablets. Conversely, NHS list prices paid in the community segment are very substantially higher than the discounted hospital prices (paragraph 145 of the Decision).

34. The Director further finds in the Decision that in the period from March to May 2000 Napp's prices to hospitals were: (i) below total delivered costs on all tablets except 15mg and 200mg tablets; and (ii) below direct cost (material and direct labour) on all tablets except 5 mg, 15 mg and 200 mg tablets (paragraphs 146 and 147). The Director considers that direct costs may serve as a proxy for average variable costs ("AVCs"), that is to say costs that vary according to the output produced (see paragraphs 189 and 190 of the Decision).

35. Napp's prices and direct costs during that period are shown in Table 5 of the Decision, but it is not disputed that those figures are representative of the whole period of the infringement to 30 March 2001.

**Table 5: Napp's average variable cost on MST tablets and average hospital prices, March to May 2000**

| Strength | Direct Costs (£) | NHS list price, excl. VAT (£) | Average hospital price (£) |
|---|---|---|---|
| 5mg | | 4.30 | |
| 10mg | | 7.17 | |
| 15mg | | 12.57 | |
| 30mg | ... | 17.22 | ... |
| 60mg | | 33.58 | |
| 100mg | | 53.16 | |
| 200mg | | 106.34 | |

36. The Director also finds in the Decision that Napp's discounts have been selectively targeted at competitors. First, Napp gave their highest discounts, of [...] [in excess of 90] per cent, only on strengths where Napp has faced a rival BIL product at a similar strength (10mg, 30mg, 60mg, and 100mg), whereas where Napp did not face a rival BIL product (5mg, 15 mg and 200 mg) the discounts are only at most [...] [less than 85] per cent (paragraph 182).

37. Secondly, the Director finds that on a number of contracts where Napp has been awarded a sole regional contract, Napp has supplied at a higher level of discount of [...] [in excess of 90] per cent, while offering only a [...] [less than the highest] discount where the contract is to be shared (paragraphs 183 to 186).

38. Thirdly, it is only on those strengths of MST where it faced a rival BIL product at equivalent strength (i.e. 10mg, 30mg, 60mg and 100mg), that Napp's prices to hospitals were below direct costs, where direct costs are defined as materials and direct labour (paragraphs 189 and 190).

39. Fourthly, the Director finds in the Decision that in many cases MST has been supplied to hospitals at prices considerably below the averages shown in Table 5 above. For example, where Napp offers [...] [in excess of 90] per cent discounts off trade price, the hospital prices for 10mg, 30mg, 60mg and 100mg are £[...], £[...], £[...] and £[...] respectively. In these cases, Napp's hospital prices are between [...] [in excess of 30] per cent and [...] [less than 50] per cent lower than direct costs, and significantly below the raw material cost (paragraph 191). None of the foregoing facts are disputed by Napp.

40. In those circumstances the Director considers that Napp has abused its dominant position from 1 March 2000 by seeking to eliminate competition in the hospital sector by pricing below direct costs and selectively targeting competitors: see notably Case C-62/86 *AKZO Chemie BV v Commission* [1991] ECR I-3359 ("*AKZO*") (paragraphs 188 to 196).

41. Furthermore, the Director considers that Napp's pricing has not only eliminated competition in the hospital segment, but has also foreclosed a large part of the total market (paragraphs 160 to 180).

42. The Director considers, first, that Napp has excluded competition in at least 24 to 27 per cent of the total market. That figure is made up of the whole of the hospital segment, which accounts for 10 to 14 per cent of the total, plus 15 per cent of the community segment (which itself accounts for 86 to 90 per cent of the total market), which is foreclosed as a result of what is referred to in the Decision as the "follow-on" effect (paragraph 160). According to footnote 67 to paragraph 111, references in the Decision to the "follow-on" effect "are to those prescriptions for a brand of sustained release morphine in the community, where the choice of brand has been determined by the hospital doctor or specialist. This occurs when patients are prescribed a particular brand in hospital, and the GP subsequently repeats that prescription when the patient re-enters community care."

43. Secondly, the Director considers that the hospital segment is a key strategic point of entry for new competitors in the relevant market. Hospitals serve to establish the reputation of a brand (described in the Decision as "the reputation effect") because (i) the prescribing decisions of hospital specialists can establish the credibility of a product brand in the minds of GPs; and (ii) through the follow-on effect, GPs acquire first hand knowledge of a product and its efficacy. For that reason, the Director considers that over the longer term the influence of hospital prescriptions on community sales is likely to be significantly greater when the reputation effect is allowed for (paragraphs 162 to 167, see also paragraphs 243 and 251).

44. The Director further relies on statements made to him by BIL, to the effect that Napp's pricing policy to hospitals led to BIL's withdrawal from the market (paragraphs 115, 168 and 174 to 178). He also relies on a statement made to him by Link in 1999:

> "[the] lack of sales was primarily due to predatory pricing in the hospital sector of the market and in 1999 we have had to adjust our sales strategy to compete on price. As a result we are now in a position of having to almost give away product to compete with Napp in the hospital market. Of course we are losing money and as a small company I

am not sure that we can continue this policy, reluctant as I am to be 'bullied' out of the market by our much larger competitor." (paragraph 116)

45. According to the Decision, Napp advanced four main arguments against the Director's conclusion that its pricing policy to hospitals is an abuse:

    (i) Napp's sales to hospitals at discounted prices, although apparently below direct cost, were incrementally profitable because of the compensating margins to be earned on the "follow-on" sales in the community segment (paragraphs 148, 149 and 192).

    (ii) What was true for Napp was true for its competitors, who could equally earn compensating margins in the community sector (paragraph 148).

    (iii) The market was not foreclosed (paragraphs 167 to 169).

    (iv) Napp's discounts to hospitals were the inevitable result of the necessity to meet competition (paragraph 197).

46. In support of its conclusion that hospital sales were incrementally profitable, Napp relied on the results of its internet survey of GPs, (the Internet Survey) which, according to Napp, showed that 15 per cent of patients receiving sustained release morphine in the community have their brand determined by a hospital doctor. Taking the ratio of hospital sales to community sales as 1:9, Napp calculated that one unit sold to hospitals would result in 1.35 "follow-on" units of the same brand sold in the community. According to Napp this follow-on effect is "mechanistic" (paragraph 149 of the Decision).

47. The Director, for his part, accepted in the Decision (at paragraph 150) that there is a "follow-on" effect between hospital and community sales and that Napp's figure of 15 per cent "may serve as a crude estimate of this effect at a national level over time". However, he did not accept Napp's other arguments.

48. First, according to the Director, the magnitude and timing of the follow-on effect is unpredictable, varying as between individual patients and as between different contracting regions. Accordingly, the Director did not accept that the follow-on effect was "mechanistic", or that a new entrant could rely on recovering losses made on a hospital contract by generating higher sales in the community segment (paragraphs 152 to 155).

49. Secondly, according to the Director there is "asymmetry" in Napp's favour, that is to say that Napp has significant advantages which its rivals do not have: see paragraphs 157 to 159 of the Decision.

50. Thirdly, the Director considered that Napp's price cuts to hospitals did not grow the overall market for sustained release morphine. There was therefore no justification for a policy of loss-leading, other than to deny a competitor the opportunity to establish itself in the community segment (paragraph 194).

51. Fourthly, according to the Director, Napp's justification for pricing below AVC is circular. That Napp can earn high compensating margins in the community segment is precisely because its discount policy in the hospital segment has hindered competition in the community segment. Napp's ability to charge high prices in the community segment cannot, therefore, be a justification for charging a price below AVC in the hospital segment. Likewise, the expectation of earning excessive margins on future sales cannot be a justification for current loss-making sales (paragraphs 151 and 195).

52. Fifthly, as regards foreclosure of the market, the Director considers that it is unusual for pioneer brands such as MST to have sustained such a high market share over time. He considers that low prices in the hospital segment were a strong factor in BIL's decision to withdraw from the market, and that Zomorph has not been earning an overall profit for Link due to the high promotional expenditure required. The Director does not consider that the evidence as to potential new entrants undermines his view that Napp's conduct has deterred competition in the relevant market (paragraphs 170 to 180).

53. Finally, as regards Napp's arguments based on "meeting competition", the Director considers that, while pharmaceutical products are sometimes sold at substantial discounts to hospitals, it is not normal that list prices are discounted by up to [...] [in excess of 90] per cent in tendering for hospital contracts. He also notes that the discount of up to [...] [in excess of 90] per cent on MST is only available on those dosages where Napp faced a BIL rival product at an equivalent strength. Furthermore, the level of price discrimination as between the hospital and community segments is exceptional. In the Director's view, Napp's discount policy on MST is different from behaviour which conditions normal competition (paragraphs 198 to 200).

54. The Director finds that Napp knew of the prices being offered to certain customers and sought to respond with lower prices aimed directly at those customers. He finds that Napp's response to competition in the hospital segment has been both unreasonable and disproportionate (paragraphs 201 to 202).

55. For those reasons, the Director concludes in the Decision that Napp has abused a dominant position in pursuing its policy on discounts to hospitals.

*Excessive prices*

56. The Director finds in the Decision (paragraphs 203 to 234) that the prices charged by Napp for MST in the community segment are excessive. At paragraph 203 of the Decision, the Director considers that a price is excessive and an abuse

> "if it is above that which would exist in a competitive market and where it is clear that high profits will not stimulate successful new entry within a reasonable period. Therefore, to show that prices are excessive, it must be demonstrated that (i) prices are higher than would be expected in a competitive market, and (ii) there is no effective competitive pressure to bring them down to competitive levels, nor is there likely to be."

57. According to the Director, Napp's prices can be shown to be above the competitive level, first, by assessing "whether the difference between costs actually incurred and the price actually charged is excessive": Case 27/76 *United Brands v Commission* [1978] ECR 207 ("*United Brands*"). In the Decision, the Director has sought to do this by showing the profit margins Napp earns on community sales and comparing these with the margins Napp earns on sales of other products, and on sales of MST to other markets (paragraph 204).

58. The second approach, according to the Director, is to establish what the competitive price of MST is likely to be and then compare this with the actual price. In the Decision the Director has sought to find a proxy for the competitive price of MST by looking at the prices of competitors, and the prices Napp charges elsewhere, and seeing whether those prices would enable Napp to earn a reasonable profit (paragraph 205).

59. The Director has not sought to rely on a single comparison, but has made six comparisons, all of which, according to him, support the conclusion that Napp's community prices of MST are

excessive (paragraph 206). Napp does not dispute the Director's figures, but does not accept his conclusion.

— *Comparisons of the prices for MST tablets with those of Napp's competitors (paragraphs 207 to 212)*

60. First, the Director finds that Napp's prices to the community are between 33 per cent and 67 per cent higher than those of its competitors, and typically around 40 per cent higher: see Table 6 in the Decision.

61. As regards Napp's argument that it is entitled to charge higher prices to reflect the research, development and promotional expenditures incurred in bringing MST to market, in the Decision the Director considers that a manufacturer with an innovative product cannot expect prices to remain at excessively high levels indefinitely. Moreover, it is not a feature of normal competition for the premium-priced pioneer product to retain such a large share of sales volume (96 per cent) for such a long time. The Director does not accept that any brand premium for MST would be as high as 40 per cent (paragraphs 208 to 212).

— *Comparison of prices for MST tablets over time (paragraphs 213 to 216)*

62. In the Decision, the Director considers that it is reasonable to infer that the price of MST was set above competitive levels prior to the expiry of its patent in 1992. However, Napp's prices of MST tablets to the community have not responded to the entry of rival products whereas Napp's hospital prices have done so. Napp's exceptionally high market share indicates that Napp's community prices have not been subject to competitive pressure.

— *Comparison of the prices of MST charged to hospitals and the community respectively (paragraphs 217 to 220)*

63. In the Decision, the Director finds that, on average, the wholesale community price for MST was over [...] [in excess of 1000] per cent higher than the average hospital prices on 10mg, 30mg, 60mg, and 100mg tablets, whereas, for example, Napp's price to the community of 5mg tablets is [...] [in excess of 70] per cent higher than its prices to hospitals: see Table 7 in the Decision.

— *Comparison with Napp's export prices (paragraphs 218, 219, 221 and 222)*

64. A similar pattern emerges, according to the Director, when comparing the prices to the community with Napp's export prices. The differential on 5mg tablets is [...] [below 5] per cent, but for higher strength tablets the differential is between [...] [in excess of 100] per cent and [...] [less than 700] per cent. The size of the differentials is, according to the Director, sufficiently large to suggest that Napp's profits on sales to the United Kingdom community segment are supra-normal. The Director does not accept that the differentials can be accounted for fully by the lower risk entailed in contract manufacturing, nor lower marketing and promotion costs.

— *Comparisons of Napp's profitability on sales to hospitals and the community (paragraphs 223 to 226)*

65. The Director finds that Napp earns a far higher margin on sales of MST to the community than it does on sales of its other products to the NHS: see Table 8 in the Decision. According to the Director, in broad terms MST community sales achieve a gross margin of around [...] [in excess of 80] per cent. Napp's total NHS sales earn a margin of around [...] [between 40 and 60] per cent, meaning that NHS sales other than MST earn a margin of around [...] [between 30 and 50] per cent (paragraph 224).

66. As to Napp's argument that it is normal for pharmaceutical companies to earn high margins on their most successful products in order to pay for the research and development of emerging products, or to subsidise less successful products, the Director considers that the system of patent protection allows companies a period in which to earn above-competitive margins as a reward for pharmaceutical innovation. When patent exclusivity is lost, it is to be expected that prices and/or market share will drop as a result of competitive entry. The lack of successful entry in this case is in part due to Napp's exclusionary practices in the hospital segment of the market (paragraph 225). The Director further finds that, taking account of the fact that Napp enjoyed patent protection from 1980 to 1992, Napp has had considerable time and opportunity to recoup its initial investment and compensate it for the risk it has taken (paragraph 233).

— *Comparison of Napp's margins with those of its competitors (paragraphs 226 to 229)*

67. According to the Director, Napp makes a gross margin of [...] [in excess of 80] per cent on its sales of MST to the community. This compares with a gross profit margin of [...] [less than 70] per cent for Napp's next most profitable competitor. In order to take account of the fact that Napp

manufactures MST tablets, while its competitors contract out the manufacture, and the possibility that Napp's operations may be more efficient, the Director has calculated Napp's gross profit margin, using the average costs of its next most profitable competitor, in order to ensure that any comparison is made on the basis most favourable to Napp. Even when calculated on this basis, according to the Director, Napp's prices imply margins of 80.5 per cent compared to [...] [less than 70] per cent for the next most profitable competitor. This further supports the conclusion that Napp's prices to the community are excessive and not subject to normal competitive constraints (paragraphs 228 and 229).

68. Finally, the Director rejects Napp's argument that the PPRS prevents Napp from charging excessive prices. The PPRS is a portfolio constraint and does not seek to ensure that the prices of individual products are not set at excessive levels (paragraph 230).

69. For those reasons, the Director concludes that Napp has maintained excessively high prices and margins on the sale of MST in the community segment of the market without effective competition from successful new entry. According to the Director, this is due, at least in part, to Napp's exclusionary pricing practices in the hospital segment (paragraphs 151, 194, 225, 228 and 232).

***The penalty***

70. The Director states in the Decision that he is satisfied that the infringements in relation to discounts to hospitals, and excessive prices in the community, have both been committed intentionally or, at the very least, negligently (paragraphs 241 to 246). Applying his published guidance on the appropriate amount of penalty, the Director concludes that Napp should pay a penalty of £3.21 million.

***The Directions***

71. The general effect of the Directions given to Napp by letter of 4 May 2001 is to require Napp (1) to reduce the NHS list price of MST tablets by at least 15 per cent; and (2) to sell MST tablets to hospitals in the United Kingdom at a price of not less than 20 per cent of the (reduced) NHS list price for the product strength in question. Transitional arrangements were made in respect of Napp's existing contracts.

## III – PROCEDURE BEFORE THE TRIBUNAL

72. By request dated 11 May 2001, Napp sought interim relief to suspend the Directions pursuant to Rule 32 of the Tribunal Rules. On 22 May 2001 the President suspended the operation of the Directions by consent, Napp having undertaken to compensate the NHS for losses incurred as a result of not reducing the NHS List price for MST between the date of the interim order and any final order of the Tribunal: see [2001] CompAR 1.

73. Napp's notice of appeal was lodged with the Registry on 29 May 2001 accompanied by a number of witness statements and over 4000 pages of supporting documents and correspondence exchanged with the Director during the administrative procedure. Notice of the appeal was published in the London, Edinburgh and Belfast Gazettes on 1 June 2001 and also on the Tribunal's website (www.competition-commission.org.uk) pursuant to Rule 13(1) of the Tribunal's Rules. No requests to intervene in the proceedings were received.

74. The first case management conference was held on 25 June 2001. At this hearing the date for the filing of the Defence was set for 11 July 2001, and the hearing fixed to commence on 24 September 2001. Napp was invited to clarify certain arguments under the Human Rights Act 1998, and to prepare a list of what it considered to be the main issues on the appeal, relating those issues to the voluminous documentation provided. Napp also agreed to provide the Director with certain items of information, and to disclose documents relating to certain factual allegations made in the notice of appeal, as requested by the Director by letter of 15 June 2001.

75. By letter of 9 July 2001 the Director sought an extension of two and a half days for the filing of his defence. That extension was granted by order of the President of 10 July 2001 following a short judgment setting out why the Tribunal was reluctant to accede to applications for extensions of time for filing pleadings: [2001] CompAR 21.

76. On 11 July 2001 the Tribunal returned to Napp a voluminous bundle of authorities relating to the Human Rights Act which had been sent by Napp on 2 July 2001 without any satisfactory accompanying argumentation and without having regard to the *Practice Direction (Citation of Authorities)* [2001] 1 WLR 1001.

77. The Defence was lodged at the Registry on 16 July 2001. The annexes to the Defence included witness statements from a further seven witnesses. A further case management conference was fixed for 30 July 2001.

78. By letters of 20 and 24 July 2001 Napp gave notice of its intention to apply at the case management conference for various orders striking out or disallowing all or parts of the defence and/or the Decision and the Directions, and excluding the witness statements. The main basis of the application was that the defence departed from, or enlarged upon, or contradicted, the Decision and that the witness statements should have been produced earlier. Having heard argument at the case management conference on 30 July, the Tribunal delivered a judgment on Napp's application at a further case management conference held on 8 August 2001: [2001] CompAR 33.

79. In that judgment (at paragraphs 46 to 47) the Tribunal left open the question whether, in the defence, the Director's case on excess pricing had shifted from that made in the Decision, but held that that was not a matter for striking out. On the issue of the witness statements, the Director withdrew the evidence of one of the witnesses and the evidence of another witness was excluded by the Tribunal. The Tribunal reserved for later decision whether it was in fact prepared to consider the further evidence annexed to the Defence (paragraphs 83 to 92 of the judgment).

80. At the same case management conference on 8 August 2001 the Tribunal gave further directions and asked the parties to endeavour to reach agreement as to what material was commercially confidential. The Tribunal also invited the parties to indicate whether further disclosure was sought and which (if any) witnesses the parties wished to cross examine. Napp did not seek further disclosure or apply to cross-examine any witness. The Director sought to cross-examine Mr John Brogden, the Managing Director of Napp Pharmaceuticals Limited, on his witness statements. Napp did not avail itself of the possibility, suggested by the Tribunal in its judgment of 8 August 2001, of serving a reply to the defence.

81. On 31 August 2001 the Tribunal wrote to the parties indicating those issues on which the Tribunal considered time at the hearing could profitably be concentrated. The Tribunal further asked Napp to draw to its attention any documents from Napp at Board or senior management level which discussed or referred to the objectives, strategy or policy considerations taken into account by Napp in setting its prices in the periods referred to in the Decision.

82. Napp replied by letter of 10 September 2001 enclosing a bundle of some 21 documents. The Tribunal having drawn attention to the fact that with one exception the documents did not relate to the period after 1997, it transpired that Napp's solicitors, Herbert Smith, had not themselves inspected Napp's files, but that Napp's in-house legal department had done so. On 25 September, during the hearing, Mr Bryan Lea, the Head of Napp's Legal Department, filed a witness statement to the effect that he had thoroughly reviewed all Napp's files which were potentially relevant and was confident that the Tribunal's request had been complied with.

83. At Napp's suggestion the Tribunal had agreed at the case management conference of 8 August 2001 to receive a short factual statement, agreed if possible, explaining the operation and work of PCGs and PCTs. It did not prove possible to agree such a statement, and the Tribunal rejected a voluminous and largely unexplained bundle of documents lodged by Napp on 7 September 2001. Eventually both parties submitted short statements outlining their respective positions as regards PCGs/PCTs.

84. In its letter of 31 August 2001 the Tribunal further invited the parties to prepare a short statement indicating to what extent they agreed or disagreed on the calculation of the alleged gain to Napp from the alleged infringements (on the hypothesis, denied by Napp, that any such infringements were established) indicating the different assumptions made. It proved difficult to reach any such agreement, but an agreed note of the respective calculations and the reasons for the differences was handed to the Tribunal on the last day of the hearing.

85. The Applicant's skeleton argument, a document of some 80 pages, was lodged with the Tribunal on 17 September and the Director's skeleton argument of some 35 pages was lodged with the Tribunal on 21 September 2001. Oral argument in the case was presented on 24, 25, 26 and 28 September. As the Director had requested, Mr John Brogden gave evidence on oath on 24 September and was cross-examined.

86. In accordance with the Tribunal's request, the parties were able to agree what material was commercially confidential and not to be discussed in open court. Certain commercially confidential material was disclosed to Napp's solicitors and counsel only, with a view to enabling the latter to decide whether to apply for formal disclosure of the material in question. No applications were made for further disclosure.

87. Following the hearing, further written submissions were made, at the Tribunal's request, principally as regards (i) the relevance or admissibility of the documents disclosed pursuant to the Tribunal's request of 31 August 2001; and (ii) whether Napp's prices fell below direct costs in 1998 or earlier (see the letters of the parties of 5, 15, 17 and 22 October 2001).

88. We comment, for the benefit of those conducting future appeals, that the procedure in this case did not go entirely according to the plan envisaged in the Tribunal's *Guide to Appeals under the Competition Act*, probably for three reasons: the notice of appeal was not as focussed as we would have wished, the Director sought to introduce a good deal of material and argument that was not in the Decision, and some of the supplementary materials supplied by Napp on such matters as the Human Rights Act and PCGs/PCTs were not in a form which we could easily absorb. We entirely appreciate the difficulties of the subject matter, the pressure of time, and the fact that all concerned are on a learning curve as regards the procedures to be followed in appeals under the Act, but we hope that the principles of the *Guide* can be closely followed in future cases.

89. Napp requests the Tribunal to:

— set aside the Decision in whole or in part;

— set aside or vary the Directions;

— to set aside or reduce the penalty;

— declare that Napp's conduct does not infringe the Chapter II prohibition;

— order the Director to pay Napp's costs of and incidental to the appeal;

— order such further or other relief as the Tribunal may consider appropriate.

90. The Director requests the Tribunal to:

— dismiss Napp's appeal;

— order Napp to pay his costs;

— order, pursuant to Rule 27 of the Tribunal's Rules, that interest be payable on the penalty.

## IV – THE BURDEN AND STANDARD OF PROOF

91. This is the first appeal under the Act against an infringement decision, so we address at the outset the issue of the burden and standard of proof where penalties are imposed under section 36 of the Act.

92. Article 6 of the European Convention on Human Rights and Fundamental Freedoms (ECHR) which is given further effect in domestic law under the Human Rights Act 1998, provides:

> "Right to a Fair Trial
>
> 1. In the determination of his civil rights and obligations or of any criminal charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law. Judgment shall be pronounced publicly ...
> 2. Everyone charged with a criminal offence shall be presumed innocent until proved guilty according to law.
> 3. Everyone charged with a criminal office has the following minimum rights:
>  (a) to be informed promptly, in a language which he understands and in detail, of the nature and cause of the accusation against him;
>  (b) to have adequate time and facilities for the preparation of his defence;
>  (c) to defend himself in person or through legal assistance of his own choosing or, if he has not sufficient means to pay for legal assistance, to be given it free when the interests of justice so require;
>  (d) to examine or have examined witnesses against him and to obtain the attendance and examination of witnesses on his behalf under the same conditions as witnesses against him;
>
> ..."

93. Both parties accept that proceedings under the prohibitions imposed by the Act which may lead to the imposition of a penalty under section 36 involve a "criminal charge" or a "criminal offence" for the purposes of Article 6 of the ECHR.

94. From that starting point, Napp argues that it is entitled to the presumption of innocence in proceedings before the Tribunal, which represent the first occasion upon which the "criminal charge" against Napp falls to be determined by an independent and impartial tribunal within the meaning of Article 6(1). Napp further argues that the Director must rebut the presumption of innocence and discharge the burden of proof to the criminal standard: see Clayton & Tomlinson *The Law of Human Rights* (2000) paragraphs 11.115 to 11.119.

95. The Director argues that the fact that the present proceedings involve a criminal charge for the purpose of the ECHR does not mean that they are to be equated with criminal proceedings under English law, or that the rights that apply in criminal proceedings automatically apply to a case under the Act: see the decision of the Court of Appeal in *Han v Commissioners of Customs and Excise,* [2001] 4 All ER 687. As regards the burden of proof, the Director accepts that it is incumbent upon him to establish the infringement, and that the persuasive burden of proof remains

on him throughout. However, that does not necessarily prevent the operation of certain evidential presumptions for example, that sales below direct cost are presumed to be abusive: see *R v Lambert* [UKHL] 37 [2001] 3 WLR 206, paragraphs 34, 87 et seq, and 150 et seq.

96. As regards the standard of proof, the Director argues that the appropriate standard is the balance of probabilities. There is no requirement, under the ECHR, of proof beyond reasonable doubt: Sir Richard Buxton, *The Human Rights Act and the Substantive Criminal Law* [2000] Crim LR 331. The balance of probabilities is a sufficiently flexible standard to require that the Tribunal (or Director) should be more sure before finding serious allegations proved than when deciding less serious matters: per Lord Nicholls in *In re H* [1996] AC 563 at 586-587. The criminal standard of proof beyond reasonable doubt would not be appropriate in relation to the kind and range of issues this Tribunal has to determine under the Act.

97. At the Tribunal's request, counsel for the Director dealt with the position as regards the standard of proof in Scots Law, citing *1st Indian Cavalry Club Ltd and Chowdhury v Customs and Excise Commissioners* [1998] STC 293 and *Mullan v Anderson* [1993] SLT 835. He also dealt with the standard of proof before the European Courts under Articles 81 and 82 of the EC Treaty, citing notably Case T-7/89 *Hercules Chemicals NV v Commission* [1991] ECR II-1711, at paragraph 59, Cases 29-30/83 *Compagnie Royale Asturienne des Mines SA and Rheinzink v Commission* [1984] ECR 1679 at paragraph 20, and the opinion of Judge Vesterdorf, acting as Advocate General, in Cases T 1-15/89 *Rhône-Poulenc and others v Commission* [1991] ECR II-867 at p.954.

98. As we have already stated in our interim judgment of 8 August 2001, we agree that the Director's concession that these proceedings are "criminal", for the purposes of Article 6 of the ECHR, is properly made: see Case C-235/92P *Montecatini v Commission* [1999] ECR I-4575, paragraphs 175 and 176. That is particularly so since penalties under the Act are intended to be severe and to have a deterrent effect: see the Director's statutory *Guidance as to the appropriate amount of the penalty*, (OFT 423, March 2000) issued under section 38(1) of the Act.

99. The fact that these proceedings may be classified as "criminal" for the purposes of the ECHR gives Napp the protection of Article 6, and in particular the right to "a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law" (Article 6(1)), to the presumption of innocence (Article 6(2)), and to the minimum rights envisaged by Article 6(3) including the right "to examine or have examined witnesses against him and to obtain the

attendance and examination of witnesses on his behalf under the same conditions as witnesses against him" (Article 6(3)(d)).

100. In our view it follows from Article 6(2) that the burden of proof rests throughout on the Director to prove the infringements alleged.

101. However, as the Court of Appeal held in *Han,* cited above, to which we referred in our judgment of 8 August 2001, the fact that Article 6 applies does not of itself lead to the conclusion that these proceedings must be subject to the procedures and rules that apply to the investigation and trial of offences classified as criminal offences for the purposes of domestic law: see Potter LJ at paragraph 84, and Mance LJ at paragraph 88 of that judgment.

102. Neither the ECHR itself nor the European Court of Human Rights has laid down a particular standard of proof that must be applied in proceedings to which Articles 6(2) or (3) apply, and still less that the standard should be that of "proof beyond reasonable doubt", which is not a concept to be found in the domestic systems of many of the signatory States (see Sir Richard Buxton, cited above, at pp. 338 and 339).

103. In our view it follows that neither Article 6, nor the Human Rights Act 1998, in themselves oblige us to apply the criminal standard of proof as established in domestic law in cases where the Director seeks to impose a financial penalty in respect of alleged infringements of the Chapter I or Chapter II prohibitions under the Act.

104. In our view the standard of proof to be applied under the Act is to be decided in accordance with the normal rules of the United Kingdom domestic legal systems. Neither party has cited to us any decided domestic cases which suggest that, in circumstances such as these, the criminal standard should be applied, nor invited us to apply by analogy certain civil situations where traditionally the criminal standard of proof is required (e.g. committal proceedings).

105. Infringements of the Chapter I and Chapter II prohibitions imposed by sections 2 and 18 of the Act are not classified as criminal offences in domestic law, in contrast, for example, to the criminal offences created under sections 42 to 44. Under section 38(8), penalties are recoverable by the Director as a civil debt. Directions are enforceable by civil proceedings under section 34. In our view the structure of the Act points to the conclusion that under domestic law the standard of proof

we must apply in deciding whether infringements of the Chapter I or Chapter II prohibitions are proved is the civil standard, commonly known as the preponderance or balance of probabilities, notwithstanding that the civil penalties imposed may be intended by the Director to have a deterrent effect.

106. We add that in many cases under the Act the factual issues before this Tribunal will often relate to such matters as determining the relevant market, whether dominance exists, and assessing whether conduct characterised as an "abuse" is economically justified. Issues of that kind involve a more or less complex assessment of mainly economic data and perhaps conflicting expert evidence. It seems to us more likely that Parliament would have intended us to apply the civil standard of proof to issues of this kind, rather than the time-honoured criminal standard of "proof beyond reasonable doubt".

107. In our view it follows from the speech of Lord Nicholls (with whom Lord Goff and Lord Mustill agreed) in *Re H*, cited above, at pp.586 to 587, that under the law of England and Wales there are only two standards of proof, the criminal standard and the civil standard; there is no 'intermediate' standard. The position is the same in the law of Scotland and Northern Ireland. Within the civil standard, however, the more serious the allegation, the more cogent should be the evidence before the court concludes that the allegation is established on the preponderance of probability: see Lord Nicholls speech in *Re H*, citing notably *In re Dellow's Will Trusts* [1964] 1 WLR 451, 455 and *Hornal v Neuberger Products Ltd* [1957] 1 QB 247, 266.

108. Since cases under the Act involving penalties are serious matters, it follows from *Re H* that strong and convincing evidence will be required before infringements of the Chapter I and Chapter II prohibitions can be found to be proved, even to the civil standard. Indeed, whether we are, in technical terms, applying a civil standard on the basis of strong and convincing evidence, or a criminal standard of beyond reasonable doubt, we think in practice the result is likely to be the same. We find it difficult to imagine, for example, this Tribunal upholding a penalty if there were a reasonable doubt in our minds, or if we were anything less than sure that the Decision was soundly based.

109. In those circumstances the conclusion we reach is that, formally speaking, the standard of proof in proceedings under the Act involving penalties is the civil standard of proof, but that standard is to be applied bearing in mind that infringements of the Act are serious matters attracting severe

financial penalties. It is for the Director to satisfy us in each case, on the basis of strong and compelling evidence, taking account of the seriousness of what is alleged, that the infringement is duly proved, the undertaking being entitled to the presumption of innocence, and to any reasonable doubt there may be.

110. That approach does not in our view preclude the Director, in discharging the burden of proof, from relying, in certain circumstances, from inferences or presumptions that would, in the absence of any countervailing indications, normally flow from a given set of facts, for example that dominance may be inferred from very high market shares (Case 85/76 *Hoffman-La Roche v Commission* [1979] ECR 461, paragraph 41); that sales below average variable costs may, in the absence of rebuttal, be presumed to be predatory (see the opinion of Advocate General Fennelly in Cases C-395/96P and 396/96P *Compagnie Maritime Belge v Commission* [2000] ECR I-1442 at paragraph 127); or that an undertaking's presence at a meeting with a manifestly anti-competitive purpose implies, in the absence of explanation, participation in the cartel alleged: *Montecatini v Commission*, cited above, at paragraphs 177 to 181.

111. Presumptions of this kind simply reflect inferences that can, in normal circumstances, be drawn from the evidence: they do not reverse the burden of proof or set aside the presumption of innocence: *Montecatini* at paragraph 181. Being essentially evidential in character, such presumptions are hardly equivalent to statutory 'reverse onus' provisions of the kind considered in *R v Lambert*, cited above. But even in the case of such a statutory provision, Article 6(2) of the ECHR does not prohibit a permissive or evidentiary presumption from which a trier of fact may (as opposed to must) draw an inference of guilt: see again *R v Lambert*, notably Lord Steyn at paragraph 40, Lord Hope at paragraphs 87 to 91 and Lord Clyde at paragraphs 150 to 158. If a defendant undertaking seeks to rebut the presumption in question, the legal burden of proof remains on the Director to show that an abuse is established.

112. Whether or not section 60 of the Act is to be construed as requiring us to follow the case law of the Court of Justice and the Court of First Instance on issues such as the burden and standard of proof, we believe that the approach we have outlined above is in line with the approach of those Courts. There is no doubt that in proceedings under Articles 81 and 82 of the Treaty, the burden of proof rests on the Commission (see *Montecatini* at paragraph 179). As far as the standard of proof is concerned, the European Courts, faced with the different traditions of the Member States, have simply indicated that the infringement should be demonstrated to the "requisite legal standard" (à

suffisance de droit), but there is no doubt that, in general, those Courts require convincing proof that the alleged infringements have been committed in the form of a "firm, precise and consistent body of evidence": see Cases 29 and 30/83 *CRAM and Rheinzink v Commission* cited above, paragraphs 16 to 20; Cases C-89/85 etc *Ahlström Osakeyhtiö and others v Commission* [1993] ECR I-1307, paragraph 127. We have no reason to suppose that the standard of proof we propose to follow is any different from that followed in practice by the courts in Luxembourg.

113. We observe, finally, that in the present case, much of the above discussion is somewhat academic. As appears in more detail from our findings below, we do not think that it makes any material difference to the outcome in this particular case whether we apply the domestic civil standard in the way described above, or the domestic criminal standard as traditionally expressed.

## V – OTHER PROCEDURAL ISSUES

*The Director's witness statements*

114. In paragraphs 64 to 92 of our judgment of 8 August 2001 we pointed out that the Act and the Tribunal's Rules envisage that further evidence could be given and documents produced before the Tribunal, and that there was no absolute bar, under the ECHR or otherwise, to that being done in a proper case. While indicating that, in general, the discretion to take account of new evidence relied on by the Director should be exercised sparingly, we held that the interests of fairness may well indicate that such new evidence should be allowed, particularly where it consists, in essence, of matters going to rebut allegations made by an applicant in the notice of appeal. We therefore declined to exclude at that stage the evidence of five of the Director's witnesses, although we excluded one statement, and a further statement was withdrawn by the Director.

115. Napp has, however, contended that the Tribunal should only take account of the five remaining witness statements in so far as they are favourable to Napp, and not take into account material to Napp's detriment which could have been, but was not, made available in the administrative procedure. Otherwise, says Napp, the administrative procedure envisaged by the Act can be circumvented and Napp's rights of defence jeopardised.

116. As we indicated in our judgment of 8 August 2001 (paragraphs 72 to 79) it is of obvious importance that, in the administrative procedure, the provisions of Rule 14 of the Director's Rules (see paragraphs 24 and 25 above) are properly observed.

117. If and when a matter moves to the judicial stage before this Tribunal, what was previously an administrative procedure, in which the Director combines the rôles of "prosecutor" and "decision maker", becomes a judicial proceeding. There is, at that stage, no inhibition on the applicant attacking the Decision on any ground he chooses, including new evidence, whether or not that ground or evidence was put before the Director. The Tribunal, for its part, is not limited to the traditional rôle of judicial review but is required by paragraph 3(1) of Schedule 8 of the Act to decide the case "on the merits" and may, if necessary and appropriate, "make any other decision which the Director could have made": paragraph 3(2)(e). If confirming a decision, the Tribunal may nonetheless set aside a finding of fact by the Director: paragraph 3(4) of Schedule 8. Unlike the normal practice in judicial review proceedings, the Act and the Tribunal Rules envisage that the Tribunal may order the production of documents, hear witnesses and appoint experts (see Schedule 8, paragraph 9 of the Act, and Rule 17 of the Tribunal's Rules) and may do so even if the evidence was not available to the Director when he took the decision: see Rule 20(2) of the Tribunal's Rules.

118. In elucidation of these provisions, we refer to the statement made in the House of Commons by the then Minister for Competition and Consumer Affairs (Mr Griffiths) during the passage of the Competition Bill on 18 June 1998 (Hansard Col 496):

> "It is our intention that the tribunal should be primarily concerned with the correctness or otherwise of the conclusions contained in the appealed decision and not with how the decision was reached or the reasoning expressed in it. That will apply unless defects in how the decision was reached or the reasoning make it impracticable for the tribunal fairly to determine the correctness or otherwise of the conclusions or of any directions contained in the decision. Wherever possible, we want the tribunal to decide a case on the facts before it, even where there has been a procedural error, and to avoid remitting the case to the director general. We intend to reflect that policy in the tribunal rules.
>
> This is an important aspect of our policy, and I shall explain the rationale behind our approach. The Bill provides for a full appeal on the merits of the case, which is an essential part of ensuring the fairness and transparency of the new regime. It enables undertakings to appeal the substance of the decision including in those cases where it is believed that a failure on the part of the director general to follow proper procedures has led him to reach an incorrect conclusion. The fact that the tribunal will be reconsidering the decision on the merits will enable it to remedy the consequences of any defects in the director general's procedures."

119. As we have already said in our judgment of 8 August 2001, if, at the judicial stage, an applicant launches an attack which places under close scrutiny particular aspects of the Decision, in principle we do not think that the Director should be denied a reasonable opportunity to reply by adducing rebuttal evidence in support of the points already made in the Decision. Thus we do not accept

Napp's principal submission that nothing may be relied on before the Tribunal unless it was relied on in the administrative procedure.

120. Nor do we accept Napp's submission that it (Napp) is entitled to rely on the Director's new evidence but that we (the Tribunal) must close our eyes and ears if the witness on whom Napp relies states something unfavourable to Napp's case. Napp has had the opportunity to cross-examine the Director's witnesses, and/or apply for orders for disclosure. In four days of argument before the Tribunal Napp has had every opportunity to make any point it wishes as to the evidence in question and has itself relied strongly on the evidence of Messrs Hartley and Penrose, and to a lesser extent that of Mr Blake. We do not see any ground on which Napp should be permitted to "have its cake and eat it".

121. As regards the individual witness statements in question, Mr John Brownlee is head of the PPRS branch in the Department of Health. His evidence goes to rebut certain assertions made by Napp in the notice of appeal as to the position of the Department in this case and the way the PPRS is said to work. We see no grounds for excluding this evidence.

122. Mr John Hartley is Head of Sales and Marketing at Link. The essence of Mr Hartley's statement is to rebut various assertions made by Napp in the notice of appeal regarding the factors Link would take into account in its decisions on prices to hospitals, the importance to Link of the hospital sector, and the effect on Link of Napp's pricing in the hospital segment. Having initially sought to exclude Mr Hartley's evidence, in the event counsel for Napp relied upon it strongly. In addition, Mr Hartley supports Napp's case as regards the Directions. In our view Mr Hartley's evidence and the documents he produces are fairly introduced and relevant to a number of issues in the case.

123. Mr Mark Connolly is the Marketing Director of the Prescription Medicine Division for BIL. His evidence is relevant mainly to the reasons for BIL's withdrawal from the market, which are relied on by the Director at paragraphs 173 to 176 of the Decision, but contested by Napp. We think this evidence is fairly introduced as rebuttal evidence but the point is academic since, as will be seen below, we do not need to express a view on the matters dealt with by Mr Connolly.

124. Mr Roger Penrose is the NHS and Development Manager for BIL. His evidence rebuts Napp's attack on BIL's competence, deals with the importance to BIL of the hospital sector, explains the history of discounting in the market from 1994 until BIL's withdrawal in 2000, and comments on

the follow-on effect alleged by Napp. Although largely relating to events before the alleged period of infringement, Napp relies strongly on Mr Penrose's evidence on at least one point, namely that it was BIL rather than Napp which initiated price cutting after 1994. We see no proper basis for excluding Mr Penrose's evidence, although it is not essential to our analysis of Napp's conduct during the period of infringement.

125. Mr Stephen Blake is a solicitor working for the Legal Division of the OFT. As far as relevant, his evidence updates the Tribunal on potential new entrants to the market, and is not seriously contested.

126. In all these circumstances, we see no reason not to take the Director's five witness statements into account in deciding this case on the merits, whether in Napp's favour or otherwise, to the extent that those witness statements are relevant to the issues which we have to decide.

*The documents disclosed following the Tribunal's request of 31 August 2001*

127. Napp argues that the documents disclosed by Napp following the Tribunal's request of 31 August 2001 are inadmissible, save to the extent that they support Napp's case. Napp argues that they are not relied on in the Decision and relate to a period prior to the infringement alleged. In addition Napp questions the inferences to be drawn from these documents: see Napp's letter of 5 October 2001.

128. The Tribunal Rules, particularly Rule 17, give this Tribunal wide powers to make directions to secure the just, expeditious and economical conduct of the proceedings (see Rule 17(1)). Rules 17(2)(d) and (k) provide for the production and disclosure of documents, while Rule 17(3) provides that the Tribunal may do certain things of its own motion, in particular putting questions, inviting further submissions and asking for further material, including asking, under Rule 17(3)(d), "for documents or any papers relating to the case to be produced". As is, we believe, well known, the Tribunal's Rules are modelled on the Rules of Procedure of the Court of First Instance of the European Communities (OJ 2001 C34/39): see Articles 64 and 65 of those Rules.

129. We decided to ask for our attention to be drawn to the documents referred to in the Tribunal's request of 31 August 2001 in view of the fact that, in its notice of appeal, Napp was asserting to us the factors that were or would be taken into account by Napp in setting its pricing policy, but as far

as we could see without referring to any documents tending to show what matters Napp had actually taken into account at the material time. We therefore asked for documents relating to the objectives, strategy or policy considerations taken into account by Napp in setting its prices in the periods referred to in the Decision to be drawn to our attention. The documents concerned were promptly supplied without objection on Napp's part.

130. The Tribunal having requested the documents pursuant to its powers under the Tribunal Rules we cannot see that the documents are "inadmissible" solely by virtue of the fact that they did not figure in the administrative procedure. Rule 20(2) of the Tribunal Rules provides expressly that documents may be submitted whether or not they were available to the respondent when the disputed decision was taken. Whether it would be proper or fair to permit the Director to rely on those documents is in our view a matter for the Tribunal's discretion, which we discuss later in this judgment: see paragraphs 311 et seq, below.

*The "Ermakov" issue*

131. At the stage of our interim judgment of 8 August 2001, Napp argued, and has since continued to argue, that the Director's case during those proceedings has shifted significantly away from the case as made in the Decision. This is particularly so, says Napp, in respect of the Director's case on excess pricing but other matters are complained of as well. In our interim judgment we held that it was not a matter for striking out, but an issue to be decided in our final judgment.

132. Napp now argues on the basis of *R v Westminster City Council ex parte Ermakov* [1996] 2 All ER 302 (CA), followed for example in *Nash v Chelsea Royal College of Art* (Burnton J, [2001] EWHC Admin 538), that the Director should not be permitted to change the reasons for his Decision before the Tribunal, nor add supplementary reasons, given in particular that the Director is a specialist decision maker. In *Ermakov*, the Court of Appeal decided that, in certain proceedings under the Housing Act 1996, the decision maker should be held to the reasons given in his original decision, in the interests of fairness and efficient decision making: see Hutchison LJ at pp. 315 to 317.

133. On this point, for the same reasons that we consider that our discretion to allow the Director to submit further evidence should be exercised only sparingly, we accept Napp's basic submission that, in principle, the Director should not be permitted to advance a wholly new case at the judicial stage, nor rely on new reasons. To decide otherwise would make the administrative procedure, and

the safeguards it provides, largely devoid of purpose; the function of this Tribunal is not to try a wholly new case. If the Director wishes to make a new case, the proper course is for the Director to withdraw the decision and adopt a new decision, or for this Tribunal to remit.

134. However, given the powers of this Tribunal, it seems to us the analogy with *Ermakov* does not go as far as Napp submits. In those circumstances it is virtually inevitable that, at the judicial stage, certain aspects of the Decision are explored in more detail than during the administrative procedure and are, in consequence, further elaborated upon by the Director. As already indicated, these are not purely judicial review proceedings. Before this Tribunal, it is the merits of the Decision which are in issue. It may also be appropriate for this Tribunal to receive further evidence and hear witnesses. Under the Act, Parliament appears to have intended that this Tribunal should be equipped to take its own decision, where appropriate, in substitution for that of the Director. For these reasons, while we accept the force of the general principle that lies behind *Ermakov*, the analogy is not exact.

135. In the present case, for the reasons given in more detail below (see paragraphs 428 to 442), we have reached the view that Napp's allegations as to the Director's alleged "change of case" do not in fact have the significance that Napp alleges as far as the Director's findings of infringement are concerned. As will be seen, we do not think that there is anything in the *Ermakov* line of reasoning which precludes us from determining this appeal on the merits in the light of all the material now before us.

*Human Rights and general issues of unfairness*

136. Napp argues, in an amended version of paragraphs 5.61 to 5.72 of the notice of appeal, which was submitted after the Tribunal had sought clarification of Napp's case on this aspect, that the Director's conduct of the investigation was unfair and failed to observe the requirements of Article 6 of the ECHR. Napp submits that the Director acted as both prosecutor and judge in investigating and reaching the Decision, and in deciding what evidence, including exculpatory evidence, might be disclosed to Napp; that the Director failed to disclose to Napp all the evidence available to him which he should, or could, have obtained; that the Director failed to collect sufficient evidence, or relied on material having no evidential value, or ignored relevant evidence; and that the Director failed to accord Napp the possibility of testing the evidence by cross-examination.

137. As we have just indicated, we accept that both Article 6(1) and (2) of the ECHR apply to proceedings potentially involving a penalty imposed for a breach of the Chapter I and Chapter II prohibitions. We also accept that there is force in the argument that the administrative procedure before the Director does not in itself comply with Article 6(1), notably because the Director himself combines the roles of investigator, prosecutor and decision maker. However, as we have already indicated in paragraph 74 of our judgment of 8 August 2001, that in itself involves no breach of Article 6 because the Director's administrative Decision is subject to full judicial control on the merits by this Tribunal: see also now the decision of the House of Lords in *Magill v Porter* [2001] UKHL 67, judgment of 13 December 2001, per Lord Hope at paragraphs 87 to 94. In those circumstances we do not find that the procedure, taken as a whole, is unfair. It has not been suggested that this Tribunal is not "an independent and impartial tribunal" for the purposes of Article 6(1) of the ECHR.

138. As to the procedural requirements governing the administrative stage, we have already drawn attention to Rule 14 of the Director's Rules, which provides, in effect, for the "right to be heard" and for "access to the file". Under these provisions the Director must put to the defendant undertaking the essential facts and matters on which he relies. It goes without saying that the Director may not rely, in establishing his case, on anything that has not been disclosed to the defendant undertaking. It is also well established that, subject to the protection of internal documents (Rule 30(1)(f)) and confidential information as defined by Rule 30(1)(c) – essentially business secrets and information relating to the private affairs of an individual – the whole of the Director's file must be available for inspection by the undertakings concerned: see Case T-30/91 *Solvay v Commission* [1995] ECR II-1775, appeal dismissed Case C-288/95P [2000] ECR I-2391. The availability of the file enables the undertaking to defend itself, notably by seeking exculpatory material.

139. In the revised version of its notice of appeal, Napp complains of the Director's failure to disclose documents relating to the conduct of other firms who are or were supplying sustained release morphine in the United Kingdom; the views of the Department of Health on the case; evidence of discounts offered on other pharmaceutical products; and documents relating to the chronology of the discounting of oral sustained release morphine.

140. As we understand it, very extensive disclosure took place during the administrative proceedings, albeit that certain documents – not relied on by the Director – were not disclosed to Napp because

commercial confidentiality had been claimed by third parties pursuant to Rule 14(6)(a) and Rule 30(1)(c) of the Director's Rules. A Schedule listing all the documents in the Director's possession, identifying those which had not been disclosed in whole or part, was supplied to Napp. Upon the lodging of the appeal, the Director disclosed further documents to named external advisers of Napp, who gave undertakings to observe the confidentiality of the documents in question. Material relating to the discounting of products other than oral sustained release morphine was disclosed by the Director in the defence. The witness statements of Mr Hartley and Mr Penrose before the Tribunal contained a great deal of further material about the commercial strategies pursued in relation to Zomorph and Oramorph, respectively.

141. We understand that these further steps have largely resolved any dispute there may have been as regards disclosure. Despite having the opportunity during these proceedings to apply to the Tribunal for the disclosure of further documents, or classes of documents, Napp has made no such application. Nor was any specific complaint made, during argument at the hearing, that material documents were still being withheld, or that Napp's defence was being hampered as a result.

142. In these circumstances, we are wholly unable to find either that any documents were wrongfully withheld from Napp in breach of Rule 14 of the Director's Rules, or that Napp has suffered any prejudice as a result of the application of Rules 14(6)(a) and 30(1)(c) in this case. In particular, given the very full argument that Napp has advanced by reference to the relatively vast amount of material now before the Tribunal, we see no grounds for suggesting that there has been any breach of Napp's right to 'a fair trial' for the purposes of Article 6(1), as far as the disclosure of material documents is concerned.

143. It is true that where, in the course of the administrative procedure, the Director refuses disclosure under Rules 14(6)(a) and 30(1)(c), there is no provision under the Act which permits that issue to be adjudicated upon until the matter reaches the judicial stage before the Tribunal. The same is true of proceedings before the Court of First Instance. However, once the matter does reach the Tribunal, the case is fully argued "on the merits", the Tribunal having the power to take its own decision, or remit the matter to the Director. It is at that stage that the Tribunal is in a position, by the exercise of its powers under Rules 17 to 21 of the Tribunal Rules, to ensure that the rights of the defence are respected as regards the disclosure of documents. That is, in effect, what has occurred in the present case, as far as documents are concerned.

144. In our view the same approach applies to the cross-examination of witnesses. The Director's Rules do not envisage the cross-examination of witnesses during the administrative stage. However, there is power to apply to cross-examine at the judicial stage before the Tribunal. In the present case, Napp did not apply to cross-examine any witness under Rule 17 or seek any witness summons under Rule 21. In those circumstances we see no basis for arguing that Napp's rights of defence have been breached by the absence of cross-examination during the administrative stage.

145. We do not accept that the Director had any duty to collect, and make available to Napp, any further material, nor did Napp make any application to the Tribunal in that regard during the appeal.

146. We add, generally, that the three evidential issues to which Napp's submissions on this part of the case are principally directed are (a) whether hospital discounting was, as Napp suggests, initiated by Farmitalia and BIL; (b) why BIL left the market in 2000; and (c) Mr Mountain's view of the competitive strategy of Link. As will be seen below, neither (a) nor (b) are matters upon which we need to make specific findings. As regards (c), Mr Mountain was available, at the Tribunal's request, at the oral hearing and Napp could have cross-examined him then had they wished to do so.

147. The remaining arguments advanced by Napp in this part of the case seem to us to go to the weight of the evidence rather than to issues of procedure. We therefore turn to deal with the merits.

## VI – DOMINANCE

### *Relevant market*

148. Napp's notice of appeal does not expressly question the Director's detailed analysis of the relevant market at paragraphs 45 to 93 of the Decision, other than to remark, without elaboration, in Annex I, paragraph 16, that the Director's approach to the relevant market is "factually and legally flawed". In paragraphs 3.48(ii) and 3.49, and footnotes 47 and 48 of the notice of appeal, Napp suggests that Durogesic, a strong opioid analgesic delivered in an adhesive patch, offers strong competition to Napp. Mr Brogden also makes that point in his second witness statement. Napp does not, however, put forward an alternative market definition, nor say what its share of any alternative market might be.

149. Paragraph 3(1) of Schedule 8 of the Act requires us to determine the appeal on the merits "by reference to the grounds of appeal set out in the notice of appeal." In our view, Napp's notice of appeal does not sufficiently put in issue the definition of the relevant market as one of the grounds of appeal, nor set out the arguments in support of any such ground, as required by Rule 6(5) of the Tribunal Rules and the Tribunal's *Guide to Appeals under the Competition Act 1998*, paragraph 5.10. We take the view that the Tribunal is not bound to consider grounds that are inadequately presented in the Notice of Appeal. In our view, the Director rightly objected to the inclusion of the relevant market in the list of issues served by Napp on 30 July 2001, and we understood counsel for Napp to accept, during the hearing, that the relevant market was not pursued as an issue in this case.

150. It is, therefore, only by way of precaution that we find that Napp's scattered references to Durogesic in the notice of appeal do not suffice to put in question the correctness of the Director's analysis, at paragraphs 53 to 70 of the Decision, which excludes non-morphine products (of which Fentanyl, sold under the name Durogesic, is one) from the relevant market. The evidence there set out is to the effect, notably, that Durogesic is used in practice when patients are intolerant to oral morphine, or for some other reason oral morphine is unsuitable; that the two products are not regarded as substitutes; that Durogesic has certain practical disadvantages when compared to oral morphine; that the price of Durogesic does not appear to constrain the price of MST; and that it is not clear whether Durogesic has in fact had any adverse impact on sales of MST: see paragraphs 56 to 64 of the Decision.

151. The references in the documents to which Napp draws our attention – without however developing any clear argumentation in the notice of appeal – do not in our view convincingly address the matters relied on by the Director in the Decision. Certain of the references relied on by Napp e.g. Dr Hunt (document A21 at paragraph 25), Professor Hanks (document A23 at paragraph 14) and Dr Forster (document A26 at paragraph 15) are at best inconclusive as, in our view, is the material referred to by Mr Brogden. Other documents to which Napp refers are in our view too general to be useful.

152. We are therefore satisfied that for the purposes of these proceedings the relevant market is the supply of sustained release morphine tablets and capsules in the United Kingdom, as the Director concludes at paragraph 93 of the Decision.

*Dominant position*

153. Napp argues in the notice of appeal that it is not dominant in any relevant market, because the PPRS is effective to prevent Napp from being able to abuse any dominance it might otherwise enjoy, at least in respect of the abuses alleged in this case. Napp argues, in particular, that the PPRS prevents Napp from engaging in excessive pricing. In addition, the Department of Health could regulate the offering, by PPRS companies, of discounts against the NHS list prices. The fact that the Department does not choose to do so is irrelevant.

154. The Director submits that Napp is dominant by virtue of its market shares alone, which are in excess of 90 per cent. That dominance is reinforced by the barriers to entry referred to in the Decision. The PPRS does not go to rebut dominance at all. That scheme controls the overall profit that a supplier of branded pharmaceuticals may earn from the NHS but is not directed at anti-competitive abuse. It does not affect discounting to hospitals. Napp's argument confuses the question of dominance with the separate question of whether, in the light of the PPRS, Napp's prices in the community segment are an abuse of its dominant position.

155. We agree with the submissions of the Director.

156. According to the classic test, a dominant position under Article 82 of the Treaty:

> "relates to 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 consumers."

Case 85/76 *Hoffman-La Roche v Commission* [1979] ECR 461, paragraph 38.

157. The Court also said at paragraph 39:

> "The existence of a dominant position may derive from several factors which, taken separately, are not necessarily determinative but among these factors a highly important one is the existence of very large market shares."

And at paragraph 41:

> "Furthermore although the importance of the market shares may vary from one market to another the view may legitimately be taken that very large shares are in themselves, and save in exceptional circumstances, evidence of the existence of a dominant position."

158. In *Hoffman-La Roche* the Court held that market shares ranging between 84 and 90 per cent over three years "prove the existence of a dominant position" (paragraph 60). In *AKZO* the Court held that the test in *Hoffman-La Roche* was satisfied where an undertaking had maintained a stable market share of about 50 per cent over five years [1991] ECR II-3359, paragraph 60.

159. In the present case Napp's overall market share in the relevant market has been in excess of 90 per cent for many years. It is currently around 96 per cent, and over 90 per cent, in the community and hospital segments of the market respectively. In addition, various further factors reinforce barriers to entry and Napp's "first mover advantage", as pointed out in paragraphs 102 to 108 of the Decision. None of these facts are contested by Napp.

160. Applying the concept of a dominant position in Community law to the Chapter II prohibition, which we are required to do by section 60 of the Act, the foregoing considerations suffice, in our view, to establish that Napp enjoys a dominant position within the meaning of section 18(1) of the Act, without it being necessary, at this stage of the analysis, to rely on the further matters to which the Director refers at paragraphs 114 to 118 of the Decision.

161. As regards the PPRS, that scheme regulates by voluntary agreement the maximum profits to be made by any scheme member in respect of branded licensed medicines sold to the National Health Service, and in some cases the maximum prices that may be charged for medicines covered by the scheme. Under section 33 of the Health Act 1999, the Secretary of State has various powers to give directions if the scheme is not effective, including the power to prevent a manufacturer from raising prices without the Secretary of State's approval. Sections 34 to 38 of that Act provide for statutory regulation of prices and profits in respect of those pharmaceutical companies which are not members of the voluntary scheme. Napp has not challenged the essence of the description of the PPRS at paragraphs 125 to 135 of the Decision.

162. As the Decision points out at paragraphs 125 to 130, the essential feature of the PPRS is that it imposes a limit on the rate of return (measured as a percentage return on capital employed on sales) that a company can earn on its sales of branded prescription medicines to the NHS. That profit limit is applied across all the products that a company sells to the NHS and is not applied to each product individually. Under the terms of the current PPRS, companies are allowed a rate of return on capital (ROC) of 21 per cent from home sales of NHS medicines with an upward margin of tolerance of 40 per cent. Companies exceeding the margin of tolerance (i.e. with an ROC over

29.4 per cent) are required to repay any excess to the Secretary of State. The scheme sets out rules on the allocation of costs and capital and has specific rules for the treatment of research and development and promotion costs. The scheme also requires participating companies to provide an annual financial return so that the Secretary of State is able to monitor participating companies' returns.

163. Under the terms of the PPRS, companies are free to set the NHS list prices of new branded products involving new molecules, although any resultant profits in excess of the ROC ceiling laid down by the scheme would be repayable to the Secretary of State. In the case of drugs which, like MST, are a new formulation of an existing chemical entity (i.e. morphine sulphate), their initial price is subject to confirmation by the Secretary of State. Once prices are set, the PPRS restricts increases. In some circumstances, however, companies may "modulate" their prices by increasing some prices and decreasing others, provided that the overall effect is cost neutral to the NHS. Periodically the Department of Health has negotiated an across the board price cut on all branded medicines sold to the NHS. In the context of the current PPRS a price cut of 4.5 per cent was negotiated to take effect from 1 October 1999. However, companies were permitted to lower some prices more than others, provided the overall effect was that of a 4.5 per cent price cut.

164. In our view the case law on the existence of a dominant position, cited above, directs our attention to the competitive situation in the market place, and in particular to whether the allegedly dominant undertaking is able to "prevent effective competition being maintained on the relevant market". As seen from the foregoing, the PPRS does not have a direct effect on Napp's freedom to conduct itself as it wishes in the market for oral sustained release morphine. As regards the issue of dominance, the effects of the PPRS are at most remote and indirect, in that the scheme might in some circumstances constrain Napp from increasing the price of MST (an issue not relevant here) and may similarly constrain Napp's profits on its range of NHS branded medicines taken as a whole, as distinct from MST in particular. In our view neither of those indirect effects go to the threshold question of whether Napp has the degree of power in the market place necessary to bring the Chapter II prohibition potentially into play.

165. The fact that the initial price set for MST in 1980 *may* have been constrained by the PPRS (see paragraph 408 below), and has been reduced since in the context of across the board reductions agreed under successive schemes, could, perhaps, be relevant to the Director's allegation that the community price for MST was excessively high, as could, perhaps, Napp's argument that the

portfolio based approach of the PPRS is to be preferred, when it comes to determining whether the price of MST is excessive for the purposes of the Chapter II prohibition. But those arguments which in any event we reject at paragraphs 406 et seq below, go to the question of *abuse*, and not to the prior question of the existence of a dominant position.

166. On the issue of discounts to hospitals, the current PPRS does not contain any provisions on discounts or any means of regulating Napp's discounts. As far as we can see, neither the current scheme nor its predecessors has or had any bearing on the question whether discounts have been used to exclude competitors, as the evidence of Mr Brownlee makes clear.

167. In Case T-228/97 *Irish Sugar v Commission* [1999] ECR II-2969 the Court of First Instance rejected the appellant's plea that its policy on offering certain rebates was in accordance with the policy of the Irish government in the following terms:

> "If anti-competitive conduct is required of undertakings by national legislation or if the latter creates a legal framework which itself eliminates any possibility of competitive activity on their part, Articles 81 and 82 do not apply. In such a situation, the restriction of competition is not attributable, as those provisions implicitly require, to the autonomous conduct of the undertakings ... Articles 81 and 82 may apply, however, if it is found that the national legislation does not preclude undertakings from engaging in autonomous conduct which prevents, restricts or distorts competition ..."

(paragraph 130).

168. In our view nothing in the PPRS affects Napp's autonomous conduct in such a way as to deprive Napp of its dominant position, as the Director found in paragraphs 122 to 136 of the Decision. Moreover, on Napp's argument virtually the entire pharmaceutical industry of the United Kingdom would be outside not only the scope of the Chapter II prohibition but also Article 82 of the Treaty. The decisions of the Commission cited by the Director at paragraph 137 of the Decision are contrary to that point of view.

169. For these reasons we are satisfied that Napp has a dominant position in the supply of tablets and capsules of oral sustained release morphine in the United Kingdom.

**VII – ABUSE: DISCOUNTS TO HOSPITALS**

170. In dealing with the issue of abuse, we follow the structure of the Decision in dealing first with discounting to hospitals, and then with excessive prices in the community segment of the market. We remind ourselves, at the outset, however, of the Director's fundamental submission that the

hospital segment of the market is the only viable point of entry into the market as a whole. Hence the alleged abuse in the hospital segment, while a discrete abuse and significant in its own right, is also, says the Director, a means to an end, namely the preservation of Napp's prices and market share in the much larger community segment of the market. Although we analyse the two abuses separately, the connection between the hospital and community segments must be borne in mind throughout this judgment.

A. ARGUMENTS OF THE PARTIES

***Napp's arguments***

171. Napp does not dispute the cost and market share figures put forward by the Director, nor the fact that Napp offers MST to hospitals at prices below direct costs, accepted in this case as a proxy for average variable costs. Napp, however, argues that its conduct is not abusive, on the basis of what appear to be seven main arguments.

172. Napp submits, first, that its discounts are the result of normal competition in the market.

173. Napp states that until 1991, it offered only modest discounts to hospitals. From 1991 onwards first Farmitalia, and then BIL, started offering much cheaper prices to hospitals. In consequence, "Napp simply aimed to match the prices they were offering". According to Napp, prices fell below average direct cost at some time in 1998 (a date disputed by the Director who says it was 1996), but it was not Napp which led prices down. Moreover, discounting to hospitals is consistent with normal commercial practice: see the evidence of Mr Tebby, a hospital pharmacist in Leeds, and various statements said to have been made by officials of the Department of Health.

174. Secondly, and more fundamentally, Napp submits that its sales below cost to hospitals are incrementally profitable on what Napp describes as a 'net revenue' basis.

175. According to Napp, its Internet Survey shows that, for each unit of oral sustained release morphine sold to a hospital, a supplier can expect to sell 1.35 "follow-on" units of its brand of oral sustained release morphine in the community(see the report by Nera, *Key Market Evidence in the Supply of Slow Release Morphine*, 16 October 2000, document A19). According to a further Nera report entitled *Napp: Analysis of OFT Decision on Abuse*, 29 May 2001 (document A107), even at Napp's highest level of discount, "the overall transaction" (i.e. the sale of MST to hospitals at the

hospital price plus the sale of "follow on" units to the community segment at the community price) is profitable. Such transactions cover not only Napp's average variable costs, but also Napp's average total cost: see Table 2.2 of document A107. Even assuming that one unit of hospital sales led to the sale of only 0.25 follow-on units in the community, Napp would still be covering its average total costs: see Table 2.3 of document A107. Even at the reduced NHS prices required by the Directions, the hospital prices currently charged for MST would be profitable for Napp (i.e. cover average total costs), once the follow-on sales are taken into account, so long as one unit sold in a hospital generated at least 0.30 units of follow-on sales in the community sector: Table 2.4 of document A107. It would require a linkage of only 0.04 follow-on units for Napp to cover its direct costs.

176. According to Napp, it is this "externality" of the "follow-on" effect, where one loss-making sale may generate other, profitable sales, which distinguishes this case from the decision of the Court of Justice in *AKZO*. According to Napp, a comparable case would be if the suppliers of razors sold them very cheaply but made their profits on razor blades. The Director's own guidance in *Assessment of Individual Agreements and Conduct* (OFT 414, September 1999) confirms that a "net revenue test" is perfectly acceptable in principle. Even a modest follow-on effect is sufficient for Napp's purposes, whether or not hospital discounting 'expands the market', or leads to additional GP prescriptions (which it does).

177. In support of its argument, Napp relies on the evidence of Mr Paul Manners, Managing Director of Napp Pharmaceutical Holdings Limited, who states at paragraph 60(ii) of his witness statement of 13 October 2000 annexed to the notice of appeal:

> "Napp considers that it makes sense to discount MST substantially to win hospital contracts, to take account of the fact that there is some linkage, albeit one that it is difficult to quantify, between sales in hospitals and sales in the community. Given that, under the PPRS, Napp can charge prices for its community sales which generate a profit margin of some [...] [in excess of 80]%, Napp does not need to stimulate many sales in the community to justify a substantial discount of its prices to the hospital sector. Thus Napp can afford to discount its prices to hospitals substantially, even on the basis of a fairly modest assumed linkage between hospitals and community sales, and the hospital sales will still be profitable.
>
> In short, we did not believe that, by discounting our prices to the extent that we did to win hospital contracts, we would be making losses; instead we believed that, if we were successful in winning contracts, we would thereby make extra sales, because we could expect to sell extra units of MST in the community segment, by virtue of the "linkage" referred to in paragraph (ii) above. We assumed that all bidders were

evaluating the opportunities in the same way, and were willing to offer discounts on the same basis."

178. Furthermore Mr John Brogden, Managing Director of Napp Pharmaceuticals Limited, states at paragraph 20 of his witness statement of 25 May 2001, also annexed to the notice of appeal:

> "Moreover, I have at all material times believed that Napp's discounts to hospitals represented a fair and normal means of competition: Napp was keen to win hospital contracts, in recognition of the follow on benefits which they bring, in terms of community sales. I believed that other suppliers would also recognise those benefits and, indeed, I believed that that was why other firms (first Farmitalia, then Boehringer Ingelheim and now Link) were offering such low prices to hospitals."

179. According to Napp, the documents disclosed as a result of the Tribunal's order of 31 August 2001 are entirely consistent with the assumption that at least for the later 1990s onwards Napp was competing with BIL in the hospital segment on a net revenue basis in order to obtain the "linked" sales in the community segment. This was a rational strategy, and cannot be regarded as abusive simply because it may make it more difficult for a new entrant to succeed.

180. It cannot be suggested that Napp did not know of the linkages between the hospital and community segments, nor factor them into their pricing, as shown by the evidence of Mr Brogden and Mr Manners cited above. Mr Brogden's e-mail of 10 June 1996, and the e-mails relating to 1999 and 2000 at Annex 2 to the defence, disclosed in answer to the Director's request of 15 June 2001, confirm this. Mr Brogden's letter to the Director of 24 September 1999 was an "overview" but does show *a* "follow-on" effect. A small but significant linkage is sufficient for Napp's purpose.

181. Thirdly, Napp argues that similar "linkages" accrue to other suppliers, such that it is rational for them to compete with Napp on the same basis.

182. The fact that BIL and Link have been prepared to sustain below cost prices for long periods shows that those suppliers too believe in "the follow-on effect", otherwise they would have had no incentive to stay in business (document A107, paragraphs 1.1.2 and 1.3 to 1.4). The fact that BIL did not, apparently, secure the benefit of such linkages and left the market was, Napp suggests, due to failings in BIL's market strategy and had nothing to do with Napp's alleged 'aggression', which Napp denies.

183. That the benefit of such linked sales is available to Link is confirmed, says Napp, by a letter to the OFT by Mr Steven Mountain, the managing director of Link dated 3rd November 2000 (OFT document 255) where he says:

> "Proof of this link [sc. between hospital and community] can be seen in the sales of Zomorph capsules over the last year where the ratio of hospital sales volumes to community sales volumes is 1:4. Link only has a hospital sales team. We do not call or advertise to GPs at all, and so the only way that there are any sales of Zomorph capsules into the community is through hospital influence via referral and the other methods outlined above.
>
> The MST ratio is currently 1:8 and so it can be seen following conversions that a hospital has an immediate and direct influence over around 50% of community usage. The ratio for Zomorph capsules sales will rise further over time as hospital influence filters through to the community...
>
> We do not dispute Napp's second point that Napp makes money overall out of loss leading into hospital. For every 1 pack they sell into hospital we can see that immediately they would sell 4 into the community, and in the long term 8. ..."

184. In addition to this letter, upon which Napp strongly relies, Tables 2.5 and 2.6 in document A107 seek to show that, on a ratio of 1:1.35, Link could match Napp's MST prices to hospitals and still break even if its average total costs were three times those of Napp. Napp's figures, handed in at the hearing, show that a follow-on linkage of between 0.10 and 0.51 would suffice to cover Link's costs. According to Nera, "once Napp's hospital prices are considered as "system prices" by including the profitable follow-on community sales, the discounted hospital prices are profitable even for a small producer such as Link ..." (A107, p.17).

185. According to Napp, the witness statements of Mr Penrose and Mr Hartley, also confirm the existence of the linkages, and make it clear that a net revenue approach is a natural way of competing. Contrary to the Director's suggestion, the follow-on effect is sufficiently predictable to be relied on. The matters referred to at paragraphs 152 to 155 of the Decision do not establish the contrary: that evidence is unspecific and pre-dates the Health Act reforms of 1999. The Link documents produced by Mr Hartley clearly show that Link is aware of the linkage between the hospital and community sector and exploits it. Indeed in permitting Napp to price below average cost under paragraph 2(d) of the Directions, the Director himself implicitly recognises the existence of the linkages in question.

186. Moreover, says Napp, these linkages are reinforced by the development of PCGs/PCTs, which incentivize both hospital buyers and GPs to take more account of the overall cost of patients'

treatment when making prescribing decisions. These effects, says Napp, were already being felt by January 2000, just as BIL was leaving the market, and have been successfully exploited by Link, as shown by Mr Mountain's letter of 3 November 2000 and the evidence of Mr Hartley. Napp particularly criticises the Director for failing to take account of Mr Mountain's letter in the Decision, despite Napp's comments on that letter at the second oral hearing during the administrative procedure. In fact, Link's sales have grown substantially since May 2000, another fact not taken into account by the Director. Napp states, however, "for the avoidance of doubt" that it is not suggested that the linkage is entirely automatic, in the sense that no further effort is required on behalf of the supplier. According to its skeleton argument, what Napp means by 'automatic' is that "a supplier need expend no more effort than one would reasonably expect of a competent supplier" (paragraph 85).

187. Fourthly, Napp submits that the Decision is based on events in the period prior to March 2000, and does not address the very different market situation prevailing after that date.

188. Napp submits that the situation changed fundamentally following the withdrawal of BIL and the emergence of Link as Napp's principal competitor. Unlike BIL, Link does not always participate in tenders but goes direct to purchasing authorities and hospitals. According to Napp, Link has won three regional contracts. In two cases it has been placed on the regional list without having tendered, and in the third case the NHS PASA terminated Napp's contract mid-term to allow Link to bid. It appears that Link in fact undercuts Napp, at least on some contracts, so there is no question of price matching on the part of Napp. Since Napp learns of Link's activities after the event, there is an asymmetry of information which is in favour of Link, not Napp. According to Napp, the recent developments of PCGs/PCTs strongly favour Link.

189. As to the Director's argument that switching costs represent an obstacle to Link, Napp says that there is no proper quantification of such costs, and Mr Hartley's evidence suggests that these are not a "material obstacle to the use of linkages as a viable entry mechanism". The same is true of promotion costs. The advent of PCGs/PCTs is likely to eliminate the problem of switching costs in hospitals since it is the overall cost in the community/hospital combined which will become determinative.

190. Nor is it possible, says Napp, to draw any adverse conclusions about Link's profitability without knowing how costs are allocated within Link. The Director now accepts that Link is doing well

and not in danger of going out of business. APS Berk, Lanacher and CeNeS are potential new entrants. BIL's statements as to why it left the market are self-serving and dubious.

191. Fifthly, Napp argues that it has not foreclosed the community segment of the market as alleged by the Director.

192. Napp accepts "that it is well established that GP's prescribing decisions are influenced by hospital prescribing" (notice of appeal, paragraph 3.27). However, in choosing a brand of oral sustained release morphine, GP's will not, according to Napp, be influenced to any substantial degree by the mere fact that a new brand of oral sustained release morphine is used in hospitals. According to the Internet Survey, and the evidence of Dr. Forster (document A26, paragraph 20) most patients are initiated by the GP, without the involvement of the hospital doctor, and the GP will go mainly by his own experience. Although accepting that the influence of hospital prescribing habits is likely to be more important in the case of new drugs (document A26, paragraph 26), Napp submits that there is no evidence to quantify to what extent the sale of a new brand of oral sustained release morphine to hospital will itself contribute to the establishment of a "reputation" for that brand in the community segment of the market, nor to what extent the making of hospital sales is better than other available means of establishing such a reputation (e.g. direct promotion and marketing of the brand to GP's and community nurses, and general promotional activities, such as the sponsoring of medical conferences and the sponsoring of training for healthcare professionals). Napp submits that, even for new entrants, hospital sales do not represent the only means by which a new entrant may establish a reputation in the community segment of the market.

193. Sixthly, Napp argues that it has had no intention to eliminate competition.

194. According to Napp, the selective nature of Napp's discounts represent a competitive response to a competitive situation. The Director himself, in the Directions, accepts that there is likely to be a substantial difference between the community price and the hospital price.

195. In particular, there is no evidence of ill-will or predatory intent on the part of Napp during the period of the alleged infringement, notably vis-à-vis Link. Even by December 2000, Napp had not formulated a policy on how to respond to Link (see the documents at Annex 2 to the Defence). Similarly, there is no evidence, during the period of the infringement, of Napp's alleged 'aggression'. Link's documents annexed to Mr Hartley's witness statement suggest that they did

not expect Napp to retaliate in hospitals nor lower their prices in the community. Nor can the Director be permitted to prove an anti-competitive intent on the basis of the material disclosed in response to the Tribunal's request, since that material was not relied on in the Decision, and predates the period of infringement.

196. Seventhly, argues Napp, there is no sufficient causal connection between Napp's conduct and any alleged harm in the market place.

197. Given the structure of the market Napp could not reasonably have been expected to act any differently than it did and was responding to "circumstances beyond its control". Napp's only alternative would have been to cede the market to its competitors, which would have been wholly unreasonable and is not something required by the Chapter II prohibition. Moreover, had Napp not competed in the way it did, it would have risked losing all or most of its main hospital contracts, and thus its association with hospitals and its ability to use hospitals for testing new drugs. Moreover, there is no distortion of consumption (because the products are prescribed on medical grounds) and no discrimination between customers (because there is only one customer, the NHS).

198. In all those circumstances, concludes Napp, it has committed no abuse. A dominant undertaking is entitled to compete on the merits, and defend its own interests, provided its conduct is reasonable and proportionate. In *AKZO*, there was express evidence of intention to eliminate a competitor, and/or the absence of any economic rationale other than ousting a competitor. That is not the case here, notably because of the follow-on effect and Napp's legitimate reliance on the net revenue test. Similarly the decision of the Court of Justice in *Compagnie Maritime Belge* does not decide that "matching prices" is per se bad. It all depends on the facts, and neither *Compagnie Maritime Belge*, nor the decision of the Court of First Instance in *Irish Sugar*, both cited below, are in point here. In the present case, Napp's conduct has been reasonable and proportionate, within the bounds of normal competition on the merits, and with no intention to eliminate a competitor.

***The Director's arguments***

199. The Director relies on the facts and matters in the Decision. He points out that Napp is "superdominant", and remains so 20 years after the launch of MST. Napp's discounts to hospitals in the present case go far beyond the norm and have "significantly and very consciously" raised barriers to entry, in order to prevent entry into the hospital segment and protect Napp's price and

market share in the community segment. Pursuant to *AKZO*, the burden is on Napp to rebut the presumption of abuse to which its below-cost sales give rise. According to the Director, Napp's arguments based on 'follow-on effect' and 'linkages' fail to rebut that presumption.

200. As to "follow-on effect", the Director submits that the Internet Survey does not support the conclusion that every one unit of sustained release morphine sold in hospital will automatically generate 1.35 units sold in the community. Even accepting that the 15 per cent finding of the Internet Survey could be accepted "as a crude estimate at a national level over time" of a follow-on effect, resulting from hospital prescriptions and referral letters combined, the Director continues to maintain that any alleged follow-on effect is neither mechanistic, nor predictable, as found in paragraphs 152 to 154 of the Decision. In any event, says the Director, suppliers of oral sustained release morphine do not in practice compete for a "package" of hospital plus directly-linked community sales.

201. The Director accepted (transcript Day 3, p.17) that the likelihood was that, from Napp's point of view, there was some direct follow-on effect, where patients initiated on MST in hospital are subsequently prescribed MST in the community, such that Napp's hospital sales are, as a result, incrementally profitable, on average across the country over time, although at a ratio much smaller than 1:1.35, and not necessarily for each sale or even each region. However, according to the Director, the main commercial value to Napp of its below-cost sales to hospitals is not this narrow 'follow-on effect', but the exclusion of competitors from the essential gateway to the profitable community segment.

202. As a matter of principle, submits the Director, the net revenue test is not an answer to an allegation of abuse where the selling practices of a dominant firm operate as a means of foreclosure. He submits, on the basis of *Compagnie Maritime Belge* and *Irish Sugar*, cited below, that a superdominant undertaking such as Napp is not entitled to engage in a policy of price cutting aimed at impeding competitors entering one part of the market, while at the same time charging higher prices in another part of the market where there is no competitive threat. According to the Director, Napp's admitted policy of price matching is abusive, because of its exclusionary effect, irrespective of whether Napp has carried out a policy of undercutting. In this case hospital switching costs substantially erase the opportunities for Napp's rivals to gain hospital sales by offering still lower prices.

203. Furthermore, the Director emphasises, as he did in the Decision, that Napp's discounted prices to a level below direct costs are only granted on the dosage strengths where Napp faces competition, that is to say 10mg, 30mg, 60mg and 100mg, where the discounts are significantly greater than in respect of those dosage strengths where there is no competition (5mg, 15mg, 200mg). It also grants a higher discount of [...][in excess of 90] per cent where the regional contract is to be awarded exclusively. No cost savings have been put forward to justify this higher discount.

204. In any event, submits the Director, the net revenue test is not a legitimate defence because of the advantages which Napp has over its rivals, which gives rise to asymmetry in the market place as between Napp and its competitors, as the Director found in the Decision. As to the extent of foreclosure, the Decision (paragraph 181) indicates that Napp has foreclosed the principal and probably the only means of entry to the market. Paragraph 251 of the Decision indicates that the policy indirectly impeded competition in the whole of the relevant market. The approach at paragraphs 166 and 167 of the Decision is an alternative approach.

205. As regards BIL's reasons for withdrawing from the market, the Director maintains the position he took in the Decision and relies on the witness statements from Mr Connolly, and Mr Penrose to rebut Napp's assertions regarding BIL. With respect to Link, the Director contends that Link's market share is still negligible and that Link has not been making a profit due to the very low hospital prices, coupled with the very high promotional spend which is necessary to enter the market. According to the Director, there is no indication that the Health Act reforms of 1999 had any effect on the market share of MST or its price in the community during the period of the infringement, as stated in paragraph 121 of the Decision. There is nothing relevant about PCGs/PCTs in the notice of appeal, nor is it alleged in the notice of appeal that the market situation after 1 March 2000 was any different from the situation beforehand. According to the Director, there is only one potential new entrant and that at least two other companies have been deterred from entering the market by Napp's conduct.

206. Finally, says the Director, Napp was clearly aware of the exclusionary effect of its conduct and intended to eliminate competitors. That can be inferred from the evidence referred to in the Decision and also from the documents disclosed to the Tribunal.

B. THE RELEVANT LAW

207. In Case 85/76 *Hoffman-La Roche v Commission* [1979] ECR 461, which concerned a system of loyalty rebates operated by the dominant firm which made it difficult for competitors to enter the market, the Court of Justice stated at paragraph 91:

> "The concept of abuse is 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 a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods different from those which condition 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."

208. In Case 322/81 *Michelin v Commission* [1983] ECR 3451, which also involved a rebate system that tended to tie dealers to the dominant company, the Court said at paragraph 57:

> "A finding that an undertaking has a dominant position is not in itself a recrimination but simply means that, irrespective of the reasons for which it has such a dominant position, the undertaking concerned has a special responsibility not to allow its conduct to impair genuine undistorted competition on the common market."

209. In *AKZO* (Case C-62/86 *AKZO Chemie v Commission* [1991] ECR I-3359), where the dominant firm offered prices discounted below cost in order to force a competitor out of business, the Court held:

> "[70] Article 82 prohibits a dominant undertaking from eliminating a competitor and thereby strengthening its position by using methods other than those which come within the scope of competition on the basis of quality. From that point of view, however, not all competition by means of price can be regarded as legitimate.
>
> [71] Prices below average variable costs (that is to say, those which vary depending on the quantities produced) by means of which a dominant undertaking seeks to eliminate a competitor must be regarded as abusive. A dominant undertaking has no interest in applying such prices except that of eliminating competitors so as to enable it subsequently to raise its prices by taking advantage of its monopolistic position, since each sale generates a loss, namely the total amount of the fixed costs (that is to say, those which remain constant regardless of the quantities produced) and, at least, part of the variable costs relating to the unit produced.
>
> [72] Moreover, prices below average total costs, that is to say, fixed costs plus variable costs, but above average variable costs, must be regarded as abusive if they are determined as part of a plan for eliminating a competitor. Such prices can drive from the market undertakings which are perhaps as efficient as the dominant undertaking but which, because of their smaller financial resources, are incapable of withstanding the competition waged against them."

210. *AKZO* was followed in Case T-83/91 *Tetra Pak v Commission* [1994] ECR II-755), on appeal, Case 333/94P *Tetra Pak v Commission* [1996] ECR I-5951 ("*Tetra Pak II*"). The Court of First Instance, applying the criteria set out in *AKZO*, found that certain of Tetra Pak's prices were below direct variable costs, and in one case below average variable cost (paragraph 151), and had no other economic rationale other than ousting Tetra Pak's principal competitor (paragraphs 147 to 151, and 188 to 192 of its judgment). On the subsequent appeal the Court of Justice held at paragraphs 41 to 44:

> "41. In *AKZO* this Court did indeed sanction the existence of two different methods of analysis for determining whether an undertaking has practised predatory pricing. First, prices below average variable costs must always be considered abusive. In such a case, there is no conceivable economic purpose other than the elimination of a competitor, since each item produced and sold entails a loss for the undertaking. Secondly, prices below average total costs but above average variable costs are only to be considered abusive if an intention to eliminate can be shown.
>
> 42. At paragraph 150 of the judgment under appeal, the Court of First Instance carried out the same examination as did this Court in *AKZO*. For sales of non-aseptic cartons in Italy between 1976 and 1981, it found that prices were considerably lower than average variable costs. Proof of intention to eliminate competitors was therefore not necessary. In 1982, prices for those cartons lay between average variable costs and average total costs. For that reason, in paragraph 151 of its judgment, the Court of First Instance was at pains to establish – and the appellant has not criticised it in that regard – that Tetra Pak intended to eliminate a competitor. ...
>
> 44. Furthermore, it would not be appropriate, in the circumstances of the present case, to require in addition proof that Tetra Pak had a realistic chance of recouping its losses. It must be possible to penalise predatory pricing whenever there is a risk that competitors will be eliminated. The Court of First Instance found, at paragraphs 151 and 191 of its judgment, that there was such a risk in this case. The aim pursued, which is to maintain undistorted competition, rules out waiting until such a strategy leads to the actual elimination of competitors."

211. In Cases T-24-26 and 28/93 *Compagnie Maritime Belge v Commission* [1996] ECR II-1201, on appeal Cases C-395 and 396/96P *Compagnie Maritime Belge v Commission* [2000] ECR I-1365 ("*Compagnie Maritime Belge*"), a liner conference, Cewal, was found to have abused a dominant position on certain shipping routes between Europe and West Africa, by selectively lowering its freight rates to match the rates charged by its main independent competitor for ships sailing on the same or similar dates, a practice known as 'fighting ships'. It was not shown that the members of Cewal had incurred losses, only a reduction in profits. The Court of First Instance held at paragraph 146:

"[146] As has already been pointed out, it has been consistently held that whilst the fact that an undertaking is in a dominant position cannot deprive it of entitlement to protect its own commercial interests if they are attacked; and whilst such an undertaking must be allowed the right to take such reasonable steps as it deems appropriate to protect those interests, such behaviour cannot be allowed if its real purpose is to strengthen this dominant position and thereby abuse it (in particular, *BPB Industries and British Gypsum v Commission*)."

The Court of First Instance held that the purpose of the practice was to eliminate the conference's only competitor, and that, in any event, the response by Cewal to the situation which it faced was not reasonable and proportionate (paragraphs 147 and 148).

212. In his opinion ([2000] ECR I-1365) on Cewal's appeal to the Court of Justice, Advocate General Fennelly referred to paragraphs 71 and 72 of *AKZO*, and said at paragraph 127:

"127. Apparently, therefore, sales below average variable (or short-run marginal: *AKZO*, paragraph 70) costs are in effect presumed to be abusive. While it is usually rational to sell above average variable costs, because that permits some return on capital, where the market will not bear a higher price, it is not usually rational to sell below average variable costs. Marginal costs need not be incurred and business has no interest in incurring them so as to make a loss. A dominant firm would be permitted, however, to rebut this presumption by showing that such pricing was not part of a plan to eliminate its competitor."

213. After considering that even prices above average variable costs, yet still below average total or long-run marginal costs, (see *AKZO*, paragraph 72), must be considered abusive where it is established that they are part of a plan to eliminate a competitor, Mr Fennelly went on to consider the case where a dominant undertaking prices above average total costs. He concluded at paragraph 132:

"132. I would, on the other hand, accept that, normally, non-discriminatory price cuts by a dominant undertaking which do not entail below-cost sales should not be regarded as being anti-competitive. In the first place, even if they are only short lived, they benefit consumers and, secondly, if the dominant undertaking's competitors are equally or more efficient, they should be able to compete on the same terms. Community competition law should thus not offer less efficient undertakings a safe haven against vigorous competition even from dominant undertakings. Different considerations may, however, apply where an undertaking which enjoys a position of dominance approaching a monopoly, particularly on a market where price cuts can be implemented with relative autonomy from costs, implements a policy of selective price cutting with the demonstrable aim of eliminating all competition. In those circumstance, to accept that all selling above cost was automatically acceptable could enable the undertaking in question to eliminate all competition by pursuing a selective

pricing policy which in the long run would permit it to increase prices and deter potential future entrants for fear of receiving the same targeted treatment."

214. Dealing with the specific facts of *Compagnie Maritime Belge*, Mr Fennelly commented at paragraph 137:

> "137. In all these circumstances, the Court of First Instance committed no error of law in finding that the response of Cewal members to the entrance of G&C was not 'reasonable and proportionate'. To my mind, Article 86 cannot be interpreted as permitting monopolists or quasi-monopolists to exploit the very significant market power which their superdominance confers so as to preclude the emergence either of a new or additional competitor. Where an undertaking, or group of undertakings whose conduct must be assessed collectively, enjoys a position of such overwhelming dominance verging on monopoly, comparable to that which existed in the present case at the moment when G&C entered the relevant market, it would not be consonant with the particularly onerous special obligation affecting such a dominant undertaking not to impair further the structure of the feeble existing competition for them to react, even to aggressive price competition from a new entrant, with a policy of targeted, selective price cuts designed to eliminate that competitor. Contrary to the assertion of the appellants, the mere fact that such prices are not pitched at a level that is actually (or can be shown to be) below total average (or long-run marginal) costs does not, to my mind, render legitimate the application of such a pricing policy."

215. In its judgment in *Compagnie Maritime Belge* the Court of Justice held at paragraphs 112 to 120:

> "112. It is settled case-law that the list of abusive practices contained in Article 86 of the Treaty is not an exhaustive enumeration of the abuses of a dominant position prohibited by the Treaty (Case 6/72 *Europemballage and Continental Can v Commission* [1973] ECR 215, paragraph 26).
>
> 113. It is, moreover, established that, in certain circumstances, abuse may occur if an undertaking in a dominant position strengthens that position in such a way that the degree of dominance reached substantially fetters competition (*Europemballage and Continental Can*, paragraph 26).
>
> 114. Furthermore, the actual scope of the special responsibility imposed on a dominant undertaking must be considered in the light of the specific circumstances of each case which show that competition has been weakened (Case C-333/94 P *Tetra Pak v Commission* [1996] ECR I-5951, paragraph 24)."

After referring to the specific circumstances of the maritime transport sector, the Court continued:

> "117 It follows that, where a liner conference in a dominant position selectively cuts its prices in order deliberately to match those of a competitor, it derives a dual benefit. First, it eliminates the principal, and possibly the only, means of competition open to the competing undertaking. Second, it can continue to require its users to pay higher prices for the services which are not threatened by that competition.

...

119. It is sufficient to recall that the conduct at issue here is that of a conference having a share of over 90% of the market in question and only one competitor. The appellants have, moreover, never seriously disputed, and indeed admitted at the hearing, that the purpose of the conduct complained of was to eliminate G&C from the market.

120. The Court of First Instance did not, therefore, err in law, in holding that the Commission's objections to the effect that the practice known as 'fighting ships', as applied against G&C constituted an abuse of a dominant position were justified. ..."

216. Finally in Case T-228/97 *Irish Sugar v Commission* [1999] ECR II-2969 ("*Irish Sugar*"), which concerned notably the legality of certain border rebates, the Court of First Instance held (at paragraph 114) that in determining whether a pricing policy is abusive under Article 82 of the Treaty:

> "it is necessary to consider all the circumstances, particularly the criteria and rules governing the grant of the discount, and to investigate whether, in providing an advantage not based on any economic service justifying it, the discount tends to remove or restrict the buyer's freedom to choose his sources of supply, to bar competitors from access to the market, to apply dissimilar conditions to equivalent transactions with other trading parties or to strengthen the dominant position by distorting competition (*Hoffman-La Roche*, paragraph 90; *Michelin*, paragraph 73). The distortion of competition arises from the fact that the financial advantage granted by the undertaking in a dominant position is not based on any economic consideration justifying it, but tends to prevent the customers of that dominant undertaking from obtaining their supplies from competitors (*Michelin*, paragraph 71). One of the circumstances may therefore consist in the fact that the practice in question takes place in the context of a plan by the dominant undertaking aimed at eliminating a competitor (*AKZO*, paragraph 72; *Compagnie Maritime Belge Transports*, paragraphs 147 and 148)."

C. FINDINGS

***Preliminary analysis***

217. We observe, first, that the events described in the Decision cover the period before, and the period after, 1 March 2000 when the Act came into force. It goes without saying that there can be no infringement of the Chapter I and Chapter II prohibitions on any date earlier than 1 March 2000, notwithstanding that the Act received Royal Assent on 9 November 1998. Nonetheless, in a case such as the present it is impossible to understand the situation as it was during the period of alleged infringement – in this case the 13-month period from 1 March 2000 to 30 March 2001 – without also understanding how that situation arose as a result of facts arising before 1 March 2000. In our

view it is relevant to take facts arising before 1 March 2000 into account for the purpose, but only for the purpose, of throwing light on facts and matters in issue on and after that date.

218. Turning first to the market situation as it was from 1 March 2000 onwards, it is common ground that Napp's overall market share by volume in the relevant market (community and hospital segments combined) was stable at 95 per cent, as indeed it had been for many years. In the community segment, which itself represents 86 to 90 per cent of the whole, Napp's market share was 96 per cent. Again, that had been the case for many years. In the hospital segment, which accounts for only 10 to 14 per cent of the total market, but has a particular strategic importance as a point of entry, Napp's market share during the period of infringement was on average some 92 per cent. In that sector, Napp's market share increased from 77 per cent in 1997 to 90 per cent in 1999, and then to nearly 93 per cent in the first quarter of 2001, largely at the expense of BIL (see Table 3, at paragraph 28 above).

219. In these circumstances, there is no doubt in our minds that, from 1 March 2000, Napp had 'a special responsibility not to allow its conduct to impair genuine undistorted competition', as held by the Court of Justice in *Michelin* [1983] ECR 3451, at paragraph 57. It is well established that such a special responsibility may deprive a dominant undertaking of the right to adopt a course of conduct that would be unobjectionable if adopted by a non-dominant undertaking (Case T-111/96 *ITT Promedia v Commission* [1998] ECR II-2937, paragraph 139), but the actual scope of that special responsibility must be considered in the light of the specific circumstances of each case: *Compagnie Maritime Belge* [2000] ECR I-1365 at paragraph 114. We for our part accept and follow the opinion of Mr Advocate General Fennelly in *Compagnie Maritime Belge*, cited above, that the special responsibility of a dominant undertaking is particularly onerous where it is a case of a quasi-monopolist enjoying "dominance approaching monopoly", "superdominance" or "overwhelming dominance verging on monopoly" [2000] ECR I-1365 at paragraphs 132 and 137. In our view, Napp's high and persistent market shares put Napp into the category of "dominance approaching monopoly" – i.e. superdominance – and the issue of abuse in this case has to be addressed in that specific context.

220. As far as the history of the matter is concerned, there now seems little dispute. From the launch of MST in 1980, until Farmitalia entered the market in 1991, Napp's prices to hospitals were discounted only slightly from Napp's standard NHS list price. When Farmitalia, and later BIL, offered discounts to hospitals, Napp matched those prices. It appears that, after the (re)launch of

Oramorph in 1994, BIL offered higher discounts to hospitals, which Napp matched. Each time BIL came back with a higher discount, Napp matched again. As a result, by 1996 Napp's discounts to hospitals were some [...] [in excess of 90] per cent if Napp was the sole supplier. For the purposes of this judgment we are prepared to assume that the policy of offering higher discounts to hospitals was originally initiated by BIL. Similarly, it is unnecessary for us to make any finding on whether there were occasions on which Napp undercut BIL. For the purposes of this judgment, it is sufficient to find that Napp pursued a policy of matching BIL's prices.

221. By at the latest 1998 (or 1996 as contended by the Director) it is common ground that, on four strengths of tablets, 10mg, 30mg, 60mg and 100mg, Napp's prices were below the direct cost to Napp, i.e. materials and labour. According to Table 5 of the Decision, during the period of the infringement the average prices and average direct costs of these tablets were:

| | **Average direct costs (£ per pack of 60)** | **Average hospital price (£ per pack of 60)** |
|---|---|---|
| 10mg | [ ... ] | [ ... ] |
| 30mg | | |
| 60mg | | |
| 100mg | | |

222. As stated in paragraph 191 of the Decision, in many instances during the period of infringement the actual price offered to hospitals on those four strengths was even further below the average direct cost, as the following figures show.

| | **Average direct costs (£ per pack of 60)** | **Typical actual hospital prices (£ per pack of 60)** |
|---|---|---|
| 10mg | [ ... ] | [ ... ] |
| 30mg | | |
| 60mg | | |
| 100mg | | |

223. According to Annex 4 of the Defence, which has not been contested, these lower prices, representing a discount of some [...] [in excess of 90] per cent, applied during the period of the infringement in 11 out of the 17 contracting regions there shown. Napp has not contested the

statement, at paragraph 191 of the Decision, that such prices are well below direct costs, by up to [...] [in between 30 to 50] per cent, and do not even cover raw material costs.

224. The above prices below direct costs are offered by Napp on strengths where Napp has faced competition, initially from BIL. The suggestion, at paragraph 146 of the Decision, that the price of the 5mg tablet has been above direct cost but below total delivered cost has not been pursued before us so we do not deal with it. As regards the other two strengths, 15mg and 200mg, it is not suggested by the Director that prices have fallen below costs. The strengths offered by Link, who entered the market in 1997, are 10mg, 30mg, 60mg, 100mg and 200mg, with the 10mg and 30mg being the largest selling lines.

225. On the uncontested facts the situation that presents itself in this case is therefore that of a virtual monopolist that has been selling at prices well below direct cost, and doing so selectively on those tablet strengths where it has faced competition (with the apparent exception of the 200mg tablet where Link has a competing product).

226. At paragraph 71 of *AKZO*, cited above, the Court of Justice said:

> "[71] Prices below average variable costs (that is to say, those which vary depending on the quantities produced) by means of which a dominant undertaking seeks to eliminate a competitor must be regarded as abusive. A dominant undertaking has no interest in applying such prices except that of eliminating competitors so as to enable it subsequently to raise its prices by taking advantage of its monopolistic position, since each sale generates a loss, namely the total amount of the fixed costs (that is to say, those which remain constant regardless of the quantities produced) and, at least, part of the variable costs relating to the unit produced."

227. The Court of Justice subsequently held in *Tetra Pak II*, cited above, at paragraphs 41 and 42:

> "Prices below average variable costs must always be considered abusive. In such a case, there is no conceivable economic purpose other than the elimination of a competitor, since each item produced and sold entails a loss for the undertaking.
>
> ...
>
> For sales of non-aseptic cartons in Italy between 1976 and 1981 ... prices were considerably lower than average variable costs. Proof of intention to eliminate competitors was therefore not necessary."

228. On the basis of *AKZO* and *Tetra Pak II*, and having regard to our duty under section 60(2) of the Act to secure, so far as compatible with Part I of the Act, that there is no inconsistency between the principles we apply and the principles laid down by the Court of Justice, in our judgment it follows,

on the foregoing facts alone, that Napp has abused its dominant position in offering prices below average variable costs to hospitals contrary to the Chapter II prohibition, as the Director found in the Decision, without it being necessary to find that Napp had a specific intention to eliminate competition. In view of the fact that the *AKZO* approach was laid down in a case where the dominant undertaking had only 50 per cent of the market, it seems to us that it is only in the most exceptional of circumstances that a similar approach should not be applied in cases of "superdominance" where the undertaking concerned has around 95 per cent of the market.

229. It is true, however, that in paragraph 127 of his opinion in *Compagnie Maritime Belge*, Advocate General Fennelly stated that while sales below average variable costs (for which in this case direct costs are considered to be a proxy) are "in effect presumed to be abusive", he went on to say that "a dominant firm, would be permitted to rebut this presumption by showing that such pricing was not part of a plan to eliminate its competitor". In view of the remarks at paragraphs 132 and 137 of his opinion, we doubt whether Mr Fennelly would necessarily have taken the same approach on this point had he been considering a case, such as the present, of a virtual monopolist selling well below direct costs. Nonetheless, as a precaution we consider in this judgment whether it is shown that Napp had no plan or intention to eliminate competition, so as to bring itself within the exception to the *AKZO* test envisaged by Mr Fennelly.

230. In that connection we begin by considering Napp's fundamental argument that the *AKZO* and *Tetra Pak II* approach is not the right starting point in this case because, properly understood, Napp's hospital sales did not "generate a loss" because of the "follow-on effects". That issue has to be considered also in the light of *Compagnie Maritime Belge* and *Irish Sugar*, cited above, which show that even if the prices of a dominant firm remain above costs, and simply match the price of a competitor, there may still be an abuse, at least where a superdominant firm is concerned, if the reduced prices in question are made on a selective basis and have no economic rationale other than the elimination of competition.

***Napp's "net revenue" defence***

231. Napp's core argument, shortly stated, is that its hospital sales have in fact always been profitable when one takes account of the 'net revenue' resulting from both the sale in the hospital and the 'follow-on' sales in the community to which the hospital sales give rise. This 'linkage' says Napp, is equally available to its competitors.

*Clarification of terms*

232. Some confusion has arisen in this case as a result of the varied use of terminology, principally by Napp, in such expressions as "follow on effect", "follow on units", "follow on benefits", "linked sales", "linkages", "hospital influence", "referral business" and "reputational links". We therefore begin by attempting to clarify the meanings of these terms. In our view it comes down to two rather different concepts which can be best expressed under two headings, namely the 'narrow follow-on effect' alleged by Napp, and 'hospital influence' respectively.

— *The narrow follow-on effect alleged by Napp*

233. As appears from paragraphs 148 and 149 of the Decision, Napp's case before the Director was that the Internet Survey (document A18) showed that on average in about 15 per cent of cases the brand of oral sustained release morphine prescribed by the GP in the community is determined by the hospital doctor's choice of brand. Using a multiplier of 9 (since the community sector is 9 times the size of the hospital sector), Napp concluded that each sale in the hospital would lead to the sale of 1.35 'follow-on' units in the community segment. On the basis of the various calculations carried out by Napp's economic consultants, Nera (document A29), Napp then argued that its hospital sales were profitable if one took into account this 'follow-on effect'. In other words, if one took the net revenue, from both the hospital sale and the 'follow-on' community sale combined, Napp was making a profit overall. Napp described this 'follow-on' effect as 'largely mechanistic' (see e.g. paragraph 34 of Napp's outline notes of oral submissions on the second Rule 14 notice). Napp distinguished this 'mechanistic' follow-on effect from the more broadly based and largely unquantifiable 'reputational links', which occur when the use of a particular brand of oral sustained release morphine in a hospital tends to establish that brand in the minds of GPs. The 'follow-on effect' thus relied on by Napp seems to have been understood by the Director as referring to a situation where a patient has been initiated on a particular brand in the hospital (i.e. there has been a supply in the hospital), and the GP then repeats the prescription when the same patient comes out of the hospital: see footnote 67 to paragraph 111 of the Decision.

234. As far as we can see, references in the Decision (e.g. in paragraphs 111, 150, 152 to 155, 157 and 158, 160, 165, and 166) to a "follow-on effect" are references to a follow-on effect in this narrow sense. However, Napp in argument has often used the expressions 'follow-on effect' or 'follow-on

linkages' or simply 'linkages' in a wider sense that in our view approximates more to the broader notion of 'hospital influence'.

— *Hospital influence*

235. In the course of this appeal, it has become apparent that the term 'follow-on effect' is not one that is in fact used by Napp or its competitors, but appears to have been coined by Napp's advisers for the purposes of this case.

236. Mr Brogden, the managing director of Napp Pharmaceuticals Limited and a businessman with long experience, told us that he had first come across the expression 'follow-on effect' when reading the papers for this case (Day 1, p.38). What Mr Brogden told us about was "hospital influence", or in his words "what I refer to as the hospital influence, what is now described as the follow-on business" (Day 1, p.48).

237. As we understand it, "hospital influence" is a phrase used in the pharmaceutical industry to describe the whole range of ways in which the fact that a drug is used in hospitals may affect the prescribing habits of GPs. This will include, in particular, what Mr Brogden referred to in a memo of 20 June 1994 as "referral" business, which is where a hospital doctor writes a referral letter recommending to the GP that the patient be prescribed a particular brand of drug. When such a referral letter is written, it may or may not be the case that the patient has been initiated onto the drug in the hospital. However, whether or not the patient has actually been prescribed the drug in hospital, the fact that the hospital stocks a particular drug will strongly influence the content of such referrals. More generally, the fact that a branded drug is used in hospitals will positively influence GPs to prescribe that brand.

238. In this judgment we use the phrase 'hospital influence' to include all the ways in which hospitals influence GPs' prescribing habits, including those cases where a patient is initiated in hospital and then returns to the community (the narrow follow-on effect), or the hospital specialist writes a referral letter, or use in hospitals enhances the reputation of the brand, or the hospital serves as a focus for disseminating information about the brand among GPs, pharmacists or nurses in the community. As we have said, when Napp has referred to "linkages" or "follow-on linkages", it has often seemed to us that Napp is really referring to "hospital influence" in this wide sense.

*The follow-on effect as alleged by Napp*

239. Dealing first with the follow-on effect in the narrow sense alleged by Napp, the Director, at paragraph 150 of the Decision, accepted "that there is a follow on effect between hospital and community sales and [that] Napp's figure of 15 per cent may serve as a crude estimate of this effect at a national level and over time", although he did not accept that such follow-on effect was mechanistic, or that it was equally available to Napp's competitors (paragraphs 152 to 159).

240. The Director, however, pointed out, in the defence, that closer analysis of the Internet Survey shows that the 15 per cent figure relied on by Napp for its "follow-on effect" comprised *both* cases where the hospital doctor wrote a prescription which was dispensed in the hospital, i.e. there was a *sale* in the hospital, and cases where the hospital doctor merely wrote a referral letter (e.g. after a patient had been referred to him for a consultation) recommending that the GP put the patient on to a particular brand of oral sustained release morphine but without writing a prescription which was dispensed in the hospital. Hence, argued the Director in the Defence, one could not use the figure of 15 per cent for working out a 'follow-on' ratio between *sales* to hospitals and *sales* to the community because the 15 per cent did not relate to *sales* in hospitals. He also challenged the 15 per cent figure on the ground that patients who had been initiated in hospital (e.g. cancer patients) would on average be treated in the community for a shorter time than other (non-cancer patients) initiated by their GP. For this reason also the 1:1.35 follow-on ratio could not be relied on.

241. These points have caused difficulty, first because neither point is taken in the Decision and, secondly, because, when the Director accepted the figure of 15 per cent at paragraph 150 of the Decision, he did not make clear that he did so on the basis that that figure includes both cases where a patient is actually supplied with MST by the hospital, *and* cases where the hospital doctor simply writes a referral letter without a supply in the hospital. The definition of 'follow-on effect', in footnote 67 of the Decision, would not appear to include the latter case.

242. Having examined the underlying material, it does appear to us from the Internet Survey (document A18) and the Nera reports (documents A19, A29 and A107) that the Director is right in his contention that the figure of 15 per cent is based on the question in that Survey "What proportion of your sustained release patients were initiated by you versus initiated by hospital/ recommendation?". In other words, that question refers *both* to cases where the patient is initiated

in hospital (i.e. there is a hospital sale), and where there is merely a hospital recommendation (but not necessarily a hospital sale). In Nera's report of 16 October 2000 (A19) Nera makes it clear that they are referring to "approximately 14.6 per cent of patients [who] consume a brand of SRM *heavily influenced* by the brand chosen originally by the hospital doctor ("follow-on linkages") (p.1), by reference to "a branded prescription *or referral letter*" (p.4) [emphasis added by the Tribunal].

243. We have no evidence as to what extent hospital doctors write referral letters recommending MST or issue prescriptions in circumstances where the patient is not supplied with MST by the hospital itself. In the absence of such evidence, it is difficult to rely on the Internet Survey as support for the proposition that, for every 1 unit *sold* in a hospital there is a "follow-on" sale in the narrow sense of 1.35 units *sold* in the community, because the 15 per cent figure includes cases where there is no *sale* in the hospital.

244. Similarly, it would seem to us over simplistic to use a multiplier of 9 to arrive at the ratio of 1:1.35, since a certain proportion of sales in a hospital (or hospice) will be to patients who do not return to the community, or who do so only for a relatively short time. Since we were told that hospitals themselves stock relatively small amounts of morphine, and that a hospital's individual purchases are small, it could turn out that any follow-on effect in the narrow sense alleged by Napp is rather small, but we simply have insufficient evidence about it. Napp's argument that the GP may, in any event, switch the patient from the brand prescribed in the hospital to his own preferred brand, supports the further conclusion that any such follow-on effect is not "mechanistic".

245. For these reasons we do not think it can be assumed that there is a follow-on effect of a narrow or mechanistic kind at a ratio of 1:1.35 as suggested by Napp.

246. However, the fact that we have examined these new points not made in the Decision does not in our view lead to procedural complications because the Director accepted in argument that in view of Nera's figures, only a relatively small follow-on effect in the narrow sense alleged by Napp would be sufficient to cover at least Napp's average variable costs. As we understood it, the Director was prepared to accept that on average, over time across the country, Napp's hospital business would be incrementally profitable, were it permissible to look at hospital and community sales together. Napp contends that this concession is sufficient for the purposes of its argument.

247. However, we have concluded that any such "incremental profitability" flowing from a follow-on effect in the narrow sense alleged by Napp, does not assist Napp's case.

248. In the first place, there is simply no evidence that Napp ever took into account any follow-on effect when setting or carrying out its pricing policy.

249. Thus, when replying to enquiries from the OFT in his letter dated 24 September 1999 to the Director, Mr Brogden said "Our experience over the last decade has shown that there is little correlation between discounting in hospitals and sales of MST in the Community" (OFT 1, p.38). That reply does not suggest that Napp was in fact taking into account, in setting its prices, what it later submitted to the Director was a 'mechanistic' follow-on effect since any such effect is effectively denied by Mr Brogden in that letter. Moreover that letter contains no reference to any 'follow-on' effect at all, in circumstances where it would be an obvious point to make in explanation of the rationale for Napp's pricing policy. Mr Brogden was not able satisfactorily to explain to us why no follow-on effect had not been mentioned in that letter, and we did not find his reference, in the witness box, to annex 3 of the same letter, to be persuasive: the whole thrust of the letter to the Director of 24 September 1999 was that there was no reliable or mechanistic follow-on effect.

250. By letter of 15 June 2001, following certain allegations by Napp in the notice of appeal as to how it set its prices to hospitals, the Director requested Napp to produce any documents which showed what factors Napp took into account in setting its prices for MST to the hospital sector (specifically in relation to certain particular contracts awarded in 1999 and 2000). Napp replied by letter of 4 July 2001 stating that

> "it had not located any documents which discussed follow on linkages and which suggested that on their face or from their context that such linkages are or should be taken into account in setting hospital tender prices."

Contrary to Napp's suggestion in argument, we do not find that the documents enclosed with that letter give rise to any inference that, in setting its tender prices, Napp took account of a follow-on effect in the narrow sense alleged by Napp.

251. When a dominant undertaking selling below cost contends that its policy is not motivated by an intention to eliminate competition but is based on some other, legitimate, commercial rationale, the best way for that undertaking to defend itself is by producing contemporary internal documents

showing that such a rationale did in fact form the basis of the company's policy at the material time. In the present case, Napp did not choose to do so, either in answer to the allegations made by the Director, or in the notice of appeal.

252. Even in reply to the Tribunal's request dated 31 August 2001 (see paragraphs 81 and 82 above), Napp has been unable to produce any document referring to or explaining the rationale for its hospital pricing policy for the period of four years from 1997 to the date of the Decision in March 2001. That period includes the period when, according to Napp, its prices to hospitals first went below direct costs, as well as the whole period of the infringement. Napp does not strike us as a naive or badly managed company. If its pricing policy had in fact been seen by Napp in the way that its economic consultants suggest, we would have expected the company's internal documents to demonstrate that.

253. As regards the documents which Napp did produce in reply to the Tribunal's request, relating to the period prior to 1997, those documents do not show that Napp ever took into account during that period the narrow follow-on effect which Napp now alleges: see paragraphs 315 et seq below.

254. While expert's reports are often relevant and helpful to understanding the issues with which this Tribunal has to deal, we find in this case that the idea of a 'follow-on' effect in the narrow or mechanistic sense relied on by Napp flows not from any internal documents from Napp but from the work done by Napp's economic advisers for the purposes of the present case. In our view such work does not carry matters any further forward in the absence of any evidence that Napp in fact took the theory upon which it is based into account in setting its prices: see *Tetra Pak II*, in the judgment of the Court of First instance, [1994] ECR II at p. 843.

255. In our view, what Napp was well aware of was not any follow-on effect in the narrow sense, but the strategic importance of hospital business, and the hospital influence thereby acquired, as the gateway to the community segment. Thus when Mr Brogden told us that Napp believed its hospital sales were profitable as a result of unquantifiable "follow-on business", what in our view he really meant was that the loss-making hospital business was still worthwhile for Napp if one took into account all the possible ways, notably referral letters, in which the influence of the hospital could lead on to sales in the community. In our judgment, for Mr Brogden, the "follow-on effect" was really the general and unquantified advantage to Napp of retaining for itself such "hospital influence", notably as a means of protecting its market share in the community segment.

256. In our judgment, that is confirmed by the documents disclosed in answer to the Tribunal's request of 31 August 2001, which we discuss at paragraphs 315 et seq below, and by the references to links between the hospital and community segments that could benefit Zomorph, to be found in the documents disclosed in answer to the Director's letter of 15 June 2001.

257. Moreover, in our judgment the 'net revenue' defence advanced by Napp, whether on the basis of the 'linkages' which may result from hospital influence, or on the basis of some narrow follow-on effect, is in any event conceptually and factually wholly misconceived, for the reasons we now give.

*Conceptual problems with Napp's net revenue test*

258. In our view, Napp's net revenue argument, whether based on the narrow "follow-on effects" alleged by Napp, or on the "linkages" resulting from hospital influence, has at least three conceptual weaknesses, taking into account the particular circumstances of the present case.

259. The first conceptual weakness is that the net revenue test, as applied simplistically by Napp, provides no yardstick for distinguishing between what is legitimate, and what is abusive, behaviour on the part of a dominant undertaking. For instance, a monopolist driving away new entrants by predatory pricing is likely to maximise his net revenue by so doing, for example by avoiding loss of market share and erosion of prices in the profitable market where he holds a monopoly. Yet plainly such behaviour does not cease to be abusive merely because it is profitable for the monopolist to engage in it. In our judgment, therefore, a "net revenue approach" cannot, standing alone, constitute a defence to a charge of abuse by a dominant undertaking, unless it is accompanied by clear evidence that there was no intention or effect of foreclosing the market and impairing competition.

260. This point may be illustrated by the circumstances of the present case. In this case (i) Napp is a virtual monopolist with a market share of 93 per cent in the hospital segment; (ii) the hospital segment is a key gateway to the community segment; and (iii) Napp is also a virtual monopolist in the community segment with a market share of 96 per cent. Let it be assumed, in Napp's favour, that there is some sense in which its loss-making hospital sales can be considered to be profitable for Napp if one takes into account the revenue from sales in the community segment which follow from hospital influence, for example, referral letters written by hospital doctors to GPs. However,

if those loss-making hospital sales also have the effect of excluding competitors, the very conduct which is profitable to Napp on a net revenue basis has at the same time the effect of eliminating competition. That in turn, protects Napp's revenues in the community segment. To then argue that the below-cost pricing in the hospital segment is justified by the revenues from the community segment is the equivalent of saying that anti-competitive behaviour which protects Napp's virtual monopoly can be justified on the basis of the profits made from the monopoly which the anti-competitive behaviour is designed to protect. The argument is circular, as the Director points out at paragraphs 151 and 195 of the Decision.

261. To put the point another way, in most cases of predatory pricing, the predator is willing to forego short-term profits, in the hope of recouping its losses on subsequent, more profitable, sales. In some cases the recoupment may take the form of raising prices again once a competitor is eliminated; in other cases it may simply be that it is well worth the cost of short-term losses in order to protect the profits that flow from a large market share. As the Director submitted in the present case, the fact that Napp's below-cost pricing in the hospital sector enables it to make money from 'follow-on' sales in the community sector merely signifies that the particular form of 'recoupment' available to Napp is more direct and more immediate than it is in other cases of predatory pricing.

262. For these reasons it seems to us that Napp's "net revenue approach" cannot displace the *AKZO* test as the correct starting point for the analysis of the abuse here in question. At best arguments based on a 'net revenue test' *may* be relevant to show that the dominant undertaking had "no plan to eliminate competition" so as to fall within the exception to the *AKZO* test recognised by Advocate General Fennelly, but not otherwise.

263. The second conceptual weakness in Napp's argument is its contention that hospital and community prices are 'system prices'. In our view that argument depends on establishing that what is being sold to the buyer is indeed a 'system', as might, at least theoretically, be the case of the sale of razors and razor blades, or photocopiers and toner cartridges. However, as *Canon KK v Green Cartridge Co* [1997] AC 728 (HL) makes clear, an essential aspect of the legitimate use of system pricing is that the buyer is in a position to evaluate the life-time, or system-wide costs, and so make a rational choice between competing possibilities (see the speech of Lord Hoffmann at pages 737 to 738). Here, that is not the case. During the period of infringement in this case, there were two separate groups of buyers, the hospital authorities, and the GPs respectively, rather than a single

buyer. Neither group of buyers was motivated to any significant extent to take account of the cost implications, for the other group, of his decisions, or had the information to do so rationally. In this case, it seems to us, what Napp has done is exploit not the connection, but the *disconnection* between purchasing decisions taken by the different component parts of the NHS, thereby maintaining widely different prices to the different purchasers concerned. That, in our view, is the exact opposite of "system pricing" as it is properly understood.

264. Even if, in the future, the activities of PCGs/PCTs may begin to alleviate the lack of any connection between the different NHS purchasing decisions with which we are concerned in the present case, it seems to us, on the evidence, that it may be some time before the prescribing decisions of individual GPs, and the purchasing decisions of hospital authorities, can sensibly be described as forming part of a "single system". They certainly did not do so during the period of infringement: see paragraphs 301 et seq below.

265. The third conceptual weakness in Napp's argument based on "follow-on effects" or "linkages", is that it presents only a small part of the total picture which needs to be examined. For the reasons already given, one cannot simply arrive at the conclusion that Napp's pricing to hospitals is in some sense "incrementally profitable", and stop there as if that shows conclusively that there is no abuse. First, in order to rebut the *AKZO* presumption, it is necessary to examine the market circumstances, in order to show that the pricing below average variable costs in question does not have the object or effect of eliminating competition. Secondly, as *Tetra Pak II*, *Compagnie Maritime Belge* and *Irish Sugar* show, the exact scope of the "special responsibility" of a dominant or superdominant undertaking has to be determined in the particular circumstances of each case. In our view, in the light of that case law, one cannot conclude that the Chapter II prohibition is not infringed merely on the basis of some kind of 'incremental profitability' without examining the effect of Napp's conduct on competition, how far Napp enjoys advantages over its competitors, and the evidence as to Napp's intentions. Napp's 'net revenue' approach does not address any of those matters.

266. The three conceptual weaknesses identified above lead us to the conclusion that Napp's net revenue approach in this case is wholly insufficient, in itself, to rebut the *AKZO* presumption that Napp's hospital prices below direct costs are abusive. That conclusion is reinforced by considering the specific market circumstances of this case from the point of view of the effect of Napp's

hospital pricing policy on competition, the alleged 'asymmetry' between Napp and its competitors, and finally, Napp's intentions. To those matters we now turn.

*The effect of Napp's hospital pricing policy on competition*

267. We accept, first, the Director's findings, at paragraphs 111 to 113, and 162 to 164 of the Decision, that hospitals play a central role in facilitating entry to the relevant market and represent a key strategic entry point for new competitors. The reason is that there are high barriers to entry to the community segment of the market, but much lower barriers to entry in the hospital segment.

268. The barriers to entry to the community segment are explained at paragraphs 104 to 113 of the Decision, which Napp has not seriously disputed (see paragraph 30 above). In brief, those barriers arise because Napp continues to have a high reputation among GPs. That reputation is a particularly strong influence in respect of products such as strong opioids, which are controlled drugs, where GPs are risk averse and reluctant to experiment with new products of which they have no direct experience. In addition – and subject to the effect of PCGs/PCTs which are not material for present purposes (see paragraphs 305 and 306 below) – GPs are not price sensitive and do not, individually, use morphine in large quantities. Promotional effects direct to individual GPs are likely to entail high sunk costs with little prospect of success, at least without the backing of hospital influence.

269. On the other hand, hospital purchasers are price sensitive, and much more willing to assess the relative efficiency of different brands and new products. As the Decision indicates, once the hospital agrees to purchase a particular brand, the supplier stands a chance of entering the community market. That is so first, because where a GP continues the patient on the brand on which he was initiated in hospital, he gains first-hand experience of the product. Secondly, hospital doctors may recommend a particular brand in their referral letters because they have become familiar with it in hospital. Thirdly, the fact that a brand is used in the hospital represents an independent endorsement of the brand, and influences GP prescribing practices (paragraphs 111 and 112, and 162 to 164 of the Decision). Link's evidence now adds a fourth possibility, namely that, once a hospital contract is gained, hospital authorities may themselves be prepared to be used as a channel of communication to dispense information about a new product to GPs, nurses and pharmacists in the community.

270. The importance of hospital influence is confirmed by Mr Roger Penrose, of BIL, who stated in his witness statement dated 12 July 2001 that:

> "The overall strategic importance of obtaining hospital usage was obvious, and was commonly accepted in the industry. It meant that the key pain management specialists (clinicians and nurses) would be endorsing our product in particular whenever clinicians referred out patients by brand, or specialist nurses, in constant contact with hospital practices, gave prescribing advice to GPs this could potentially have a major influence on the GPs prescribing habits." (paragraph 34)

271. Mr Mountain of Link put the matter even more forcefully when he explained in his letter of 3 November 2000 (OFT III, p. 1338) to the OFT, that

> "The reality is that hospital influence on the community prescribing is incredibly strong"

and that

> "the influence of the hospital in this market is profound".

Among the reasons Mr Mountain gives are that palliative care teams working in the community have been trained in hospitals, GPs invariably follow the hospitals' advice in referral letters, and GPs will be anxious to secure consistency of treatment as between primary and secondary care.

272. According to the witness statement of Mr Hartley of Link:

> "Link depends entirely on achieving a successful 'conversion' of a hospital to Zomorph as the basis for establishing a reputation and sales in the surrounding community segment of the market. This can only really be appreciated when one considers the way in which we inform GPs and retail pharmacists about our product." (paragraph 28)

Mr Hartley goes on to explain that Link's strategy is first of all to secure a hospital contract. Once that contract has been won, Link does not market directly in the community segment but seeks to persuade the hospital authorities to inform GPs, retail pharmacists and others that the switch to Zomorph has taken place, explaining the advantages, and if possible recommending that it should be prescribed as "Zomorph capsules". In addition Link's team spends time at the hospitals carrying out training for the personnel who will be using Zomorph on a day-to-day basis.

273. The evidence before us is that hospitals are the key, and indeed the only, viable point of entry from which a new competitor may aspire to penetrate the community segment because of the strength of the barriers to entry already mentioned. In our view, in this particular market, attempts to sell sustained release morphine direct to GPs without a significant hospital presence are likely to be

expensive and fruitless, and we reject any suggestion by Napp to the contrary. We have no reason to doubt the statement of Mr Mountain in his letter to the OFT of 3 November 2000 where he said, with reference to hospitals,

> "There is only one way into this market and Napp have the key to the gate"

274. In addition, although a significant presence in the hospital segment is a *necessary* condition for subsequently being able to penetrate the community segment, the evidence is that a hospital presence is not, in itself, *sufficient*. The experience of BIL was that, for whatever reason, a certain presence in the hospital segment did not, in fact, lead on to a significant market share in the community. We accept Mr Hartley's evidence, referred to above, that if and when Link gains a hospital contract, it is necessary to invest considerable further promotional effort in training the staff in its correct usage of the drug, in educating hospital consultants to specify Zomorph or slow release morphine capsules (as distinct from tablets) in referral letters, and in persuading the hospital authorities to inform GPs, nurses and pharmacists in the community about Zomorph as an alternative to MST. Napp itself accepts, in its skeleton argument, that such efforts will be necessary. In addition, switching costs for busy GPs, including the additional costs of learning new titrations, are likely, in our view, to add to the difficulties of entering the community segment.

275. Against that background, we accept the Director's argument that Napp's policy of matching competitors' prices in the hospital segment significantly hinders competition by adding an additional, strategic, barrier to the already high barriers to entry.

276. First, Napp does not dispute that it is impossible for another supplier to sell into hospitals unless they match the price of MST. Since Napp's prices are below, and in many cases, well below, direct costs on those tablet strengths where it faces competition, Napp's policy constrains its competitors to suffer substantial losses on their sales to hospitals. Mr Hartley's evidence is to the effect that Link has been making losses on Zomorph since it entered the market in 1997, as stated in paragraph 179 of the Decision. In our view, that evidence has not been effectively challenged, and we accept it.

277. The fact of having to match Napp's prices at below direct cost, probably for a long period, is likely to be a deterrent to a would-be entrant, or to be a reason for a new entrant to decide, after a period, to withdraw. At best Napp's policy of selling at below direct cost constitutes a substantial

additional hurdle to be overcome by a new entrant, who already faces the development and promotional costs associated with launching a new product, as well as the need to overcome Napp's strong first mover advantages, and the other barriers to entry we have already mentioned.

278. In addition we accept that the hospital faces substantial switching costs in moving away from MST. It is necessary to train doctors and nurses to administer the new drug and about its properties, as well as adapting the hospital computer systems. Mr Brogden in his oral evidence accepted that there is a substantial "hassle factor" involved in any change which is likely to favour the incumbent supplier, (Day 1, pp.44 and 45).

279. Moreover, even if another supplier matches the price of MST, in many cases the hospital has little incentive to switch its business to that supplier at all, because the value of the total annual purchases of slow release morphine by an individual hospital are now so small that it is hardly worth while doing so. On this point, Mr Hartley states at paragraph 44 of his witness statement:

> "The unique barrier that we face as a company trying to become known in this market place is Napp's practice of offering extreme discounts to hospitals making their product almost free. At the levels of discount in question the average hospital spend on MST tablets comes to something under £500 a year."

280. Even if a competitor were to undercut Napp's extremely low prices, and virtually give its products away, the savings to a hospital are now so small that the hospital would still have little incentive to switch. As Mr Hartley points out, the level of cost saving that Link is able to offer hospitals resulting from a switch to Zomorph is almost negligible, and has to be weighed against the significant switching costs they would have to bear. Mr Brogden's e-mail of 10 June 1996 makes the same point: "the total value of the purchases by an individual hospital are now so small as to largely negate any desire or reason for a hospital to move away from MST CONTINUS". This factor of "switching costs" (mentioned at paragraph 158 of the Decision) means that even if a new entrant is prepared to match or indeed undercut Napp's prices and sustain prolonged losses in the hospital segment for a substantial period, entry to the market is effectively blocked because Napp's policy of pricing below direct cost deprives the hospital of any incentive to switch.

281. Since the hospital segment is virtually the only point of entry into the community segment, it also follows that Napp's policy of pricing below direct cost has tended to foreclose not only the hospital segment, but also the possibility of new entry into the community segment as well. As the Director says at paragraph 166 of the Decision, the direct extent of that foreclosure can be measured by

adding Napp's share of the hospital segment to that part of the community segment which is directly foreclosed by the follow-on effect of hospital prescriptions (or referral letters) which directly refer to MST. That alone gives a direct foreclosure of some 24 to 27 per cent of the relevant market (paragraphs 160 and 167 of the Decision).

282. It is true that a substantial proportion of patients are prescribed MST by their GP without the intervention of the hospital doctor. It is also true that paragraph 167 of the Decision gives the impression that the Director considered that up to 40 per cent of the relevant market was foreclosed taking into account the "reputation effect". Nonetheless it seems to us that the Director is correct in saying, at paragraph 251 of the Decision, that the effect of Napp's pricing policy has been indirectly to impair competition in the whole of the relevant market. In our judgment, had it not been for Napp's low prices to hospitals other competitors would have gained hospital contracts from which they could have been expected to succeed, over time, in penetrating the community segment of the market, as a result of the "hospital influence" thereby acquired. Once such penetration began to be achieved, we see no reason why the availability of an alternative, cheaper, product to MST should not progressively have come to the attention of GPs, including those GPs who were accustomed to initiate patients without the intervention of a hospital doctor.

283. The point here is not simply that the use of a new brand of sustained release morphine in hospitals is likely to enhance the product's general reputation which, as Dr Forster accepts (A26, at paragraph 26), is more likely to be the case with new drugs. The point is that entry into the hospital segment gives a new competitor access to the only effective means of penetrating the community segment, at least initially, through hospital prescriptions repeated in the community, referral letters, and the dissemination of information by the hospital authorities, as well as general reputational effects. Napp has denied these possibilities to competitors by means of its hospital pricing policy. In those circumstances Napp can, in our judgment, fairly be said to have effectively, albeit indirectly or potentially, foreclosed the community segment of the market as a whole by blocking, to a substantial extent, the only viable point of entry.

284. We do not need to make a specific finding as to why BIL left the market, having decided to do so in February 2000 just before the Act came into force. It is sufficient to note that, during the period of infringement, and 20 years on since the launch of MST, Napp has continued to have 93 per cent of the hospital segment. There is only one other competitor, Link. Link, we were told at the hearing has, after some four years of effort, obtained some 22 hospital contracts out of a potential

of about 400. Although Link's share of the hospital segment has grown since the Director's investigation started from 1.7 per cent in 1999 to 4.3 per cent in 2000 and 7.3 per cent in the first quarter of 2001, that is no doubt partly due to BIL's departure. We regard Link's position as little more than a toehold – acquired at considerable loss over several years – in the face of Napp's share of 93 per cent in that segment. Link's share of the total market (hospital and community segments together) was just under 4 per cent by the first quarter of 2001, while Napp still had over 95 per cent of the total.

285. Neither the fact that Link has remained in the market, nor that there is, apparently, at least one confirmed new entrant in the foreseeable future (and perhaps other possibilities) mean that the barriers to entry and hindrance to competition faced by actual or potential competitors to Napp during the period of infringement were not substantially greater than they would have been but for Napp's policy of pricing below direct costs. In any event, it is unnecessary to wait until competition has actually been eliminated in order to establish an abuse: see *Tetra Pak II* at paragraph 44 of the judgment of the Court of Justice.

286. In a situation where the barriers to entry protecting an incumbent monopolist are already high, even a modest raising of further barriers by the pricing actions of that monopolist is potentially a serious matter. In this case, it seems to us that the effect of Napp's pricing policy in hindering competition has been significant. We accept the Director's view, expressed at paragraph 159 of the Decision, that it is not normal for a mature product such as MST to have actually increased its share of the hospital segment from 80 per cent in 1997 to 93 per cent in 2000. Even during the period of infringement, Napp increased its market share in the hospital segment from 91.9 per cent to 92.7 per cent.

287. More generally, it seems to us that the Director was right to conclude, at paragraphs 159 and 172 of the Decision, that it is not normal for pioneer brands to retain such a high market share, in either the hospital or community segment, for so long after patent expiry. The table presented by the Director at Annex 7 of the defence, by way of correction to Table 3.1 to Nera's Report of 29 May 2001, *Napp: Analysis of OFT Decision on Excess Pricing for MST* (A 106), shows, in general, substantial falls in market share following the expiry of a patent, often within two years of generic entry, although admittedly there is one unexplained exception shown in that table. Similarly, in the light of the comments made by the Director at Annex 8 of the defence, it does not seem to us that Napp's paper *Evidence on Other Therapeutic Markets* (A 112) establishes that it is normal for a

pharmaceutical product coming out of patent to maintain both its existing price *and* a virtual monopoly market share for prolonged periods. On the contrary, in our view, after patent expiry, one would normally expect some fall in price, or market share, or both, as competitive forces come to bear on the previously patented product. In the present case, that has not happened, *either* to Napp's prices, *or* to its market share, in the community segment. It has not happened to Napp's market share in the hospital segment. Even allowing for the fact that in this case Napp's actual or potential competitors represent branded, rather than generic, entry, in our judgment the overwhelming inference from the totality of the evidence is that Napp's prices in the community segment, and its market shares in both the hospital and community segments, have been protected, at least in part, by the foreclosure effects of Napp's hospital discount policy. Nor do we doubt that that was Napp's intention: see paragraphs 307 et seq below.

288. In our judgment the foregoing circumstances are very far removed from the matters considered in paragraphs 4.15 to 4.17 of OFT 414 *Assessment of Individual Agreements and Conduct*. It is true that those paragraphs can be read as suggesting that certain behaviour should not be regarded as predatory where a price cut is incrementally profitable to an undertaking on the basis of a net revenue test. We, for our part, accept that there may be some very limited circumstances in which a dominant undertaking could justify pricing below average variable costs for a short period on a net revenue basis (e.g. to expand the total market). However, it seems to us, for the conceptual and factual reasons we have already given, that any such "net revenue" approach cannot be applied where, as here, the result of the pricing conduct in question is to foreclose the market. In addition, in the present case, it is not in any realistic sense a question of Napp making significant *additional* sales – the classic justification for "loss leading" (see paragraph 194 of the Decision). The situation in the present case is that of a superdominant undertaking pricing selectively and below direct cost in order to *protect* a market share of 95 per cent from new entrants, and doing so as a long-term strategy rather than on a short-term basis. For those reasons we do not think that paragraphs 4.15 to 4.17 of OFT 414 have any relevance in the present case.

*Asymmetry: Napp's advantages over its competitors*

289. Napp, however, argues, that the 'linkages' between the hospital segment and the community segment which flow from hospital influence are equally available to its competitors. Since there is no reason why its competitors should not also compete on the basis that any losses in the hospital

segment can be made up on subsequent sales in the community segment, Napp submits that there was in fact a level playing field between itself and its competitors.

290. We accept that there is in a broad sense a potential "linkage" between the hospital and community segments in that, in general, "hospital influence" may lead on to sales in the community segment. We do not, however, accept that the existence of such a 'linkage', actual or potential, enables Napp's competitors to compete with Napp on equal terms. Nor, in our view, does the existence of such 'linkages' alter the fact that Napp's low hospital prices tend to eliminate, or at least significantly hinder, competition.

291. During the period of infringement the disparity between Napp's market share and that of its next largest competitor, Link, was 95:4 overall, 96:3 in the community segment and 93:7 in the hospital segment. Those figures do not support the argument that there was a level playing field.

292. The evidence of Nera which Napp has relied on before the Director and on this appeal does not support the argument that significant linkages are automatically available to new entrants. Thus, in Nera's Report of 26 October 2000 *Key Market Evidence in the Supply of Slow Release Morphine* (A19) it is stated at page 12 that:

> "[The data] shows that even where and when Zomorph succeeds in gaining access to hospitals, this has a minimal impact on its market penetration among GPs."

In relation to Oramorph the same report comments (p. 18):

> "there are only limited linkages between hospital and community sales of SRM. Most of the community market that is currently "captive" to MST cannot be won simply by winning some hospital contracts."

293. Mr Brogden in his letter dated 24 September 1999 to the Director, to which we have already referred, said "Our experience over the last decade has shown that there is little correlation between discounting in hospitals and sales of MST in the Community" (OFT 1, p.38). Again, that does not support Napp's subsequent argument that "linkages" are equally available to its competitors.

294. As regards Napp's suggestion that the low prices that BIL was prepared to tender for the regional hospital contracts indicate that BIL was competing for a profitable "package" which included "follow-on" sales in the community segment, Mr Penrose comments in his witness statement:

> "This is utterly mistaken. Where patients were prescribed Oramorph SR in the hospital, we made every effort to maximise the chances that patients would continue to be prescribed it subsequently in the community, but we could never be sure this would actually happen or to what extent. In many cases we found there was no significant follow-on effect."

295. As regards Link, Napp relies on a passage in Mr Mountain's letter of 3 November 2000, (paragraph 183 above) where he acknowledges that "Napp make money overall out of loss leading into hospital" Napp does not, however, quote Mr Mountain's last sentence in that passage:

> "This is why Napp aggressively defend the hospital business, and as a monopoly supplier why their pricing is predatory."

296. It is true that, according to Mr Mountain's letter, the ratio between Link's hospital sales and its community sales is 1:4. However, that figure simply states a fact, namely that Link has four times as many sales in the community segment as in the hospital segment. As Mr Hartley points out, Mr Mountain's letter does not mean that Link can or does operate on the basis that gaining a hospital contract will itself automatically produce consequential referral business in the surrounding community which is profitable when looked at as a package. He explains:

> "on the contrary it is only the application by Link of the various methods described above, which include, above all, harnessing the reputation of the hospital specialists and the PCG officials to communicate with GPs, nurses and retail pharmacists in the community that achieves vital sales growth" (paragraph 37).

297. In our view, the reality is that, in order to obtain any significant sales in the community, Link has to make very significant efforts and investment, (i) to gain a hospital contract in the first place, then (ii) to persuade hospital consultants to recommend Zomorph, and (iii) to persuade hospitals or PCGs/PCTs to inform GPs, pharmacists and community nurses about the product. What in our view Napp's hospital discounting policy does is to make it significantly more difficult for Link (a) to achieve step (i), and (b) to afford, or even justify, the investment necessary for steps (ii) and (iii).

298. In those circumstances, in our view, it is wholly artificial to argue that on quite small "linkages", Link's hospital sales can be incrementally profitable or that any such supposed 'incremental profitability' would be a sufficient basis on which competitors could sustain effective competition to Napp. Whatever the reason for BIL's withdrawal, the fact that they did withdraw provides no support for Napp's argument. The evidence is that Link's business has been loss-making since the

launch of Zomorph in 1997. It cannot be known how long Link could have stayed in the market had it not been for the present proceedings (and see paragraph 44 above).

299. Among the reasons why the potential availability of the "links" mentioned by Mr Mountain do not give rise to a level playing field are the following: (i) Napp has an established flow of profits from the community segment which can subsidise the losses on its hospital business, whereas a new entrant has to start from scratch without that advantage; (ii) Napp is in a position to impose its hospital prices on new entrants, thereby forcing them to incur losses on sales to hospitals over and above the normal costs of development and promotion associated with entering a new market; (iii) Napp as the incumbent supplier benefits from the existence of hospital switching costs which new entrants have to overcome; (iv) the low level of purchases by individual hospitals means that switching costs may prove an insuperable barrier to a new entrant; (v) with its established reputation Napp no longer has to incur additional costs of promotion in order to benefit from hospital influence in the community segment, whereas its rivals have to invest heavily; (vi) Napp has higher prices in the community segment than its rivals and thus can more easily recoup its losses in the hospital segment; (vii) any "linkage" is likely to be more reliable and predictable in the case of MST than other products because of Napp's established reputation; (viii) according to the Internet Survey, 30 per cent of patients with a hospital prescription or referral letter may be switched by their GP to another brand, which is most likely to be MST; (ix) where Napp has procured a sole contract, that will be an additional barrier to a new entrant; and (x) Napp has the benefit of its established position in the community segment in the large proportion of cases where a patient is initiated by a GP without the intervention of a hospital or a referral letter.

300. For these reasons, we reject Napp's argument that the 'linkages' upon which it relies are equally available to Napp's competitors. For the reasons already given at paragraphs 267 to 288 above, in our judgment the fact is that, whatever 'linkages' may exist, Napp's pricing policy to hospitals has succeeded over a significant period in hindering competition and raising barriers to entry to the significant disadvantage of its rivals.

*The market since 1 March 2000*

301. We do not accept Napp's argument that the Decision takes insufficient account of alleged changes to the market situation during the period of infringement.

302. We note, first, that there is no suggestion that Napp's hospital prices altered in any way during the period of the infringement from 1 March 2000 to 31 March 2001. Those hospital prices remained below direct cost on those strengths (10mg, 30mg, 60mg and 100mg) where Napp faced competition. In 11 out of 17 regions the contract prices were up to [...] [in between 30 to 50] per cent below direct cost, as already stated (paragraph 223 above). The continuation of Napp's below direct cost contract prices during the period of the infringement meant that Link could not bid for any of that hospital business without matching Napp's prices, and thus itself selling at a loss. Similarly, for the reasons already mentioned, the barriers to entry which those prices present to any supplier seeking to enter the market (taking account of switching costs and the small volumes purchased by individual hospitals) remained firmly in place. In all essential respects, therefore, Napp's prices continued to be a barrier to entry throughout the period of the infringement.

303. The evidence before the Tribunal shows that at least two contracts were renegotiated during the period of the infringement, Link being added on a shared basis, but it is not suggested that Napp took the opportunity to raise its prices on those occasions. Link's prices thus had to match Napp's. The evidence at Annex 4 to the defence indicates that certain other contracts were due to come to an end during the period of the infringement and our understanding is that these contracts were continued in Napp's favour at the same low prices. We were told in the context of the application for interim relief that, with few exceptions, Napp's contracts were terminable on three months' notice. We have no doubt that, had it wished, Napp could have ceased to offer prices below direct cost to hospitals during the period of the infringement. Napp chose not to do so.

304. We do not accept Napp's argument that Link's new-found tactic of going straight to hospitals rather than necessarily competing in the tendering process in the way that BIL had done represents a material change in the market situation. Napp's prices still represent a significant barrier to Link whether it approaches individual hospitals or participates in the tendering process. As regards the fact that in two regions Link has apparently succeeded in being added to the regional contract, once again Link has only achieved that by offering the loss-making prices forced upon it by Napp. We are not wholly clear from the evidence whether Link has, in fact, been able to participate in a third regional contract, but even if it has, we have already said that we have no reason to doubt that, as at September 2001, Link was supplying only some 22 hospitals out of a possible 400. Although the rate of growth in Link's market share in the hospital segment has accelerated slightly following BIL's withdrawal, Napp's market share in that segment has increased as well, from 90 per cent in

1999, to 91.9 per cent in 2000 and to 92.7 per cent in Q1 2001. That picture does not suggest to us that there was any material weakening of Napp's dominance during the period of the infringement, nor that the playing field became materially more level in the period since 1 March 2000.

305. As regards PCGs/PCTs, and the Health Act reforms of 1999, no ground of appeal was based on these developments in the notice of appeal, the only significant comments made being under the heading "Prospects for competition" in the factual part of that document. It was not argued in the notice of appeal that PCGs/PCTs, which started to come on stream in 1999 and 2000, had made any material difference to the market for oral sustained release morphine during the period of infringement from 1 March 2000 to 31 March 2001.

306. The material relating to PCGs/PCTs subsequently submitted by Napp, apparently largely taken from various websites, does not in our view take the matter much further. Among the few documents that were submitted to us on an agreed basis, the Kings Fund Tracker Surveys for 1999/2000 and 2000/2001, suggest to us that in the initial period of their operation PCGs/PCTs were likely to concentrate on purchasing policies for those drugs which represent a large proportion of the budget, rather than on drugs such as slow release morphine which according to the Decision (paragraph 121) have a relatively minor impact on their total budgets. It is true that in the documents produced by Mr Hartley of Link there is evidence that in some limited areas PCGs/PCTs may be beginning to have an impact in making GPs more aware of prescribing costs for sustained release morphine, and hospital purchasers more aware of such costs in the community segment. However, there is nothing to suggest that such developments had any material impact during the period of the infringement: see paragraph 121 of the Decision. In particular, during that period, the advent of PCGs/PCTs had no material effect on Napp's prices, nor its market shares, in either the community or hospital segments.

*Intention to eliminate competition*

307. Since we have found that Napp's policy of pricing below direct costs hindered competition and raised barriers to entry, to the significant disadvantage of its competitors, it is, strictly speaking unnecessary to examine Napp's intentions in order to establish an abuse: see *Tetra Pak II* in the judgment of the Court of Justice at paragraph 42. We do so for completeness.

308. The Director finds, in the Decision, that Napp pursued its pricing policy to hospitals with the intention of eliminating competition: see e.g. paragraphs 145, 181, 196, 201 and 202. He bases that view notably on (a) the fact that Napp's discounts were targeted on those strengths of tablet where Napp faced a competitor; (b) the fact that Napp's highest discounts of [...][in excess of 90] per cent were offered on sole contracts which by their nature were intended to exclude competitors; and (c) the absence of any other credible explanation for a policy of pricing below direct costs for a prolonged period, in circumstances, where Napp was protecting a market share of around 96 per cent in the community segment.

309. We accept the Director's submission that to establish an intention to eliminate competition it is sufficient to show that the undertaking concerned must have been aware or, at least, could not have been unaware, that its conduct was of such a nature as to eliminate competition: see the cases cited at paragraphs 450 and 456 below.

310. On that basis, and in the light of the facts that (a) Napp's discounts below direct costs were targeted selectively only on those tablet strengths where it faced competition; (b) Napp's lowest prices were given on sole contracts; and (c) in our view Napp and its senior executives must have been aware that its discounts had the object or effect of preventing or hindering competitive entry into the market, we are satisfied that the Director was fully entitled to come to the conclusion that Napp's intention was to eliminate competition, on the material before him at the time the Decision was taken.

311. The Director further invites us to take into account, on the issue of intention, the documents disclosed in answer to the Tribunal's request of 31 August 2001, on the ground that they go to the question whether Napp did have an intention to eliminate competition, and in particular to the credibility of Napp's assertions to the contrary. As already indicated, Napp submits that we should disregard these documents except to the extent that they are in Napp's favour (see paragraphs 127 to 130 above).

312. In our judgment, while these documents pre-date the period of the infringement, they explain the origins and motives of Napp's pricing policy. In the absence of any indication that Napp's intentions changed at any later date, and in the face of the company's continued assertion that it possesses no documents any later than 1997 which explain the policy it adopted, they are in our view evidence of what Napp's intentions were during the period of the infringement.

313. To remove any doubt on that point, Mr Brogden explicitly confirmed to us that Napp's policy had remained consistent throughout the 1990s and the period of the infringement. Mr Brogden said, in the context of questions about Napp's strategy as regards Link:

> "I can only say to you from my position that we always had a consistent strategy within the company. As you well know, we were facing aggressive pricing discounts by our competitors and they were constantly lowering their prices in the hospitals, apart from also having lower prices in the community, but they aggressively undercut our prices in hospitals and that has always been the case with the competitors that we have faced. Our strategy over the years to my mind has been absolutely consistent and you will see it, I think, repeatedly in the documents, that our strategy was to match those prices." (Transcript, Day 1, p.19.)

When asked about the absence of documents since 1997, he said:

> MR BROGDEN ... "I do not know whether I am right or wrong on this, but I can only attempt to explain it by the sense that our strategy over the years has not changed, and our strategy in terms of matching the prices that Boehringer created within the hospital market has, to some extent been perpetuated with Link also continuing to aggressively undercut our prices. In that sense there is ...
>
> THE PRESIDENT: So in relation to Link you have been following, broadly speaking, the same strategy that you followed with Boehringer?
>
> A. Yes, sir, broadly speaking, we have been following the same strategy. There are differences, but those are not of our making, and not our strategy.
>
> Q. But the strategy has remained consistent throughout?
>
> A. The strategy has remained consistent throughout, sir. If I may just say ...
>
> Q. Of course.
>
> A. ... because there is an important difference, the one thing that Boehringer seemed to do to my knowledge over the years was consistently submit tenders for the regional health authority contracts. These are the big contracts. It seems, as we have learned from our experience of late, that they [Link] have not consistently done that, but our approach has always been consistent in the sense of trying to match prices and submit tenders to hospitals." (Day 1, p 19)

314. Rule 20(2) of the Tribunal Rules provides:

> "The tribunal may admit or exclude evidence, whether or not the evidence was available to the respondent when the disputed decision was taken and notwithstanding any enactment or rule of law relating to the admissibility of evidence in proceedings before a court."

In the light of that Rule, in our view it is open to the Director to rely on the documents disclosed to the Tribunal even though they were not relied upon by the Director in the Decision (i) as evidence tending to rebut assertions made by Napp in the course of this appeal and (ii) as secondary support for the finding already made by the Director in the Decision, that Napp's intention was to eliminate

competition. Napp has had a very full opportunity to comment on the documents in question. We do not see any unfairness to Napp if we permit the Director to rely on them.

315. An extract from Napp's 1991 year end report states:

> "The launch of SRM-Rotard in tablet strengths of 10mg, 30mg, 60mg and 100mg, in identical colours to MST CONTINUS Tablets, is clearly the most important issue with which we now have to deal... We have agreed internally that we will match (beat, if necessary) their prices to hospitals and hospices."

316. In the period up to the end of 1993 Napp continued that policy on the basis that:

> "Farmitalia's approach has been to concentrate on hospitals and hospices by offering extremely low prices, which we have been forced to match in order to retain this important and influential business." (year-end report for December 1992).

and that:

> "an aggressive pricing policy is essential to prevent the adoption and acceptance of new competitors." (June 1993 mid-year report)

317. Following the launch of Oramorph by BIL, a Napp filenote of 25 March 1994 from Mr Chris Smailes to Mr Brogden and others stated that BIL's discounts were beginning to "hit home". In recommending a "pre-emptive strike mid-contract" Mr Smailes commented:

> "The effect, however, would be to deflate the vital element of Boehringer's promotional strategy and limit their opportunities to give Oramorph SR early success. It would also reaffirm that this is our market and any "would be" competitor may hurt us but will gain nothing for themselves."

318. In a memo dated 2 June 1994, Mr Smailes reported that he had become, "even more acutely aware of the potentially massive threat we face to our MST CONTINUS Tablet business." Mr Smailes proposed to reduce the price of MST in certain hospital regions to at least that of the Oramorph contract price. He concluded:

> "The above action is both immediate and uncompromising as a response to Boehringer's threat, and will hopefully signal to them that we are NOT leaving this market open to them..."

319. In a further memo of 17 June 1994 Mr Smailes undertook a review of the options facing Napp. He stated:

> "Clearly the 90% discount option would send an unequivocal message to Boehringer that there was no place for them in this market. We do not of course know what their

intentions are and can only assume that they would not be prepared to lose money in order to penetrate the market."

Mr Smailes' proposal was to "offer 80% discount prices and review the situation in the light of the outcome." Mr Brogden responded to Mr Smailes' memo on 20 June 1994 in the following terms:

> "I know there is a school of thought that argues that we should 'stuff Boehringer' by quoting substantial discounts, eg, 90%. However, I don't want to simply win the battle and lose the war by getting stuck with such low prices that our hospital sales have no absolute value (other than referral). It's the usual difficult balancing act. I'd be inclined to accept the proposal of 80% made by Chris providing that the contracts come up in such a sequence as to allow us to drop our price if we should fall at the first hurdle. If three significant contracts have to be completed at the same time then I would consider moving to 85%. Incidentally, Arthur, these judgments have to be made in relation to the cost of goods and you should encourage Chris to include these in future."

320. On 18 August 1994 Mr Smailes wrote a follow-up memo indicating that BIL had responded to Napp's reductions on a particular contract price. Mr Brogden's response, dated 19 August 1994, is recorded in manuscript on the memo as follows:

> "Chris I'd be inclined not to prevaricate. Simply match the prices."

321. Napp's December 1994 year-end report noted that:

> "In volume terms MST CONTINUS Tablets have done surprisingly well. Our aggressive stance towards Boehringer's pricing is certainly working although, of course, reducing our overall sales and profit. I have already reported that our discounts are around 80% on tender business ... Perhaps more significantly though we are preventing them from getting a "toe-hold" in the GP market."

322. Napp's mid-year report of June 1995 stated that the "key issue" facing Napp's domestic sales was "price pressure":

> "The cost of a drug is now the prime consideration with many if not most doctors. Unfortunately our major promoted products are highly exposed: MST continues to suffer severe price erosion from Boehringer's efforts. Recently Oramorph SR was offered on contract at 97.5% discount compared with MST."

The report goes on to identify under the heading "Competitor Activity",

> "(i) the continuing need to keep Boehringer at bay. This focuses particularly on the hospital contract market and those retailers supplying hospices."

323. The end of year report of December 1995 noted, under the heading "Major Products":

"The projected decline in cash sales for the tablets is in part due to the continued need for aggressive contract pricing to match Boehringer's (Oramorph SR) ..."

324. An internal email from Mr Brogden of 10 June 1996 explains to others in Napp what he describes as "two essential points" about BIL's pricing practices:

> "1. Perhaps understandably, they [BIL] felt hospital/hospice endorsement was very important to their market entry and aggressively undercut our own contract prices. As you appreciate, hospital endorsement (usage) can influence greatly the general practitioner and to prevent them gaining this foothold we also reduced our contract prices. They have now stabilised at the ludicrous figures you see in the table and whilst they are still half our price, the total value of the purchases by an individual hospital are so small as to largely negate any desire or reason for a hospital to move away from MST CONTINUS.
>
> 2. The above strategy [by BIL] was coupled with lower basic NHS price than MST. There are two reasons. Firstly, many hospitals appreciate the influence that their choice of drug has on the community general practitioner and believe therefore that they have a responsibility to make their choice of product with some regard to what the wider community will have to pay. Thus Boehringer use the lower Basic NHS price to persuade the hospital pharmacist – "not only will you pay less, but by following you the community, general practitioner will also pay less". Secondly, of course, the lower basic NHS price is simply placed in front of the general practitioner as a money saving device against the practice budgets."

325. The June 1997 mid-year report states as follows:

> "Our morphine preparations have done considerably better than anticipated. This reflects the introduction of MXL once-a-day morphine ... We have been very successful in containing our competitors though not without a continued erosion of prices when trying to keep them out of the hospital market."

326. Reading these documents as a whole, they seem to us amply to confirm that the commercial purpose of what Mr Brogden described in his e-mail of 10 June 1996 as the "ludicrous" level of discount was none other than to prevent BIL from gaining a foothold in the hospital segment, primarily because, as Mr Brogden said in that e-mail, "hospital endorsement (usage) can greatly influence the general practitioner". That Napp's policy was throughout "to retain this important and influential business" (December 1992) and thus prevent BIL "from getting a toehold in the GP market" (December 1994) is made explicit by a number of the documents cited above. Those documents thus explicitly confirm that Napp realised the importance of "hospital influence" and saw its policy of discounts to hospitals as part of a strategy to prevent competitors from entering the community segment. As Mr Smailes said in his notes of 25 March 1994 and 17 June 1994, Napp's intention was

"to reaffirm that this is our market and that any 'would be' competitor may hurt us but gain nothing for themselves."

and

"to send an unequivocal message to Boehringer that there is no place for them in this market."

327. In our judgment there is no credible evidence that Napp ever saw any justification for its hospital discount policy other than the need to exclude competitors from the hospital segment, and thus prevent them from gaining hospital influence which would, in turn, threaten Napp's market share in the community segment.

328. It is clear from Mr Brogden's memo of 20 June 1994, where he says that he does not want to be "stuck with such low prices that our hospital sales have no absolute value (other than referral)" that Mr Brogden did not see "referral business" as, in itself, a self-standing commercial justification for low hospital prices. That memo further demonstrates Mr Brogden's then view that "these judgments have to be made in relation to the cost of goods." As he told us in evidence, his preference would always have been "to make a profit on the sale of the unit to the hospital in its own right" (Day 1, p.34). In our view, the fact that at some point, in 1996 or, possibly, 1998, Napp's prices went below direct costs, was due entirely to Napp's policy of matching competitors' discounts, whatever the cost, so as to exclude competitors from the vital hospital influence.

329. In the light of all the material before the Tribunal, we do not feel that either Mr Manners, in his witness statement of 13 October 2000, nor Mr Brogden in his witness statement of 25 May 2001, gave us a full account of the reasons why Napp pursued its hospital discounting policy.

330. Mr Manners (see paragraph 177 above) states, in effect, that "it makes sense" for Napp to discount hospital prices because of the high margins it makes in the community segment. As we have pointed out (paragraphs 259 to 262 above), what this argument comes down to is the assertion that the hospital discounts which tend to protect Napp's virtual monopoly in the community segment are justified by the retention of the very high market share, and the high margins, which Napp earns from that monopoly. That argument, in our view, tends to confirm the existence of the abuse rather than justify it. Mr Manners also sought to persuade us that Napp's belief, and by implication its motivation, was that "if we were successful in winning contracts, we could thereby make extra sales". Leaving aside the fact that there were few 'extra' sales to be made, since Napp already had

96 per cent of the community segment, Mr Manners makes no reference to any internal documents which support his description of Napp's hospital pricing policy. Those we have seen in the course of these proceedings confirm that it was not simply a case of "making extra sales", but of a consistent policy of excluding competitors from the hospital segment.

331. Similarly, Mr Brogden told us in his witness statement of 25 May 2001, that "Napp was keen to win hospital contracts, in recognition of the follow-on benefits which they bring, in terms of community sales" (see paragraph 178 above), but made no reference to Napp's internal documents. Those documents in our view show that it was not simply a question of Napp being "keen" to win hospital contracts "in recognition of the follow-on benefits they bring", but rather of Napp's seeking to exclude competitors from the hospital segment. Mr Brogden's witness statement did not, in our view, tell us the whole story.

332. In addition, both Mr Manners and Mr Brogden assert Napp's belief that other suppliers were "evaluating the opportunities in the same way" and offering low discounts to hospitals "in recognition of the benefits that follow-on sales bring in terms of community sales". However, since (i) Mr Brogden asserted to the Director, in his letter of 24 September 1999, that Napp's experience "over the last decade" showed little correlation between hospital and community sales; and (ii) that Napp itself, as we have found, was setting its hospital prices with a view to eliminating competition, we find it hard to determine what Napp thought was in the minds of its competitors. Nothing in that evidence persuades us that Napp's intention was other than the elimination of competition.

333. However, as we have said (paragraphs 307 to 310), the documents disclosed in the course of the proceedings merely confirm the findings as to Napp's intention to eliminate competition already made by the Director in the Decision. We think that the Director would have been fully justified in coming to the same conclusion even without the documents in question.

***Conclusion on Napp's net revenue defence***

334. On the basis of the foregoing, we find on the facts that, during the period of infringement, (a) Napp's policy of selling to hospitals at prices below direct costs, and on a selective basis, had a significant effect in hindering competition in the hospital and community segments of the market for oral sustained release morphine; (b) existing and potential competitors of Napp seeking to enter,

or gain market share in, the hospital segment and, ultimately, in the community segment of the market, were placed at a significant competitive disadvantage by Napp's hospital discounting policy; (c) Napp's intention was, so far as possible, to eliminate competition by preventing or hindering market entry into both the hospital and the community segments; (d) Napp's primary motivation was not to make "extra sales", nor to make "an incremental profit" in recognition of the "follow-on benefits" accruing from hospital contracts, but to deny to its competitors a key means of entering the market for oral sustained release morphine in the United Kingdom through the gateway of the hospital segment.

335. In those circumstances, we reject Napp's submission that the *AKZO* test is not a proper starting point in this case. MST is sold to hospitals below direct cost. Those sales, when made, generate a loss. Such sales are thus presumed to be an abuse, in accordance with *AKZO* and *Tetra Pak II*.

336. Even assuming in Napp's favour that the *AKZO* presumption is not an irrebuttable presumption, the Director has satisfied us that there are no grounds for rebutting the presumption of abuse stated in *AKZO*. Napp's 'net revenue test' turns out, on examination, to be little more than a circular argument to the effect that it is, in a general sense, "profitable" for Napp to sell at low prices in hospitals in order to deny to competitors a toehold in the hospital segment and the "hospital influence" which might flow from that. Even accepting, at a general level, a "linkage" between "hospital influence" and sales in the community segment, we do not think there is any conceptual or factual reason not to apply the *AKZO* presumption in the circumstances of this case. As seen above, Napp's hospital pricing policy has prevented competitive entry on any significant scale and exploited the advantages available to Napp which are not available to its competitors. Moreover, there is no evidence to bring Napp within the possible exception to *AKZO*, left open by Advocate General Fennelly, to the effect that there was "no plan to eliminate competition". On the contrary, in the present case the evidence establishes that Napp's pricing policy was intended to eliminate competition, and in fact hindered competition to a significant extent.

337. Even if, contrary to our view, the "linkages" relied on by Napp could be prayed in aid to distinguish this case from *AKZO* and *Tetra Pak II*, we remind ourselves that Napp is a superdominant undertaking in both the hospital and community segments with, in consequence, a particularly onerous special responsibility "not to impair further the structure of the feeble existing competition", as Advocate General Fennelly said at paragraph 137 of his opinion in *Compagnie Maritime Belge*. As appears from the Court's judgment in that case, a dominant enterprise with

over 90 per cent of the market may commit an abuse if it selectively cuts prices deliberately to match those of a competitor, even if it is not shown that the undertaking has priced below total costs. In that case the dominant undertaking had eliminated the principal, and possibly the only means of competition open to its sole rival, thereby maintaining higher prices in the area not threatened by competition. There was a market share of over 90 per cent, and an intention to eliminate competition (paragraphs 117 and 118 of the judgment). As Mr Fennelly pointed out in his opinion (at paragraphs 135 and 137) it was a case of a superdominant undertaking which had selectively targeted competitors with discriminatory price cuts, implemented with relative autonomy from costs, with the aim of eliminating all competition.

338. Even on the view of the facts most favourable to Napp, most of the features of *Compagnie Maritime Belge* are present here, even though the factual context is different. Napp is a superdominant undertaking with well over 90 per cent of the market. During the period of the infringement it had only one significant competitor, Link. Napp pursued its hospital pricing policy with the deliberate intention of eliminating competition, as the Director found. That policy was implemented by low prices targeted selectively against those strengths of tablet where Napp faced competition, with higher discounts being given for sole contracts. The policy ensured that the much higher prices and high market shares in the profitable community segment were not threatened by competitive entry through the gateway of the hospital segment. It seems to us, on those facts, that each of the features identified by the Court of Justice in paragraphs 117 and 118 of its judgment in *Compagnie Maritime Belge* are present here.

339. In those circumstances, in our judgment, Napp's 'net revenue test' arguments fall to be rejected, not only on the basis of the principles of *AKZO* and *Tetra Pak II* but also, and in any event, on the basis of the principles of *Compagnie Maritime Belge*. *Irish Sugar*, cited above, further shows that selective discounting by a dominant undertaking, without any economic justification, which tends to eliminate competition, is equally an abuse of a dominant position.

***Napp's other arguments***

340. It follows from the above that we reject Napp's argument that it has not "had recourse to methods different from normal competition" (*Hoffman-La Roche*, paragraph 91). We accept that in the pharmaceutical sector discounts granted to hospitals by pharmaceutical companies may be substantial. However, nothing in the evidence before us leads us to doubt (i) that discounts of up to

[...] [in excess of 90] per cent are not normal in hospital tenders; (ii) that such discounts have been granted selectively only where Napp has been faced by a competitor; and (iii) that the resulting difference between what the hospital pays and the normal NHS list price is exceptional – in some cases over 2000 per cent – as the Director finds at paragraphs 198 to 200 of the Decision (see Section VIII below). Perhaps more significantly, we do not regard it as "normal" for prices to hospitals to remain below direct costs for many years. For the reasons already given, we find that the below-cost pricing in question was not a 'normal' commercial response but the response of a superdominant undertaking aiming to eliminate competition. Nothing in the structure of the NHS compelled Napp to act as it did.

341. There is no evidence that Napp's selective discounts below direct cost were based on any "economic service" justifying them, such as cost savings, so as to fall within paragraph 114 of the judgment of the Court of First Instance in *Irish Sugar*, cited above. Nor does it seem to us "normal" that a pharmaceutical product out of patent, facing a number of other products considered to be therapeutically equivalent, should have maintained such high market shares, for such a long period, in both the hospital and community segments of the market, as we have already found (paragraph 287 above).

342. As to Napp's argument that it had no commercial alternative but to meet the competition offered by BIL, and later to maintain the same prices in competition with Link, a dominant undertaking is entitled to take reasonable steps to protect its own commercial interests if attacked, but only by means which are reasonable and proportionate. Moreover, the behaviour in question will not be justified if the real purpose of the undertaking is to strengthen its dominant position and thereby abuse it: see the judgment of the Court of First Instance in *Compagnie Maritime Belge* at paragraphs 146 to 148.

343. In our view, these principles are implicit in the "special responsibility" of a dominant undertaking, and even more so when it is a question of "superdominance" amounting to a virtual monopoly. By virtue of the Chapter II prohibition there is thus a certain limit beyond which a dominant undertaking may not go when reducing its prices, purportedly to "meet" competition, particularly when it is defending a market share of around 95 per cent. In a case such as the present, that limit is, at the very least, the point where its prices go below average variable cost, on a selective basis, in order to "see off" the competitor on the particular products where the dominant enterprise is facing competition, leaving other prices unchanged.

344. As *Tetra Pak II* and *Compagnie Maritime Belge* make clear, the freedom of action of a dominant undertaking, particularly a superdominant undertaking is still constrained, even where prices remain above average variable costs, or even above average total costs, if the price cutting is carried out on a selective basis, with the purpose of eliminating a competitor. If that purpose can be achieved by simply matching the competitor's prices, it is no answer to say that there was no undercutting: see *Compagnie Maritime Belge*, at paragraphs 113 to 119 of the judgment of the Court of Justice, and Mr Fennelly's opinion in that case, especially at paragraph 137.

345. For the reasons we have already given, we are satisfied that Napp's conduct went well beyond the limits to which the activities of dominant undertakings are subject by virtue of the Chapter II prohibition. On any view, we do not think that Napp's conduct can be described as "reasonable" or "proportionate", as the Director found at paragraph 202 of the Decision.

346. More specifically, we do not accept that Napp had no commercial alternative but to reduce its prices below direct costs. Even if Napp's hospital prices had remained above average total costs, in our view non-dominant competitors such as BIL or Link would still have faced difficulties in building up a significant market share in view of the high existing barriers to entry already mentioned. It is unlikely, in our view, that Napp would have lost all or even most of its hospital contracts.

347. Nor do we accept Napp's argument that it is placed in an impossible position if there is, legally speaking, a 'floor price' on its discounts to hospitals at the level of average direct costs or average total costs, because, according to Napp, competitors such as Link would be able to undercut Napp, making up their losses on hospital contracts by means of the profits from the community segment generated by the 'linkages' between the two segments.

348. First, we see force in the Director's view, expressed in his letter of 4 May 2001, that discounts offered by competitors would be unlikely to remain at their present levels if Napp's hospital prices were to rise. Link has already suffered considerable losses, which Link would have an incentive to minimise. Moreover, even with the benefit of the "linkages" which Napp asserts, it seems to us, on the evidence, that Link or any other new entrant, may still face some difficulties in establishing itself in either the hospital or the community segments, even on the basis of selling at low prices to hospitals, because of the substantial switching costs in both segments and Napp's existing dominant position.

349. It is also open to Napp to compete on the therapeutic qualities of what is no doubt an excellent product, and on the efficiency of its operations. More importantly, if Link or another new entrant began to secure more hospital business, and thereby threaten Napp's business in the community segment, in our judgment the correct response on Napp's part is not to engage in predatory pricing in the hospital segment, but, if necessary, to reduce its high prices in the community segment. That in our view would be "competition on the merits", which has so far been prevented by Napp's abusive conduct in the hospital segment.

350. As to Napp's point that paragraph 2(d) of the Directions permits Napp to price below average variable costs provided that it maintains the minimum permitted differential of 80 per cent between its hospital and community prices, that provision rightly reinforces our own view that the lawful competitive behaviour for Napp to follow, in response to competition, is to reduce its prices in the community segment. However, we take the view that there is a legal and practical difficulty, as regards paragraph 2(d) of the Directions, and we return to that issue in Section X of this judgment.

351. We observe, finally, that in his conclusion on abuse at paragraph 236(a) of the Decision, the Director has included as part of the abuse, at paragraph 236, subparagraph (i),

> "selectively supplying sustained release morphine tablets and capsules to customers in the hospital segment at lower prices than to customers in the community segment."

Although the Director has, in the Decision, rightly criticised the *extent* of the differential between Napp's prices in the hospital and community segments, it does not seem to us that, in the Decision, the Director has alleged that supplying the hospital segment at lower prices than the community segment is, *of itself*, an abuse. The Director has not addressed to us any detailed argument on this issue, nor made specific reference to subparagraph (i) of paragraph 236. If and in so far as the word "selectively" in subparagraph (i) is intended to add anything, the "selective" nature of Napp's discounts is already referred to in subparagraphs (ii) and (iii) of paragraph 236. It seems to us, therefore, that sufficient grounds have not been shown for upholding paragraph 236(a)(i) of the Decision if and in so far as that subparagraph is intended to identify an element of the abuse not otherwise covered by the rest of paragraph 236(a).

*Conclusion*

352. For all those reasons, we find that Napp has abused its dominant position in the supply of tablets and capsules of oral sustained release morphine in the United Kingdom by supplying hospitals at excessively low prices in the period from 1 March 2000 to 31 March 2001, as the Director concluded in paragraph 236(a) of the Decision. For the reason just given, we exclude from that finding paragraph 236(a)(i).

## VIII — ABUSE: EXCESSIVE PRICES

### A: ARGUMENTS OF THE PARTIES

*Napp's arguments in the notice of appeal*

353. The essence of Napp's case is summarised in the notice of appeal as follows:

> "Napp has not charged excessive prices for MST. The price of MST is set in accordance with the PPRS, and is a reasonable price, having regard to the objects of the PPRS, and the fact that its terms are calculated, inter alia, to provide an appropriate incentive to Napp and to other companies to invest in R&D to secure a new generation of drugs for supply to the NHS." (paragraph 4.1(ii)(a))

Napp relies very largely on Nera's report of 29 May 2001, *Napp: Analysis of OFT Decision on Excess Pricing for MST* (A 106) and a paper of 24 May 2001 prepared by Napp entitled *Evidence on Other Therapeutic Markets*, (A 112).

354. Napp's basic submission is that the PPRS and the Department of Health's powers under the PPRS and the Health Act 1999 are effective to prevent Napp from engaging in excessive pricing or exceeding "the competitive price" for MST. According to Napp, a competitive price for a pharmaceutical product should be one which,

> "... over the life cycle of the product as a whole, provides pharmaceutical firms ... with the appropriate incentive to invest in such R&D, education, training and promotion to the extent that consumers collectively are willing to fund such investment. Any such competitive price will take account of the *ex ante* uncertainty as to whether a particular product will succeed." (notice of appeal, paragraph 5.21)

355. According to Napp, these are precisely the factors underlying the PPRS, which thus properly takes into account questions which Nera describes as of "dynamic", as opposed to, "static" efficiency. For many years, Napp has been within the limits on ROC permitted by the PPRS. The Director is

incorrect to suggest, at paragraph 130 of the Decision that the limits set by the PPRS are "not restrictive". The pharmaceutical industry is a relatively high risk industry because of the amount of R&D required and the uncertainty of finding successful drugs. Napp's overall rates of return are well within reasonable limits for an industry of this kind.

356. Napp contends that the Director's alternative view is that competition should drive prices down to reflect long run marginal costs of manufacture, marketing and distribution, and that any price above that level is excessive. Such a view, according to Napp, disregards the particular features of the pharmaceutical industry. That industry is a research-based, innovative industry, in which a few successful "winners" must not only repay their own development and promotion costs, but must also fund the research and development of a large number of other products which do not cover their own costs, as well as ongoing research into new products, very many of which ultimately turn out to be unsuccessful. According to evidence cited by Napp, most pharmaceutical products fail to cover their development costs; it takes on average 10 to 12 years and more than £350 million to develop a new medicine; very few compounds are licensed; and only one in seven licensed compounds are commercially successful.

357. In these circumstances, says Napp, only a "portfolio-based" approach such as that of the PPRS, which assesses profitability across a range of investments made in conditions of "ex ante uncertainty", can evaluate whether a firm is enjoying excessive profitability. According to Napp, both European Community and United Kingdom law recognise the importance of portfolio pricing: see Advocate General Reischl in Case 262/81 *Coditel II* [1982] ECR 3381 at pp 3411, 3412 and Monopolies and Mergers Commission Report, *"The Supply of Recorded Music: a report on the Supply in the United Kingdom of Pre-recorded compact discs, vinyl discs and tapes containing music"* (1994).

358. According to Napp, the Director's response, at paragraph 209 of the Decision, to the effect that the costs of R&D, and of bringing an innovative product to market, can be recovered during the period of patent protection, is far too narrow. According to Napp, its formulation patent on MST never prevented the launch of competing products such as those subsequently launched by BIL or Link. More fundamentally, the Director's reliance on patent protection fails to recognise that, in the pharmaceutical industry, the successful products have to fund not only their own costs, but also the costs of developing the unsuccessful products. The reasonableness of Napp's margins in the community segment cannot be determined without, first, assessing what its initial investment in

MST was, secondly, considering Napp's expected volume of sales, and, thirdly, assessing how much profit Napp needs to make in order to fund its ongoing research activities.

359. Moreover, according to Napp, an adequate return on investment should not be limited to the patent period. The Director's contrary approach reduces the incentive to produce new drugs. By contrast, the PPRS adopts a "smooth pricing profile" which avoids the "bunching" of recoupment on R&D during the life of the patent. The reality is that many drugs which come off patent continue to command high prices and maintain substantial market shares because of legitimate "first mover" advantages.

360. The Director's approach further fails to recognise that, under the PPRS, Napp was obliged to set its price for MST lower than it otherwise could have because of the success of another of its products, Phyllocontin. Under the PPRS Napp had to obtain Department of Health approval for the original price of MST because it was a formulation of an existing chemical molecule, and the Department of Health approved that price as a reasonable price in 1980. Since then, apart from a price increase in 1983, the price of MST has been subject to the general across-the-board reductions agreed between the Department of Health and the pharmaceutical industry of 3.5 per cent, 2.5 per cent and 4.5 per cent in 1985, 1993 and 1999 respectively. In real terms, the price of MST has fallen by some 63 per cent since it was launched in 1980.

361. According to Napp, the fact that the Department of Health does not appear to adopt the Director's approach suggests that the Director's model of how competition should operate in this market is not "unequivocally the best one to use". At the least, the Director should have undertaken his own informed assessment of the optimal balance between considerations of static and dynamic efficiency to determine a competitive price for MST. The Director's approach unjustifiably interferes with the amount the Department of Health has decided it wishes the pharmaceutical industry to spend on R&D in the public interest. There is no good reason for the Director, or the Tribunal, to question the Department of Health's judgment on these issues, particularly since the PPRS has been structured so as encourage innovation, an area where the United Kingdom pharmaceutical industry has been outstandingly successful by international standards.

362. Apart from those arguments of principle, Napp criticises the details of the comparators used by the Director to conclude that Napp's prices are excessive. According to Napp, the comparison of MST with other products is flawed because different brands are not fully equivalent. MST's brand

strength enables it to attract a premium over other brands, as the Director accepts. Nothing in the Director's analysis serves to show that MST's legitimate brand premium is excessive, or by how much. In addition, Napp points out that the Director has miscalculated the price of Morcap SR. Further the Director has misunderstood the nature of Napp's export sales. Napp is merely a contract manufacturer and has no involvement or risk in the marketing of the product outside the United Kingdom. Comparisons with Napp's other NHS products are not meaningful either.

363. Finally, Napp points out that other benchmarks investigated by the Director failed to support his case. A comparison with similar products in other EU member states did not show that Napp's prices were excessive. Nor did an investigation into the return on capital employed earned by Napp reveal that Napp's prices were excessive as compared with other firms. Nothing in Community law, notably Case 27/76 *United Brands v Commission* [1978] ECR 207 ("*United Brands*"), supports the Director's approach.

***The Director's arguments in the defence***

364. In the defence, at paragraphs 16 and 17, the Director summarised his case in relation to the abuses found to have been committed by Napp:

> "16. In essence, the Director General's case is that Napp charges excessively low and/or discriminatory prices in the hospital segment and thereby sustains very high prices and market share in the community segment of the market. These two aspects are accordingly interlinked. Napp's pricing practices have the effect of placing significant obstacles against the successful entry of competitors, and in consequence serve to preserve its quasi-monopoly position in the community segment of the market and enable it to continue to charge prices for MST higher than could be sustained in the absence of that quasi-monopoly position ie competitive prices ...
>
> 17. Accordingly, the Director General does not seek to condemn the prices in the community segment in isolation; in other words, if his case should fail as regards the exclusionary character of Napp's pricing practice in the hospital segment, he does not contend that the prices in the community segment violate the Chapter II prohibition simply because of their absolute level."

365. The Director states at paragraph 84 of the Defence:

> "As stated above, it is the Director General's case that Napp's conduct has had the effect of excluding competitors from the hospital segment, thereby foreclosing the essential gateway for entry to the community segment. As a result Napp has retained its quasi-monopoly position in the community segment and has been able to charge quasi-monopoly prices. In those circumstances, the charging of prices, which are

higher than Napp would be able to charge in a competitive market, constitutes an abuse."

The Director relies on *United Brands*, at pages 301 and 302 of that judgment.

366. As to Napp's specific criticisms of the comparators used, the Director accepts that MST's brand strength will command some premium but contends that Napp's price is still excessive: it is a question of degree. As to Morcap SR, the Director considers that Morcap SR is inappropriate as a comparator. As to export prices, the Director does not claim that Napp's export prices should be the same as domestic prices, but that the "extraordinary scale" of the discrepancy is significant. As regards the comparison with Napp's other products, it is again the degree of the size of differential that is significant, according to the Director.

367. With regard to Napp's arguments as to the need to apply a "dynamic" concept of competition, the Director submits that such arguments cannot serve as a justification for a product to earn a limitless stream of monopoly profits through keeping out competitors. When a monopoly comes to an end, whether due to the expiry of a patent or otherwise, and competitive entry occurs, this will normally have some impact on prices. The PPRS in fact assumes that there is likely to be an impact on prices following the expiry of a pharmaceutical patent. This is why the PPRS prevents "price modulation" where a patent has expired: see the 1999 version of the PPRS, paragraphs 21.3, 21.4 and 21.7. In its *Report on the Supply of Chlordiazepoxide and Diazepam*, (13 February 1973, no.197), the Monopolies Commission found, at paragraphs 223 and 232, that the prices of Librium and Valium were excessive even before the expiry of the relevant patents.

368. According to the Director, the PPRS is irrelevant to this case as it is not concerned with the control of anti-competitive practices, including the charging of a higher price by reason of conduct excluding competitors.

369. The Director rejects Napp's arguments based on Nera's report of 29 May 2001, *Analysis of OFT Decision on Excess Pricing of MST*, and the Napp paper entitled *Evidence on Other Therapeutic Markets*. He argues generally that there are difficulties in making comparisons on the basis of "selective data" with situations which concern different products. However, according to the Director, most branded pharmaceutical products suffer very extensive falls in market share when they come off patent, in some cases within a year of competitive entry: see Annexes 7 and 8 to the defence.

370. As regards the extent of the excess price for MST charged in the community segment, the Director accepts that determining the price which would prevail in competitive conditions is necessarily a matter of economic judgment rather than precise quantification. He draws attention to the methodology adopted by the European Commission in its decision in *United Brands* OJ 1976 L96/1, which was accepted by the Advocate-General on appeal, [1978] ECR at page 312, 338. The Director considers that, on the basis of the evidence before him, he has adopted a conservative approach in concluding that Napp's community prices are at least 15 per cent higher than they would be under competitive conditions. He submits that the Tribunal should accord him a margin of discretion in relation to such decisions: see Case 71/74 *Frubo v Commission* [1975] ECR 563, paragraph 43; and the opinion of Advocate General Warner at p. 597; Cases C-68/94 etc *France and Others v Commission* ("Kali and Salz"), [1998] ECR I-1375, paragraphs 223 and 224.

*Napp's submissions on the Director's alleged change of case*

371. After service of the defence, Napp sought to argue that the Director's case on excessive pricing in the Decision had been reformulated in paragraphs 16 and 17 of the defence (quoted at paragraph 364 above). According to Napp, the Director should not be permitted to do so, and that part of the defence should be struck out. As has already been mentioned, the Tribunal concluded in its interim judgment of 8 August 2001 that this was not a matter for striking out, and left the ultimate decision on this issue over to this final judgment: [2001] CompAR 33.

372. Napp submits, first, by reference notably to a detailed textual analysis, that in the Decision the Director treated excessive pricing as a discrete abuse from that of the excessively high discounts. According to Napp, what was alleged was a 'stand alone' abuse of excessive pricing in the community segment, regardless of the effects of Napp's prices to hospitals. Now, however, the Director has abandoned his position in the Decision by making the abuse in the community segment *dependent upon* the abuse in the hospital segment. The Director should not be allowed to advance a new case now.

373. Secondly, the Director's reformulation of his case does not establish whether as at 1 March 2000 Napp's prices were "excessive". This is because his analysis does not address what Napp's community prices would have been if Napp had pursued what the Director considered to be legitimate pricing in the hospital segment. Napp's argument is that, even if it had been forced to raise its hospital prices on 1 March 2000, it would then have been faced with a choice as to when to

lower its community prices. Napp might have decided that it was more profitable to maintain its community prices for some time, even though this would have lost market share, before responding with lower community prices. Napp suggests that any reduction in its community prices would most likely have occurred after 30 March 2001.

374. Thirdly, Napp claims that the Director's reformulation of his case assumes that all community sales are affected by its conduct in the hospital sector whereas the Director's case in the Decision was that only 24 to 27 per cent of the community market was directly affected by the hospital conduct through the follow-on effect, plus an indirect "reputation effect". However, it was never suggested in the Decision, contends Napp, that this "reputation effect" had a foreclosing effect on the entirety of the community market: see paragraphs 160 to 167 of the Decision.

375. At the final hearing Napp further argued that the Director's "new case", as made in the defence, must be proceeding on one of two hypotheses: (i) that Napp should have reduced its community prices as of 1 March 2000 because they had been maintained at an excessive level by anti-competitive behaviour prior to that date; or (ii) that, had Napp rectified its hospital prices on 1 March 2000, its prices in the community would have fallen to "competitive" levels. Neither hypothesis is spelt out in the Decision, which alleged an abuse in the community segment regardless of how Napp behaved in the hospital segment. It is not open to the Director to change the Decision now.

376. As to the first hypothesis, Napp argues that, by relying on the fact that Napp's community prices were excessive as the result of its hospital pricing, the Director is forced to rely on that conduct prior to the coming into the force of the Act. Taking into account its hospital conduct prior to 1 March 2000, which was at all times legal, to reach the conclusion that its prices were excessive and unlawful on 1 March 2000, would be to apply the Act retroactively and amounts to an infringement of Article 7 of the ECHR. Moreover, submits Napp, the Director's reformulation of his case requires Napp, quite unrealistically, to attempt an assessment of how the market would have developed prior to 1 March 2000, if Napp had not set its hospital prices as it did from 1994 onwards, in order to determine at what level to set its community prices after the coming into force of the Act. In any event there was no accepted norm for saying that Napp's hospital prices were "anti-competitive" prior to 1 March 2000.

377. As to the second hypothesis, Napp submits that the consequences of Napp raising its hospital prices as at 1 March 2000 have never been examined by the Director. If the matter had been raised in a Rule 14 Notice, Napp would have had to prepare detailed "economic and/or statistical or econometric" evidence in response. In any event, according to Napp, the Director has not demonstrated that Napp would have reduced its community price during the relevant period as a result of any increase in hospital price. Napp lists the following imponderables in support of this proposition: (i) at what price would Napp have been required to offer MST to hospitals? (ii) at what rate would hospitals have switched to competing products such as Zomorph and what effect would the Health Act 1999 reforms have on this process? (iii) at what rate would hospital sales convert to community sales in favour of MST's competitors? (iv) what would have been the optimal moment for Napp to decide to lower its community prices, having regard to the trade-off between maintaining prices at a reduced market share, or reducing margins in order to retain market share? In Napp's view there is no evidence to suggest that Napp would have reduced its prices in the community segment by as much as 15 per cent in the period of the infringement, or indeed at all, even if it had charged higher hospital prices as from 1 March 2000.

378. Napp adds that, in any event, the Director's evidence pre-dates March 2000 and therefore does not take any account of the rapidly evolving pressures in the community brought about by reforms under the Health Act 1999: see notably the documents produced by Napp in answer to the Director's request of 15 June 2001.

*The Director's response to the alleged change of case*

379. The Director maintains that the abuse of excessive prices alleged in the Decision is a distinct abuse. According to the Director, Napp's exclusionary conduct in the hospital sector enables it to charge unfair prices in the community segment, it does not mean that Napp automatically does so. The distinct abuse here consists in Napp's decision to charge unfair prices as from 1 March 2000.

380. According to the Director the Decision does not expressly state that the Director's case *depends* on establishing the exclusionary character of Napp's conduct, but it does make clear, in paragraphs 211, 225, 228 and 232, that its prices in the community segment are due in part to the exclusionary character of Napp's pricing practice in the hospital sector. Paragraphs 162 and 251 of the Decision show that the whole market was affected by Napp's discount policy.

381. According to paragraph 31 of his skeleton argument for the final hearing, the Director's position is that:

> "The essential significance of Napp's exclusionary conduct (both before and after 1 March 2000) to the finding of excessive prices is that it provides a solid basis on which to conclude that, in the absence of such conduct, there would have been effective price competition in this market as from 1 March 2000."

382. The Director denies that, in order to establish his case, he must rely impermissibly on matters arising prior to 1 March 2000. Matters arising prior to 1 March 2000 merely serve to inform the judgment as to whether the prices charged after 1 March 2000 were above the competitive level.

383. As the Director's case properly understood impugns Napp's prices in the community sector as excessive and an abuse as at 1 March 2000, there is no need to consider either how the market would have developed if Napp had not engaged in exclusionary practices prior to 1 March 2000, nor what the effect would have been had Napp raised its hospital prices on 1 March 2000.

384. The Director rejects Napp's criticism regarding the other two price benchmarks not referred to in the Decision. A comparison of gross profit margins earned by other companies as a whole with those of Napp on MST is unreliable. Similarly, a comparison with international prices is "fraught with difficulty" according to the Director: see the decision of the Restrictive Practices Court *In re Chocolate and Sugar Confectionery reference (foreign evidence)* LR 6 RP 325, at 337B-F. These problems are compounded where different national regulatory regimes exist.

385. Finally, the Director rejects Napp's assertion that he failed to take into account the reforms introduced by the Health Act 1999: see paragraph 121 of the Decision. As late as 6 March 2001, Napp expressly referred in its reply to the second Rule 14 Notice that these changes were a matter for the future (AI, p.432).

B: LAW

386. Section 18(2)(a) of the Act provides that conduct by a dominant undertaking may constitute an abuse, in breach of section 18(1), if it consists in

> "directly or indirectly imposing unfair ... selling prices".

387. Although cases at European Community level concerning unfair selling prices have been few, in *United Brands* the Court said:

> "248 The imposition by an undertaking in a dominant position directly or indirectly of unfair purchase or selling prices is an abuse to which exception can be taken under Article 82 of the Treaty.
>
> 249 It is advisable therefore to ascertain whether the dominant undertaking has made use of the opportunities arising out of its dominant position in such a way as to reap trading benefits which it would not have reaped if there had been normal and sufficiently effective competition.
>
> 250 In this case charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied would be such an abuse.
>
> 251 This excess could, *inter alia*, be determined objectively if it were possible for it to be calculated by making a comparison between the selling price of the product in question and its cost of production, which would disclose the amount of the profit margin; however the Commission has not done this since it has not analysed UBC's costs structure.
>
> 252 The questions therefore to be determined are whether the difference between the costs actually incurred and the price actually charged is excessive, and, if the answer to this question is in the affirmative, whether a price has been imposed which is either unfair in itself or when compared to competing products.
>
> 253 Other ways may be devised – and economic theorists have not failed to think up several – of selecting the rules for determining whether the price of a product is unfair"

388. In Case 30/87 *Bodson v Pompes funèbres des régions libérées* [1988] ECR 2479, the Court referred to a comparison between the prices charged in circumstances where there was competition, and those charged where there was a local monopoly, as one way of determining whether prices were excessive (paragraph 31).

C: FINDINGS

389. It seems to us that the most convenient approach is to deal first with the issues on the basis of what the Director found in the Decision, and then to examine Napp's arguments about the Director's alleged "new case".

***The abuse as found in the Decision***

390. In paragraph 203 of the Decision, the Director states that, as a matter of principle a price is excessive for the purposes of the Chapter II prohibition:

> "if it is above that which would exist in a competitive market and where it is clear that high profits will not stimulate successful new entry within a reasonable period. Therefore, to show that prices are excessive, it must be demonstrated that (i) prices are higher than would be expected in a competitive market, and (ii) there is no effective competitive pressure to bring them down to competitive levels, nor is there likely to be."

391. While there may well be other ways of approaching the issue of unfair prices under section 18(2)(a) of the Act, the Director's starting point, as stated in paragraph 203 of the Decision, seems to us to be soundly based in the circumstances of the present case.

392. Measuring whether a price is above the level that would exist in a competitive market is rarely an easy task. The fact that the exercise may be difficult is not, however, a reason for not attempting it. In the present case, the methods used by the Director are various comparisons of (i) Napp's prices with Napp's costs, (ii) Napp's prices with the costs of its next most profitable competitor, (iii) Napp's prices with those of its competitors and (iv) Napp's prices with prices charged by Napp in other markets. Those methods seem to us to be among the approaches that may reasonably be used to establish excessive prices, although there are, no doubt, other methods.

393. The facts set out in paragraphs 207 to 234 of the Decision, establish the following:

- Napp's prices in the community segment are typically around [...] [between 30 to 50] per cent higher than its competitors.
- Apart from certain across-the-board reductions applying to the pharmaceutical industry as a whole under the PPRS, Napp's price in the community segment has remained the same since the launch of MST in 1980, (save, as we understand it, for one increase in 1983) notwithstanding the expiry of its formulation patent in 1992.
- Napp's list price (less wholesale discount) in the community segment of the market is on average over 1400 per cent higher than its price in the hospital segment of the market for 10mg, 30mg, 60mg, and 100 mg tablets, where Napp faces competition.
- At Napp's highest level of discount, the list price in the community segment is on some tablets over 2000 per cent higher than Napp's hospital prices.
- Napp's prices in the community segment are over 500 per cent higher than its prices for export on a contract manufacture basis. As we understand it, MST faces competition in export markets.

— Napp's gross profit margin on sales to the community segment is [...] [in excess of 80] per cent, compared with a margin of around [...] [between 30 and 50] per cent on Napp's other products sold to the NHS.

— Napp's gross profit margin of [...] [in excess of 80] per cent on sales to the community segment compares with a gross profit margin of [...] [less than 70] per cent for Napp's next most profitable competitor. If Napp's manufacturing margin is recalculated on the basis of the costs of its next most profitable competitor, Napp's gross margin becomes [...] [less than 90] per cent compared with that competitor's [...] [less than 70] per cent.

394. As to the facts of those comparisons, Napp criticises the Director for not including the price of Morcap SR. Since Morcap SR does not seem to be actively promoted, and has a negligible market share, we agree with the Director that Morcap SR is not a relevant comparator. The fact that some prescriptions for Morcap SR are for once-daily treatment is a further reason for excluding Morcap SR.

395. Napp has also criticised the inclusion of export prices in the Director's comparisons on the grounds that that business is contract manufacture, which is risk free, and does not carry marketing and promotion costs. Although we accept that there is likely to be some differential in export prices as a result of those two factors, we agree with the Director that that is unlikely, in itself, to explain why prices to the NHS in the community segment are, on some strengths of tablet, over 500 per cent higher than export prices.

396. We therefore conclude that no serious criticism can be made of the detail of the price comparisons relied on by the Director.

397. In our view those comparisons, taken together, amply support the Director's conclusions that Napp's prices in the community segment were, during the period of the infringement, well above what would have been expected in competitive conditions. Thus we agree with the Director's finding, at paragraph 211 of the Decision, that it is only in the community segment, where buyers are less price sensitive, and where there is an absence of effective competition, that Napp can sustain a premium of 40 per cent over competitors. With the exceptions mentioned in paragraph 360 above, Napp's prices have remained unchanged for 20 years, including nearly 10 years since the expiry of Napp's formulation patent. At the same time, Napp has retained a market share of the

community segment of some 96 per cent. Those facts also support the proposition that Napp's community prices, unlike its hospital prices, have not been subject to competitive pressure, as the Director found in paragraph 213 of the Decision.

398. That conclusion is further supported by the fact that where Napp faces competition, in the hospital segment and export markets, Napp's prices are very significantly lower than Napp's prices in the community segment. As the Director found, Napp's prices in the community segment are, depending on the tablet strength, over 500 per cent higher than in the export market and are on average over 1400 per cent higher than in the hospital segment (paragraphs 217 to 222 of the Decision). The following table illustrates how large the price differentials are, taking Napp's 10mg, 30mg, 60mg and 100mg tablets, where Napp faces competition, and the prices for its 5mg, 15mg and 200mg tablets where that is not so to any significant extent:

**Napp's prices (£ per pack of 60)**

| | *NHS List price to the community* | *NHS price to the community less wholesale discount* | *Average hospital price* | *Lowest hospital price* | *Export price* |
|---|---|---|---|---|---|
| 5mg | 4.30 | 3.76 | | | |
| 10mg | 7.17 | 6.27 | | | |
| 15mg | 12.57 | 11.00 | | | |
| 30mg | 17.22 | 15.07 | ... | ... | ... |
| 60mg | 33.58 | 29.38 | | | |
| 100mg | 53.16 | 46.52 | | | |
| 200mg | 106.34 | 93.05 | | | |

399. Similarly the fact that NHS list prices in the community segment are set in regular increasing steps, according to tablet strength, whereas in the hospital and export markets that is not the case, strongly suggests that in those other markets prices vary according to the competitive forces affecting different tablet strengths. Again, that does not appear to be the case in the community segment, as the Director points out at paragraph 220 of the Decision.

400. It is therefore established, on the facts of this case, that during the period of infringement Napp charged significantly higher prices in the community segment than in other markets or segments where it faced competition, and has significantly higher margins in the community segment than its



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most profitable competitor. In addition, Napp faced no competitive pressure on its prices in the community segment, had no patent protection, and enjoyed a market share of 96 per cent throughout.

401. The fact that the Director has not chosen to rely on other comparators such as international price comparisons or returns on capital does not in our view lessen the force of the comparators upon which he does rely. Napp itself has not, in the notice of appeal, put forward any other comparators.

402. On those facts we are satisfied that Napp "has made use of the opportunities arising out of its dominant position in such a way as to reap trading benefits which it would not have reaped if there had been normal and sufficiently effective competition", so as to satisfy the test of abuse as laid down by the Court of Justice in *United Brands* at paragraph 249 of its judgment.

403. To put the matter in terms of the principle set out at paragraph 203 of the Decision, in our view the above facts demonstrate (i) that, during the period of the infringement, Napp's prices in the community segment were significantly higher than would be expected in a competitive market; and (ii) that, during the period of the infringement, there was no significant competitive pressure to bring them down to competitive levels, nor was there likely to be over any reasonable time scale.

404. For the reasons we have already given at paragraphs 301 to 306 above, we do not think that there was any significant competitive change in the market circumstances during the period of the infringement as compared with the period prior to 1 March 2000.

405. The fact that the Director has not, in the Decision, precisely quantified by how much he considers Napp's prices in the community segment to be excessive, leaving it over to the Directions to order an appropriate reduction, does not in our view alter the fact that, measured by a number of different yardsticks which all yield the same result, Napp's prices in the community segment were well above the levels to be expected in conditions of normal competition, during the period of infringement.

***Napp's defence based on the PPRS***

406. To rebut the Director's conclusion, Napp puts forward three main arguments based on the PPRS and the nature of the pharmaceutical industry: (i) that whether the price of MST is excessive

cannot be judged without knowing the size of Napp's initial investment in that product and its expected volume of sales; (ii) that the PPRS is a sufficient control over the price of MST; and (iii) that the Director has failed to take into account the need for "portfolio" pricing: see paragraphs 353 to 361 above.

407. As to the first of these arguments, Napp's original investment in MST was made in the early 1980s in launching and promoting a product which, at the time, represented an important innovation. Napp has provided no figures as to what that initial investment was. In the absence of any indication to the contrary, we would expect that initial investment to have been recouped long ago, as the Director found at paragraph 233 of the Decision. Nera's report of 29 May 2001 *Analysis of OFT Decision on Excess Pricing of MST* is to the same effect "If the OFT had carried out an assessment of the costs associated with the development and launch of MST and the subsequent returns (which it has not) it is likely that it would have found that the product has done more than compensate Napp for their investments" (p.3). We do not think that the Director can fairly be criticised for not having further investigated this point in circumstances where Napp has produced no credible evidence to suggest that its initial investment has not been recouped. We therefore reject any argument that the price of MST might be justified, during the period of infringement, by the initial investment made many years ago.

408. As regards Napp's second argument that the PPRS is a sufficient control on the price of MST, we have no solid information as to the basis on which the Department of Health allegedly approved the initial launch price of MST in 1980. It is common ground that the PPRS principally controls a company's overall ROC and does not, in that connection, concern itself with individual products. On the information provided by Napp, we are unable to evaluate whether, in 1980, the price of MST really was significantly constrained by the success of Phyllocontin, and we note that Napp did receive a price increase for MST in 1983. We note also Mr Brownlee's statement that, under the PPRS, Napp could have increased the price of MST in 1993 but did not do so. In all those circumstances, it is unclear whether the PPRS has ever had a significant effect as regards the original price of MST. In any event, in our view, the effect of the PPRS in the original launch price of MST in 1980 is not relevant to the issue which we have to decide, which is whether Napp has maintained the price of MST above the competitive level contrary to the Chapter II prohibition during the period of infringement after 1 March 2000. In our view it has, for the reasons already given in paragraphs 393 to 405 above.

409. The essence of the third argument put forward by Napp is that, in an industry, such as the pharmaceutical industry, in which relatively few successful drugs must fund the research and development costs of many unsuccessful drugs, and the ongoing research costs of new products yet to be discovered, it is wrong to look at the margins of a single successful product and deem those margins, standing alone, to be excessive. The only sensible approach in such an industry, argues Napp, is to look at the company's prices and profits over a portfolio of products and then judge whether its return on investment is reasonable on that portfolio basis. That is precisely what the PPRS does. Accordingly, says Napp, a company whose ROC is well within the limits of the PPRS cannot be judged to have charged excessive prices on a single product.

410. We note that the PPRS is a voluntary, non statutory scheme. According to the 1999 version, its purpose is to:

> "— Secure the provision of safe and effective medicines for the NHS at reasonable prices.
>
> — Promote a strong and profitable pharmaceutical industry capable of such sustained research and development as should lead to the future availability of new and improved medicines.
>
> — Encourage the efficient and competitive development and supply of medicines to pharmaceutical markets to this and other countries."

411. In our view there are several reasons why Napp's arguments based on 'portfolio pricing' under the PPRS must be rejected.

412. First, as already stated, the PPRS is primarily directed to ensuring that a pharmaceutical company does not exceed the permitted ROC on the totality of its NHS business. The PPRS is not directed to the question whether or not the price of an *individual product* sold in a market where there is dominance is above the competitive level, which is the essential question in the present case. In our view, the fact that a pharmaceutical company is subject to the PPRS does not, of itself, give that company any kind of exemption from the Chapter II prohibition in general, or from section 18(2)(a) in particular, as regards the prices of *individual products*.

413. In so far as Napp argues that its prices for MST cannot be excessive under the Chapter II prohibition simply because it is subject to the PPRS, any such argument has, in our view, no foundation in law or logic. In our judgment that argument, and indeed Napp's whole argument based on "portfolio pricing", impermissibly directs attention away from the specific product market

which we are required to consider when deciding whether there is an abuse of a dominant position under section 18 of the Act. In our view, it is not appropriate, when deciding whether an undertaking has abused a dominant position by charging excessive prices in a particular market, to take into account the reasonableness or otherwise of its profits on other, unspecified, markets comprised in some wider but undefined "portfolio" unrelated to the market in which dominance exists.

414. Secondly, the PPRS is not intended to guarantee a company the right to earn profits up to the limits of the scheme. Thus, as the Director points out, the 1st Report to Parliament on the PPRS (1996) at paragraphs 4.73 and 4.76 states:

> "The PPRS does not guarantee a company a particular level of sales, or a particular level of profit associated with those sales, for a number of reasons..."
>
> "... a company facing competing products may not be in a strong position to increase prices as a way of generating additional revenue, unless it has other products in its portfolio facing little therapeutic competition."

415. As Mr Brownlee points out in his witness statement, an underlying assumption of the PPRS is that member companies comply with the prevailing laws of the United Kingdom. Since 1 March 2000 those laws have included the Competition Act 1998.

416. Thirdly, we agree with the Director's view, at paragraph 209 of the Decision, that a manufacturer with an innovative product cannot demand or expect prices to remain at excessively high levels indefinitely. Indeed, one of the principal purposes of the patent system is to confer a degree of exclusivity, thus enabling companies to recover substantial research and development costs and investment in new medicines: see the 3rd Report to Parliament on the PPRS (1999) at paragraph 1.1(ii). In the present case, it is now 20 years since the launch of MST, and Napp's formulation patent expired 10 years ago.

417. We do not accept that, after such a long period, the price of MST can credibly be defended on a 'portfolio pricing' theory. The evidence we have is that, in the case of many pharmaceutical products, the expiry of a patent leads to competitive (often generic) market entry, with the consequence that the incumbent supplier either lowers prices, or loses market share, or both, perhaps quite rapidly: see paragraph 287 above. In the present case, however, Napp has maintained *both* the price of MST *and* an exceptionally high market share for many years. Neither

the remarks of Advocate General Reischl in *Coditel II*, nor the Monopolies and Mergers Commission Report *The Supply of Recorded Music,* seem to us to be relevant to the present case.

418. Fourthly, the Department of Health has not, as it could have, intervened in this case. We would have expected the Department to have intervened, had it thought that the Director's approach undermined either the objectives of the PPRS, or jeopardised the successful development of the United Kingdom pharmaceutical industry. The Department has, on the contrary, provided Mr Brownlee's witness statement to the Director in which no such views are expressed.

419. Mr Brownlee, in his witness statement, emphasises notably that the PPRS does not contain any requirement for member companies to undertake R&D as a condition of membership of the scheme, and that it is unlikely that companies would do so specifically for the United Kingdom market, which represents only a small proportion of the world market for medicines. He also points out that the PPRS contains no assurance that Napp would not be penalised for an abuse of dominance under the Act as long as it observed the terms of the PPRS, and that no such assurance has been given. Nor does Mr Brownlee accept Napp's argument that it is normal business practice for suppliers of leading brands to maintain their list prices after patent expiry and to offer differential discounts. Mr Brownlee states that the Department of Health expects suppliers to respond to whatever market pressures exist after a patent expires.

420. Fifthly, in our view, the PPRS is not intended to permit a company to maintain excessive differentials on its sales to different parts of the NHS. In the present case, Napp has been able to exploit its dominance to the extent that, on certain strengths of tablet, it can charge on average over 1400 per cent more, when a prescription is dispensed by a community pharmacist, than it can when *the same prescription, for the same patient,* is dispensed in a hospital. We do not think that the PPRS can credibly be put forward as a justification for maintaining, in the community segment, high prices which result in differentials on that scale.

421. Sixthly, in our view, we do not think that arguments based on the PPRS have any application where the lack of competitive pressure on the prices concerned is due, to an appreciable extent, to anti-competitive practices by the dominant undertaking concerned. A key feature of the present case is that Napp's high prices in the community segment do not represent a competitive market outcome but, on the contrary, occur in circumstances where, throughout the period of infringement, Napp's discounts to hospitals substantially hindered competitive entry: see Section VII above. Whatever

the public interest arguments may be for the PPRS, those arguments do not seem to us to be relevant to the justification of an excessive price in circumstances where it is the undertaking's own anti-competitive activities which have, to a material extent, prevented any significant competitive pressure being brought to bear on the price in question. To seek to justify such a price on the basis of the PPRS is in our view to move wholly outside the objectives of the PPRS and to bring the PPRS into potential conflict with the Act.

422. It is clear, from the Decision, that the Director considered that Napp's prices in the community segment were not subject to competitive forces, and that that was due, to a material extent, to Napp's hospital discounting policy. Thus the Director maintained, in the Decision, that Napp's pricing policy "has to be considered as a whole" (paragraphs 142 and 236). In finding that the hospital segment plays a central role in facilitating entry (e.g. paragraphs 111 and 162), and that Napp's hospital discounting policy had hindered competition in that segment (paragraphs 145 to 202) the Director also found that the object and effect of that policy was to protect Napp's prices in the community segment. Thus:

> "These margins [in the community segment] result from a lack of competition in the community segment which, in turn, results from the anti-competitive effects of Napp's discounting behaviour in the hospital segment." (paragraph 151)
>
> "Napp cannot therefore justify a policy of loss leading [in the hospital sector] except in so far as cutting hospital prices below AVC denies a competitor the opportunity to establish itself in the community sector and thereby allows Napp to continue to earn high margins in that sector." (paragraph 194)
>
> "That Napp can earn high compensating margins in the community segment ... is because its discount policy in the hospital segment has hindered competition in the community segment. ... The object and effect of the low pricing in the hospital segment is indeed to protect and take advantage of Napp's near monopolist position [in the community segment]." (paragraph 195)
>
> "It is only in the community segment where buyers are less price sensitive and where there is an absence of effective price competition, partly as a consequence of Napp's conduct, that Napp can sustain a premium of 40 per cent on competitors." (paragraph 211)
>
> "That Napp has sustained these higher margins without stimulating successful new entry is due, at least in part, to its exclusionary pricing policies in the hospital segment of the market." (paragraph 228)
>
> "Napp has maintained excessively high margins on the sale of MST in the community segment of the market without effective competition from successful new entry. This is due, at least in part, to Napp's exclusionary pricing practices in the hospital segment." (paragraph 232)

"The lack of successful entry in this case is in part due to Napp's exclusionary practices in the hospital segment of the market." (paragraph 225)

423. The same conclusion flows from our own findings in Section VII above. In those circumstances, so it seems to us, the PPRS is wholly irrelevant. In our judgment, the fact that a company does not exceed the limit on ROC allowable under the PPRS across the range of its products, does not constitute a defence to a charge of excessive pricing contrary to the Chapter II prohibition if that price has been maintained above the competitive level and has, to a material extent, been shielded from competition by the anti-competitive practices of the undertaking concerned.

424. This latter consideration does not, in our view, imply that Napp's hospital discount policy is in some sense an "ingredient" of the abuse of excess pricing. The fact that Napp's prices in the community segment were protected by the hospital discount policy is simply one further reason for rejecting Napp's defence based on the PPRS. The abuse of excessive pricing consists of maintaining prices higher than would be expected in a competitive market, in circumstances where there is no significant competitive pressure to bring them down to competitive levels, nor likely to be. In our judgment, the relevance of Napp's hospital pricing to the abuse of excessive pricing in the present case is simply to show that Napp's reliance on the PPRS by way of defence is unfounded.

425. The point that the PPRS has little, if any, relevance since the excessive price complained of in this case has been protected by Napp's hospital discounting policy was canvassed, in one form or another, before the Tribunal, in the course of the appeal. We take that point into account as a further reason for rejecting Napp's reliance on the PPRS, arising out of facts and matters found by the Director in the Decision.

426. The fact that one reason why we reject Napp's reliance on the PPRS is because Napp itself has hindered competition in the community segment by its hospital discounting policy does not in our judgment involve any 'retroactive' application of the Act to some period prior to 1 March 2000. As at 1 March 2000, Napp's prices in the community segment were above the competitive level, and not subject to competitive pressure. The abuse of excessive pricing consists in maintaining those prices at levels above the competitive level as and from that date.

427. It follows, for the reasons already given, that Napp committed the abuse of excessive pricing during the period of infringement found in the Decision.

***The Director's alleged "change of case"***

428. We do not think that the foregoing analysis is affected by Napp's arguments that the Director has impermissibly "changed his case", notably in paragraphs 16 and 17 of the defence.

429. In the first place, our principal task is to decide the appeal "on the merits". In exercising that jurisdiction, our starting point must be what the Decision itself says. For the reasons already given, we are satisfied that an abuse of excessive pricing by Napp in the community segment may properly be found on the basis of the facts and matters set out in the Decision. In our view, that is the end of the matter.

430. In any event, what the Director stated at paragraph 17 of the defence was that he would not wish to maintain the abuse of excessive pricing in the community segment in circumstances where the Tribunal found that there had been no exclusionary conduct in the hospital segment. Since the Tribunal has found that there *was* exclusionary conduct in the hospital segment the concession set out in paragraph 17 of the defence simply falls away.

431. If, contrary to the above, it is necessary to examine whether the Director did, in the defence, move away from what he said in the Decision, we find as follows.

432. According to the explanation given to us at the hearing of the appeal, the wording in the defence was intended to distinguish the present case, where the allegedly excessive pricing was protected by exclusionary conduct, from a case in the pharmaceutical industry where no exclusionary conduct was alleged. In view of the fact that the pharmaceutical industry is regulated by the PPRS, a case of alleged excessive pricing by a pharmaceutical company, in which there was *no* suggestion of any exclusionary conduct, would, in the Director's view, be a different case, and would require a more detailed and complex analysis than the Director felt it necessary to undertake for the purposes of the present Decision.

433. Looked at in this light, the essence of the Director's position before the Tribunal seems to us to be that, in this case, Napp's defence under the PPRS does not bear examination because, among other reasons, the excessive prices in the community segment have been protected by exclusionary conduct in the hospital segment. That is the point which we have ourselves accepted at paragraphs 421 to 423 above.

434. What in our view the Director was really saying to us was that the hospital pricing abuse created the conditions in which the community pricing abuse could take place, which is not significantly different from what is said in the Decision. If, in the defence, the Director intended to go further and say that the excessive pricing in the community segment was abusive *only* because of Napp's exclusionary conduct in the hospital segment, any such view would have been erroneous in law. Nothing in *United Brands* suggests that the existence of exclusionary conduct is a prerequisite to a finding that prices are excessive contrary to the Chapter II prohibition.

435. However the defence is to be read, we do not accept Napp's argument that the Director's position in the defence implies that he has impermissibly taken account of Napp's actions prior to 1 March 2000 and thus applied the Act retrospectively, contrary to Article 7 of the ECHR. As we see it, neither the Decision, nor the defence, alleges any infringement committed before 1 March 2000.

436. Even if, in the defence, the Director were saying that Napp's prices in the community segment were abusive because they were maintained in the context of Napp's exclusionary pricing policy in the hospital segment, it is not necessary to rely on Napp's conduct prior to 1 March 2000 to establish that, as from 1 March 2000 (i) Napp's prices in the community segment were above the competitive level, and (ii) that such prices were, on and after that date, protected from competition by exclusionary pricing in the hospital segment. Point (i) is established by the matters set out at paragraphs 390 to 405 above and point (ii) is established by the matters set out in section VII above.

437. Thus Napp's contention that it is impossible to know what price it would have charged in the community segment on 1 March 2000, had it not engaged in allegedly anti-competitive conduct prior to that date, is irrelevant. The question is whether the price that Napp was *in fact* charging in the community segment was above the competitive level, whether or not protected by exclusionary conduct, in the period from 1 March 2000 to 30 March 2001.

438. Nor is it necessary, in order to establish the abuse of excessive pricing, to speculate on what might have happened in the market place if Napp had raised its hospital prices on 1 March 2000. Napp did not raise its hospital prices on 1 March 2000 so the issue does not arise. Moreover, we are concerned with what the prices actually were, and not what they might have been in other hypothetical circumstances.

439. The same applies to Napp's argument that, even if it had raised hospital prices on 1 March 2000, it is unlikely that its community price would have been any different during the period of the infringement. Again, the point is that Napp did *not* raise its hospital prices on 1 March 2000. Thus it is impossible to know how competition would have developed in those new circumstances and what the strategies of Napp, its competitors, and the relevant purchasing authorities would have been. We decline to rule out the possibility that Napp would, in these hypothetical circumstances, have reduced its community prices. But we do not need to consider the various hypothetical alternatives because Napp's prices were not, in fact, subject to competitive pressures in the period from 1 March 2000 to 30 March 2001, and remained throughout that period at levels we have found to be excessive.

440. Finally, Napp argues that the case as made by the Director in the defence suggests that Napp's conduct in the hospital segment affected all sales in the community segment, contrary to what is suggested in paragraph 167 of the Decision. As we have already held, the result of Napp's hospital discount policy was to affect, at least indirectly, the whole of the community segment by preventing new entry and the competitive pressure on Napp's prices in the community segment that such new entry would bring: see paragraphs 282 to 283 above. In this respect we do not think that the way the Director pleaded the abuse of excessive pricing in the defence involved a material change to the general thrust of the Decision, as shown by the extracts cited in paragraph 422 above, albeit that paragraph 167 of the Decision is not drafted very satisfactorily.

441. It follows that little, if anything, turns on the wording of the defence, despite the time and effort devoted to argument on this aspect both at the final hearing and at the earlier stage of Napp's application to strike out the defence.

***Conclusion***

442. For all those reasons, we find that Napp has abused its dominant position in the supply of tablets and capsules of oral sustained release morphine in the United Kingdom by charging excessive prices to customers in the community segment of that market, as the Director found in paragraph 236(b) of the Decision.

## IX — THE PENALTY

### A: INTENTIONALLY OR NEGLIGENTLY

***Arguments of the parties***

443. Napp contends, in the alternative, that even if it has committed an infringement of the Act, it did not do so intentionally or negligently and that accordingly, pursuant to section 36(3) of the Act, the Director was not entitled to require Napp to pay him a penalty.

444. Napp argues in the notice of appeal (paragraph 5.57) that in order to establish an infringement committed intentionally or negligently it would have to be shown that Napp was aware, or ought to have known, that its hospital prices were not subject to sufficient constraints by other suppliers to keep them within reasonable limits; that Napp was aware that, or ought to have known, the PPRS was not effective to ensure that its community prices remained within reasonable limits; and that Napp was aware, or ought to have known, that it had resorted to methods of competition which were abnormal and could not be regarded as a form of competition on the merits. Napp argues that there is a relevant analogy with the *mens rea* requirement in cases of theft, citing *R v Ghosh* [1982] 2 QB 1053, HL.

445. Napp further submits, in reliance on the witness statements of Mr Manners and Mr Brogden, that:

> "(i) Napp has at all material times believed that the PPRS was effective to prevent it from charging excessive prices and that, provided that Napp observed the terms of the PPRS, its pricing of MST to the NHS would not be regarded as excessive.
>
> (ii) Napp has at all material times believed that it was normal and acceptable commercial practice for a supplier of a leading brand of a pharmaceutical product, facing competition from new entrants, and with no patent protection, to maintain the NHS list price of its product, and to offer differential discounts to different buyers according to their willingness to pay, in the manner and to the extent that Napp has offered discounts against the list price of MST.
>
> (iii) Napp did not believe that, by offering substantial discounts against the list price of MST to hospital buyers, it would thereby incur incremental losses. It believed that sales of MST to hospital buyers would result in incremental profits to Napp, when account was taken of the effects which hospital sales could be expected to have in maintaining or increasing sales of MST in the community segment of the market. Prior to the commissioning of the Internet Survey at document A18, Napp did not, however, seek to quantify the extent of any such linkages between hospital and community sales. Napp believed that it was normal commercial practice to offer discounts to hospitals which took account of linkages between hospital and community sales. Nor did Napp have any reason to believe

> otherwise: Napp observed that other firms were offering discounts which were suggestive that those other firms were also competing on that basis. Napp did not believe that it could expect to secure greater linkages between hospital and community sales than other suppliers of oral sustained release morphine."

(paragraph 5.58 of the notice of appeal, as substituted.)

446. Napp also submits that the Director failed as the Act requires to address his mind to the question of whether the infringement was committed intentionally rather than negligently, or vice versa, and that the infringement was novel (notice of appeal, paragraph 5.60).

447. In its skeleton argument for the hearing, Napp further contends that changes in the Director's case show that Napp could not reasonably have been expected to have known that its conduct would have anti-competitive effects. According to Napp: (i) the Director has changed his case several times regarding the extent of the foreclosure brought about by Napp's conduct in the hospital segment of the market, (ii) the Director changed his case by abandoning during the administrative procedure the allegation in his first Rule 14 Notice that differential pricing between the hospital and community segments of the market was itself an abuse, (iii) the Director has changed his case in relation to the availability of linkages to Napp and other suppliers, and (iv) Napp used the net revenue test endorsed by OFT 414 (paragraph 4.16) and was entitled to assume that such an approach was lawful.

448. Napp also submits that the reforms introduced by the Health Act 1999 mean that the market remains "in a state of flux". Napp suggests that it was merely responding to "circumstances beyond its control", in the hospital segment to the pressure imposed by the NHS purchasing authorities, and in the community segment to pressure from the Department of Health in the form of the PPRS. Finally, Napp suggests that the circumstances it was responding to are now addressed by the Health Act reforms. Napp should not be punished if those reforms have not yet fully unfolded.

449. The Director submits that the question whether an infringement was "intentional or negligent" under section 36(3) of the Act is a threshold question which "corresponds" to the position under Article 15(2) of Council Regulation 17. In order to cross that threshold, the Director does not have to determine whether an infringement was intentional rather than negligent or vice versa. Once the Director is satisfied that the threshold criteria for imposing a penalty are satisfied, he can then turn to consider the appropriate level of penalty having regard to his guidance issued under section 38

of the Act. Paragraph 7.3 of the Director's *Guidance as to the Appropriate Amount of the Penalty* (OFT 423) ("the *Director's Guidance*") states that "Mitigating factors include: ... infringements which are committed negligently rather than intentionally."

450. The Director submits that it is not necessary for an undertaking to have been aware that it was infringing the Act for an infringement to be regarded as having been committed intentionally. It is sufficient that it could not have been unaware that the contested conduct had as its object or effect, or could have had as its effect, the restriction of competition: e.g. by way of example Case T-65/89 *BPB Industries and British Gypsum v Commission* [1993] ECR II-389, paragraph 165; see also: Case T-77/92 *Parker Pen v Commission* [1994] ECR II-549, paragraph 81; Case 100/80 *Musique Diffusion Française v Commission* [1983] ECR 1825, paragraph 112; Case 85/76 *Hoffman La Roche v Commission*, cited above, at paragraph 39.

451. To establish that the infringements in this case were committed intentionally or negligently the Director relies on paragraphs 241 to 246 of the Decision. He also points out that as Napp did not in fact set its hospital prices by reference to any follow-on effect or other objectively justified factor, Napp must have realised that its practice could have an exclusionary effect. As to the specific points made by Napp, the Director argues notably (i) that there was no basis for Napp to assume that the PPRS shielded it from anti-competitive conduct infringing the Act; (ii) Napp must be taken to have been aware that differential discounting to a level below cost can be anti-competitive conduct for a dominant company; and (iii) that such an infringement cannot be considered novel. Finally, in his skeleton argument the Director now relies on certain of the documents disclosed by Napp pursuant to the Tribunal's request of 31 August 2001.

***Law***

452. The Director's power to require Napp to pay him a penalty in respect of Napp's infringement of the Chapter II prohibition is set out in section 36(2) of the Act. Section 36(3) provides that the Director may impose such a penalty "only if he is satisfied that the infringement has been committed intentionally or negligently by the undertaking". If the penalty is challenged before this Tribunal, in our judgment the Tribunal itself must be satisfied that the infringement was committed "intentionally or negligently".

453. Article 15(2) of Council Regulation no. 17 provides that the Commission may impose fines on undertakings where "either intentionally or negligently they infringe Article 81(1) or Article 82 of the Treaty". In Case C-137/95P *SPO and others v Commission* [1996] ECR I-1611, the Court of Justice held, in effect, that the requirement set out in Article 15(2) of the Council Regulation no.17 that a fine for an infringement of Article 81(1) or 82 may be imposed only if the infringement was committed "intentionally or negligently", is a threshold condition which must be fulfilled in order to impose a fine. However, in determining whether that threshold condition is met, the Commission is not required to decide whether the infringement was committed intentionally or negligently, so long as it is satisfied that the infringement was *either* intentional *or* negligent. Having decided that the threshold is crossed, i.e. that the infringement was *either* intentional *or* negligent, it is then for the Commission to assess the gravity of the infringement, taking into account its duration and all other relevant factors, in accordance with the last sentence of Article 15(2) of Council Regulation no.17, which provides "In fixing the amount of the fine, regard should be had both to the gravity and to the duration of the infringement".

454. It is true that section 36(3) of the Act does not, unlike Article 15(2) of the Council Regulation no.17, expressly refer to the need to take into account, when fixing the penalty, the gravity and duration of the infringement. Under the Act, the matters to be taken into account in fixing the amount of the penalty are required to be set out in the *Director's Guidance* published under section 38. Paragraph 2.12 of that *Guidance* states that the fact that an agreement was committed negligently, rather than intentionally, is to be regarded as a mitigating factor.

455. In our view the slightly different structure under sections 36 and 38 of the Act, as compared to Article 15(2) of Council Regulation no.17, does not constitute a relevant difference between the provisions concerned for the purposes of section 60 of the Act. In those circumstances, and having regard to our general duty under section 60 to apply the Act consistently with the principles of Community law, in our judgment we should follow the decision of the Court of Justice in *SPO and others v Commission*, cited above. It follows that we uphold the Director's submission that, in order to impose a penalty under section 36(3), he has to be satisfied, as a threshold matter, that the infringement was either intentional, or negligent. However, he does not, for the purposes of crossing that threshold, have to determine specifically which it was. He may well have to do so, however, at the subsequent stage of his appraisal when he is considering the gravity of the infringement.

456. As to the meaning of "intentionally" in section 36(3), in our judgment an infringement is committed intentionally for the purposes of the Act if the undertaking must have been aware that its conduct was of such a nature as to encourage a restriction or distortion of competition: see *Musique Diffusion Français*, and *Parker Pen*, cited above. It is sufficient that the undertaking could not have been unaware that its conduct had the object or would have the effect of restricting competition, without it being necessary to show that the undertaking also knew that it was infringing the Chapter I or Chapter II prohibition: see *BPB Industries and British Gypsum*, cited above, at paragraph 165 of the judgment, and Case T-29/92 *SPO and Others v Commission* [1995] ECR II-289, at paragraph 356. While in some cases the undertaking's intention will be confirmed by internal documents, in our judgment, and in the absence of any evidence to the contrary, the fact that certain consequences are plainly foreseeable is an element from which the requisite intention may be inferred. If, therefore, a dominant undertaking pursues a certain policy which in fact has, or would foreseeably have, an anti-competitive effect, it may be legitimate to infer that it is acting "intentionally" for the purposes of section 36(3).

457. As to "negligently", there appears to be little discussion of this concept in the case law of the European Community. In our judgment an infringement is committed negligently for the purposes of section 36(3) if the undertaking ought to have known that its conduct would result in a restriction or distortion of competition: see *United Brands v Commission*, cited above, at paragraphs 298 to 301 of the judgment. For the purposes of the present case, however, we do not need to decide precisely where the concept of "negligently" shades into the concept of "intentionally" for the purposes of section 36(3), nor attempt an exhaustive judicial interpretation of either term.

458. In view of our obligations under section 60 of the Act, and the Community case law relating to Article 15(2) of Council Regulation no.17, we do not think it useful to import into section 36(3) the concept of 'mens rea' as found in domestic criminal law.

***Findings on intentionally or negligently***

*Discounts to hospitals*

459. At paragraph 241 of the Decision the Director held that Napp's infringement of the Chapter II prohibition in relation to discounts to hospitals was committed "intentionally, or at the very least

negligently". As we have just held, the Director was not, at this stage of the analysis, obliged to specify whether he considered the infringement to be intentional or merely negligent.

460. The Director was, however, obliged to set out the reasons for his conclusion. After holding, in paragraph 242, that Napp was aware of its strong market position and the high barriers to entry facing rivals, the Director continued at paragraphs 243 and 244 of the Decision:

> "243. Napp was similarly aware of the strategic importance of the hospital segment for new competitors and potential entrants. It must therefore have been aware that its discounts to hospitals would have the effect of reducing the ability of competitors to gain market share in the hospital and community segments of the market, and could lead them to exit the market altogether. That this was Napp's intention is shown the more clearly by the fact that its prices to hospitals were below direct cost and by its having adjusted discounts on particular products and in respect of supplies to particular hospital regions according to the amount of competition it faced.
>
> 244. The Director is satisfied therefore that Napp's conduct had as its object the restriction of competition. He is equally satisfied that Napp was aware that its actions would be, or, at the very least, would be reasonably be likely to be, restrictive of competition, but was still prepared to carry them out. Furthermore, contrary to Napp's representations, Napp cannot have been unaware of the exceptional magnitude of the discounts it was offering to hospitals or of the asymmetry between its position in the market and that of its competitors. It must therefore have been aware that it would not be possible for competitors to engage in similar pricing behaviour over the long term."

461. For the reasons already given in Section VII above, we entirely agree with the Director's findings in paragraphs 243 and 244 of the Decision. In our judgment, it follows from the findings we have already made in section VII above, that Napp's infringement of the Chapter II prohibition in relation to discounts to hospitals was committed intentionally within the meaning of section 36(3) of the Act. The Director himself held that Napp had the intention to eliminate competition: paragraph 236(a), last sentence.

462. As regards the various contrary arguments put forward by Napp, we have already found that Napp itself did not set its hospital prices by reference to any alleged narrow or mechanistic follow-on effect. Whether or not Napp believed that its hospital sales were in some sense "profitable" when the effects in the community segment are taken into account, is in our view irrelevant, since we are satisfied that Napp's intention was to exclude competitors from the hospital segment for as long as possible. We do not accept that Napp believed, or could reasonably have believed, that the conditions of competition were similar as between Napp and its competitors during the period of

infringement. We do not regard sustained pricing below direct cost by a superdominant enterprise enjoying a virtual monopoly 20 years after the launch of the product as in any sense "normal competition" or "legitimate commercial usage", as those terms are understood in Community or domestic competition law.

463. The same applies to selective discounting in the hospital segment by Napp, a superdominant enterprise, with the aim of protecting its monopoly in the community segment. In our judgment nothing in the structure of the NHS compelled Napp to act as it did or give rise to circumstances "beyond its control". The reforms of the Health Act 1999 were not material during the period of infringement. In our judgment, Napp's "net revenue" defence is and always was conceptually flawed and factually unsustainable for the reasons we have already given. We see no novelty in the infringement, given the decisions of the Court of Justice in *AKZO*, *Tetra Pak II* and *Compagnie Maritime Belge*. Napp's arguments as to alleged changes in the Director's case do not alter the overwhelming inference, to be drawn from the evidence as a whole, that Napp's hospital discounting policy was pursued with the deliberate intention of eliminating, or at least severely hindering, competition.

464. In all those circumstances in our judgment the infringement of the Chapter II prohibition consisting in low prices to hospitals was committed by Napp intentionally within the meaning of section 36(3).

*Excessive prices*

465. At paragraph 246 of the Decision the Director finds:

> "246. Napp has maintained high prices in the community segment of the relevant market in the full knowledge of its own very high market share, its profit margins on such sales, its competitors' prices, the preference for its brand on the part of the GPs, and their lack of price sensitivity. The Director therefore considers that Napp's infringement in respect of its excessive prices to the community was, for the purposes of section 36 of the Act, intentional or, at the very least, negligent."

466. There is little guidance in Community law as to the meaning of "intentionally or negligently" in the context of the exploitative abuse of maintaining unfairly high prices. In our judgment, it must be shown that the dominant undertaking either knew (in the sense that it could not have been unaware), or ought to have known, that it was, without objective justification, maintaining prices

above the levels that would prevail in conditions of normal competition. In this case Napp knew that it had a virtual monopoly in the community segment. Napp also knew that the price of MST was not subject to competitive pressure in the community segment. Napp, however, maintained the price of MST knowing that that price was (i) around 40 per cent above that of its competitors; (ii) on average over 1400 per cent above its price to hospitals on 10mg, 30mg, 60mg and 100mg tablets; and (iii) up to [...] [in excess of 500] per cent above its export prices on those tablets. Napp also knew that its gross profit margin was some [...] [in excess of 80]per cent, well above its average NHS margin.

467. On those facts, in our judgment, Napp at least ought to have known, that (i) it was a dominant undertaking; (ii) it was maintaining prices in the community segment well above competitive levels, and (iii) that those prices were not subject to significant competitive pressure.

468. Although the point is not made in paragraph 240 of the Decision, that conclusion is reinforced by our finding that Napp's pricing in the hospital segment was designed to prevent competitors from entering the market. Since BIL and Link both have (or had) lower prices than Napp in the community segment, Napp must have known that, once those competitors became established, its prices in the community segment would come under pressure. In our judgment, the natural inference is that Napp intended to do everything it could to maintain its community prices at levels above those which would prevail in competitive conditions. That inference is drawn by the Director himself in several places in the Decision, as the citations in paragraph 422 above show.

469. As to whether Napp knew or ought to have known that it had no objective justification for maintaining prices at those levels, Napp argues, in essence, that the abuse of excessive pricing could not have been committed "intentionally or negligently" because it reasonably thought its prices were not abusive so long as they remained within the limits of the PPRS. Furthermore, the Director varied his case in the administrative procedure, initially alleging that Napp's community prices should be aligned with its hospital prices, then alleging that Napp's community prices should be reduced by 20 per cent, and then finally settling on a reduction of 15 per cent. Before the Tribunal, says Napp, the Director has further shifted his case on excessive pricing, now alleging that the abuse in the community segment exists in consequence of Napp's hospital pricing.

470. In our view Napp ought to have realised, on reasonable reflection, that its arguments of objective justification based on the PPRS were unfounded, for the reasons we have given at paragraphs 390

to 427 above. Moreover the fact that the Director's case has developed in the course of the proceedings does not alter the fact that, objectively speaking, Napp maintained prices in the community segment that it at least ought to have known were well above competitive levels and protected from competition. We do not accept that the question of "intentionally or negligently" under section 36(3) of the Act depends on whether or not the undertaking was told by the Director how to conduct its business. In the present case reference to *United Brands*, at paragraphs 248 to 253 of the judgment, cited above, would or should have put Napp on notice of the possibility that it was reaping trading benefits in the community segment "which it could not have reaped if there had been normal and sufficient competition".

471. On those facts, it seems to us, the abuse of excessive pricing was committed by Napp, at the least, negligently, within the meaning of section 36(3) the Act.

472. On the other hand, we consider that there is mitigation available to Napp on the excessive pricing abuse, which we deal with below.

B: THE AMOUNT OF THE PENALTY

***The Director's Guidance***

473. In the Decision, the Director has set the penalty by reference to the "five step" approach set out in the *Director's Guidance*, published under section 38 of the Act with the approval of the Secretary of State: section 38(4). The Director is obliged by section 38(8) to have regard to that guidance.

474. According to paragraph 1.8 of the *Director's Guidance*:

> "The twin objectives of the Director's policy on financial penalties are to impose penalties on infringing undertakings which reflect the seriousness of the infringement and to ensure that the threat of penalties will deter undertakings from engaging in anti-competitive practices. The Director therefore intends, where appropriate, to impose financial penalties which are severe, in particular in respect of agreements between undertakings which fix prices or share markets and other cartel activities, as well as serious abuses of a dominant position, which the Director considers are among the most serious infringements caught under the Act. The deterrent is not aimed solely at the undertakings which are subject to the decision, but also at other undertakings which might be considering activities that are contrary to the Chapter I and Chapter II prohibitions."

475. According to the *Director's Guidance*, section 2, the first 'step' in fixing a penalty (Step 1) is to apply a percentage rate, up to a maximum of 10 per cent, to the "relevant turnover" of the undertaking. The "relevant turnover" is not a statutory concept but is defined by the Director in his *Guidance* as the turnover in the relevant product market and relevant geographic market affected by the infringement in the last financial year.

476. Paragraphs 2.3 and 2.4 of the *Director's Guidance* state:

> "2.3 The starting point for determining the level of financial penalty which will be imposed on an undertaking is calculated by applying a percentage rate to the "relevant turnover" of the undertaking, up to a maximum of 10%. The "relevant turnover" is the turnover of the undertaking in the relevant product market and relevant geographic market affected by the infringement in the last financial year. This may include turnover generated outside the United Kingdom if the relevant geographic market for the relevant product is wider than the United Kingdom.
>
> 2.4 The actual percentage rate which will be applied to the "relevant turnover" will depend upon the nature of the infringement. The more serious the infringement, the higher the percentage rate is likely to be. Price-fixing or market-sharing agreements and other cartel activities are among the most serious infringements caught under the Chapter I prohibition. Conduct which infringes the Chapter II prohibition and which by virtue of the undertaking's dominant position and the nature of the conduct has, or is likely to have a particularly serious effect on competition, for example, predatory pricing, is also one of the most serious infringements under the Act. The starting point for such activities and conduct will be calculated by applying a percentage likely to be at or near 10% of the "relevant turnover" of the infringing undertakings."

477. The second 'step' (Step 2), according to the *Director's Guidance*, is an "adjustment for duration". Under that step, penalties for infringements which last for more than one year may be multiplied by not more than the number of years of the infringement.

478. Step 3, entitled "adjustment for other factors", is intended, to enable the Director to increase the penalty arrived at under Steps 1 and 2, in particular to achieve the necessary deterrent effect. Paragraphs 2.8 and 2.9 of the *Director's Guidance* provide:

> "2.8 The penalty figure reached after the calculations in steps 1 and 2 may be adjusted as appropriate to achieve the policy objectives, outlined in paragraph 1.8 above, in particular, of imposing penalties on infringing undertakings in order to deter undertakings from engaging in anti-competitive practices. The deterrent is not aimed solely at the undertakings which are subject to the decision, but also at other undertakings which might be considering activities which are contrary to the Chapter I and Chapter II prohibitions. Considerations at this stage may include, for example, the Director's estimate of the gain made or likely to be

made by the infringing undertaking from the infringement. Where relevant, the Director's estimate would account for any gains which might accrue to the undertaking in other product or geographic markets as well as the "relevant" market under consideration. The assessment of the need to adjust the penalty will be made on a case by case basis for each individual infringing undertaking.

2.9 This step may result in a substantial adjustment of the financial penalty calculated at the earlier steps. The consequence may be that the penalty which is imposed is much larger than would otherwise have been imposed. The result of any one of steps 2 or 3 above or 4 below may well be to take the penalty over 10% of the "relevant turnover" identified at step 1, but the overall cap on penalties is 10% of the "section 36(8) turnover" referred to in step 5 below and must not be exceeded."

479. Step 4 enables the Director to adjust the penalty arrived at under steps 1 to 3 in order to reflect other aggravating or mitigating factors. Examples are given in paragraphs 2.11 and 2.12 of the *Director's Guidance*.

480. As far as relevant for present purposes, step 5 in fixing the penalty is to ensure that the amount arrived at steps 1 to 4 does not exceed the maximum penalty permitted under The Competition Act 1998 (Determination of Turnover for Penalties) Order 2000 (SI 2000 no. 309) ("the Maximum Penalties Order"). Under section 36(8) of the Act, "no penalty fixed by the Director under this section may exceed 10 per cent of the turnover of the undertaking (determined in accordance with such provisions as may be specified in an order made by the Secretary of State)". According to Article 3 of the Maximum Penalties Order:

"3. The turnover of an undertaking for the purposes of section 36(8) is:

(1) the applicable turnover for the business year preceding the date when the infringement ended;

(2) where the length of the infringement is more than 12 months, in addition the amount of the applicable turnover for the business year preceding that identified under paragraph (1) which bears the same proportion to the applicable turnover for that business year as the period by which the length of infringement exceeds 12 months bears to 12 months; and

(3) where the length of the infringement is more than 24 months, in addition the amount of the applicable turnover for the business year preceding that identified under paragraph (2) which bears the same proportion to the applicable turnover for that business year as the period by which the length of infringement exceeds 24 months bears to 12 months;

save that the amount added under paragraph (2) or (3) shall not exceed the amount of the applicable turnover for the preceding business year in question."

*The Director's approach in the Decision*

481. At paragraphs 249 to 254 of the Decision the Director states under the heading "Step 1 – starting point":

> "249. The relevant product market affected by the infringements is the supply of sustained release morphine tablets and capsules in the UK. Napp's turnover in the relevant product market in the year ending 31 December 2000 was £[...] million. The Director has taken this as the relevant turnover for the purposes of calculating the starting point.
>
> 250. The actual percentage rate applied to the relevant turnover depends upon the nature of the infringement. The more serious the infringement, the higher the percentage rate is likely to be.
>
> 251. Napp has supplied sustained release morphine tablets and capsules to hospitals at significant discounts with the object and effect of preventing competitors from increasing their share of the relevant market and deterring new entry. Napp has further targeted its discounts at those areas where it faced or expected competition. The Director considers that Napp's discount policy directly restricted competition in at least a quarter of the relevant market and indirectly impaired competition in the whole of the relevant market. These discounts have therefore seriously disadvantaged Napp's competitors in competing for hospital sales and thereby further restricted and diminished competition in the hospital segment of the market. Furthermore, the hospital segment of the market is of considerable strategic importance for competitors wishing to increase sales in the larger community segment of the market. Hence Napp's discounts to hospitals have restricted and diminished competition in both the hospital and the community segments of the market.
>
> 252. Napp faces very little competition in the community segment of the market and the barriers to entry are high. Napp's prices to the community are typically some 40% higher than those of its competitors and, in most cases, over 1000% higher than the prices it charges to hospitals. They are also between [...] [in excess of 100%] and [...] [less than 700%] higher than its prices for export. In addition, its gross profit margins on community sales are in excess of [...][80%] compared to average NHS margins of around 40%. The result of Napp's conduct is a serious distortion of competition, and a considerable excess cost to the NHS and so to the taxpayer.
>
> 253. Sustained release morphine tablets and capsules are supplied for use in the final product market, rather than as an intermediate good, and the cost is borne by the taxpayer. The effects are therefore widespread.
>
> 254. The Director therefore concludes that, contrary to Napp's submissions, Napp has committed a serious infringement of the Chapter II prohibition and has taken as the starting point for determining the penalty 8% of the relevant turnover."

482. Under "Step 2 – adjustment for duration" the Director makes no adjustment since the infringement lasted little more than a year (paragraph 256 of the Decision).

483. At paragraphs 257 to 260 of the Decision the Director states under the heading "Step 3 – adjustment for other factors":

> "257. The penalty figure reached after the calculations in steps 1 and 2 may be adjusted as appropriate to achieve the Director's policy objectives of reflecting the seriousness of the infringement and deterrence. As regards the latter, the deterrent is not aimed solely at the infringing undertaking but also at other undertakings which might be considering activities contrary to the Act.
>
> 258. The Director considers that it is appropriate to make an adjustment to the penalty in order in particular to achieve his policy objective of deterrence. To achieve this objective, the Director has decided that in the present case the basis for the adjustment should be his estimate of Napp's gain from the infringements.
>
> 259. It is impossible to estimate with certainty how much lower Napp's profits would have been, or would now be, on sales of sustained release morphine tablets and capsules in the UK in the absence of the infringements. It is however clear that prices in the community segment of the market are, and have been throughout the period of the infringement, excessive and typically 40% higher than the prices charged by Napp's competitors. Moreover, it could be expected that were it not for the infringements, not only would Napp's community prices have been lower but the volume and value of its sales in the market as a whole would also have been, and would now be, lower. However, it is likely that Napp's revenues from hospital sales, representing on average 15% of the market by volume and less than 1% by value, have been less than they would otherwise have been.
>
> 260. On the basis of these findings, the Director estimates that Napp's likely gain from the infringements is, at the very least, £2m. The Director considers that this figure probably underestimates Napp's gain from the infringements but is satisfied that it is appropriate in this case to adjust the penalty by this amount in order to meet the Director's policy objectives on penalties. In reaching this conclusion, the Director has had regard both to Napp's turnover on the relevant market and to the fact that Napp's profits are subject to taxation. Following Step 3, the penalty is therefore adjusted to £2.92m."

484. At paragraph 262 of the Decision the Director states under the heading "Step 4 – adjustment for further aggravating and mitigating factors", that that figure of £2.92 million should be increased by 10 per cent since Napp did not alter its pricing policy since it became apparent to it, at least since 25 August 2000, that the Director regarded its behaviour as infringing the Chapter II prohibition. At paragraph 263 the Director states that there are no mitigating factors in this case.

485. Following Step 4, the Director therefore arrives at a penalty in the amount of £3.21 million.

486. Under the heading "Step 5 – adjustment to prevent maximum penalty being exceeded and to avoid double jeopardy" the Director states at paragraph 265 of the Decision:

"265. The final amount of any penalty imposed under section 36 may not exceed 10% of the turnover of the undertaking calculated in accordance with the Competition Act 1998 (Determination of Turnover for Penalties) Order. The UK turnover of Napp Pharmaceutical Holdings Limited in 2000 amounted to £51.2 and in 1999 to £53.9m. The length of the infringement exceeds 12 months by 30 days, so that the turnover for the purposes of section 36(8) of the Act is £51.2m + 30/365 of £53.9m, i.e. £55.6m. The calculated penalty does not exceed 10% of this figure."

***Arguments of the parties***

487. The essence of Napp's case, advanced in the alternative, is that the penalty should be cancelled or substantially reduced for the following reasons, in addition to those already advanced. (i) The Director has not addressed his mind to whether the infringement was negligent or intentional. (ii) The infringement was novel, taking into account OFT 414 and Community case law. (iii) Napp had a legitimate expectation it would not be penalised as long as it observed the PPRS. (iv) Little if any loss was caused to consumers, in terms of them having to forego goods which they could have purchased under competitive conditions, or by restricting innovation. (v) The persistence of Napp's infringement was in substantial part attributable to the Director's delay in pursuing his investigation and his failure to state his case earlier. (vi) The Director has failed to justify increasing the penalty by £2 million to represent Napp's "gain" from the infringement. (vii) Any "clawback" should not be from a date earlier than 13 March 2001, the date of the third Rule 14 Notice. (viii) Events prior to 1 March 2000, such as the exit of BIL, should not be taken into account in fixing any penalty. (ix) Napp did not initiate any "price war" with Farmitalia and BIL; it was hospital buyers who encouraged Napp to reduce its prices. (x) Napp could not have been expected to know that after the expiry of its patent it should have substantially reduced its list price for MST. (xi) It was reasonable for Napp to believe that provided it observed the terms of the PPRS its community prices would be regarded as reasonable. (xii) It is normal for suppliers of leading brands to maintain NHS list prices after patent expiry and offer differential discounts according to buyers' willingness to pay. (xiii) The Department of Health as the ultimate buyer of MST was well aware of Napp's costs and prices and of the prices of rival products. Department of Health officials do not agree with the Director's assessment. (xiv) Napp fully co-operated with the Director's investigations under the Act and earlier legislation. (xv) The Director was wrong to increase the level of penalty under step 4 by 10 per cent just because Napp continued to contest the case after the issue of the first Rule 14 Notice.

488. Napp also contends that the Director's "change of case" on pricing in the community segment should give rise to a reduction in the penalty of 70 to 75 per cent. According to Napp, the Director no longer advances a 'stand alone' abuse on prices in the community segment but only that the abuse on prices in the community segment results from the abuse on prices in the hospital segment. But, according to Napp, sales to hospitals influence only 25 to 30 per cent of the total market, well below the 40 per cent mentioned by the Director in paragraph 160 of the Decision. Since the community segment accounts for 90 per cent of sales of MST, the penalty attributable to the community segment should be assessed to be 70 to 75 per cent of the whole and reduced by that amount.

489. In any event, Napp contends that any alleged gain it has made is very much less than the figure of £2 million mentioned in paragraph 260 of the Decision. In exhibit "JB 6" to his first witness statement Mr Brogden set out various calculations of Napp's alleged "gain" which calculated the after-tax amount at approximately £1 million, assuming a 15 per cent reduction in the community price and an increase in hospital prices in accordance with the Directions. In these calculations, Mr Brogden assumed a 10 per cent loss of hospital sales, and a modest *increase* in Napp's community sales, resulting from the fall in the price in the community segment.

490. In Annex 9 of the defence, the Director produced various counter calculations which showed that Napp's "gain" properly calculated during the period of infringement was of the order of £2 million. The Director assumed a reduction of 15 per cent in the community price, a loss of volume in hospital sales of some 40 per cent, and a consequential reduction in Napp's market share in the community segment of 12½ per cent, over the first year of the infringement.

491. In response to those calculations, and a request by the Tribunal to the parties of 31 August 2001 to consider a period longer than one year, Napp produced further revised calculations in a letter from Herbert Smith dated 14 September 2001. That letter estimated Napp's after-tax 'gain' at approximately £1.1 million during the period of the infringement, again assuming a 15 per cent reduction in its community prices and an increase in hospital prices in line with the Directions. Napp further assumed an average loss of some 21 per cent of hospital sales in the first year, and a corresponding decline of 2 per cent in community sales. Napp points out, in its skeleton argument, that there would be hardly any 'gain' in the period of infringement if it were not required to reduce its community prices by 15 per cent.

492. The Director, in his defence, rejects Napp's arguments in mitigation and refutes Napp's criticisms of the penalty. He submits that the 10 per cent uplift at 'step 4' was not because Napp contested the case but because Napp did nothing to correct its behaviour despite being on notice that its selective discounting in the hospital segment was abusive.

493. As regards the gain, the Director did not produce the calculations that had been used to arrive at the figure of £2 million referred to in paragraph 260 of the Decision, although he told us in argument that at least some of those calculations were predicated on the 20 per cent price reduction in the community price, as originally suggested in the third Rule 14 Notice, rather than on the 15 per cent reduction required by the Directions. He did, however, produce the calculations just mentioned at annex 9 to the defence showing a gain of £2 million during the period of the infringement. In his skeleton argument the Director further submits, notably, that Napp's "gain" properly understood lasts for more than the 13 months of the infringement. That is because, even if the infringement had been terminated on 30 March 2001, there would be a certain time lag before rivals began effectively to penetrate the market.

494. As far as the parties' calculations of the 'gain' during the period of infringement are concerned, the key points of difference between the parties relate to (a) the assumed rate at which Napp would have lost hospital sales if it had raised its prices in accordance with the Directions on 1 March 2000 and (b) the assumed rate at which, in consequence, Napp would have lost market share, and thus profits, in the community segment. Factor (b) is more important than factor (a).

495. Thus, on (a) Napp assumes that it would lose 20 per cent of hospital contracts in the first 3 months, and lose a further 15 per cent of hospital sales over the following 21 months, giving a loss on average of 21 per cent of hospital sales over the year 1 March 2000 to 28 February 2001. The Director, on the other hand, assumes a loss of 40 per cent of hospital sales over the first twelve months from 1 March 2000.

496. As to (b), Napp assumes that its loss of hospital sales would lead to a loss of 2 per cent of community sales in the first 12 months, assuming a follow-on effect of 15 per cent, building up to 7 per cent over a period of 3 years. The Director, on the other hand, assumes that Napp's loss of hospital sales would lead to a loss of 12½ per cent of community sales over the first 12 months, or 25 per cent over the first 2 years. As to Napp's assumptions, the Director says that with a follow-on effect of 15 per cent, Napp's assumed loss of 35 per cent of hospital sales should lead to a loss

of community sales of 5.25 per cent. It is implausible that the reputation effect would account for only a further 1.75 per cent of the market (over 3 years) to make up Napp's figure of 7 per cent. As to the Director's assumptions, Napp says that the ratio of hospital to community sales suggests a high 'linkage' in favour of Link of about 1:2.8, which undermines the Director's case on the lack of "follow-on effect".

***Findings***

*General observations*

497. We observe first, that the Tribunal is not bound by the *Director's Guidance*. The Act contains no provision which requires the Tribunal to even have regard to that *Guidance*.

498. Schedule 8, paragraph 3(2) of the Act, provides that "the tribunal may confirm or set aside the decision which is the subject to the appeal, or any part of it, and may ... (b) impose, or revoke, or vary the amount of, a penalty ... or (e) make any other decision which the Director could have made."

499. It follows, in our judgment, that the Tribunal has a full jurisdiction itself to assess the penalty to be imposed, if necessary regardless of the way the Director has approached the matter in application of the *Director's Guidance*. Indeed, it seems to us that, in view of Article 6(1) of the ECHR, an undertaking penalised by the Director is entitled to have that penalty reviewed *ab initio* by an impartial and independent tribunal able to take its own decision unconstrained by the *Guidance*. Moreover, it seems to us that, in fixing a penalty, this Tribunal is bound to base itself on its own assessment of the infringement in the light of the facts and matters before the Tribunal at the stage of its judgment.

500. That said, it does not seem to us appropriate to disregard the *Director's Guidance*, or the Director's own approach in the Decision under challenge, when reaching our own conclusion as to what the penalty should be. The *Director's Guidance* will no doubt over time take account of the various indications given by this Tribunal in appeals against penalties.

501. We emphasise, however, that the only constraint on the amount of the penalty binding on this Tribunal is that which flows from the Maximum Penalties Order. In the present case the maximum penalty under that Order is £5.56 million, for an infringement by Napp lasting from 1 March 2000

to 31 March 2001. It is clear from that Order that Parliament intended that it is the overall turnover of the undertaking concerned, rather than its turnover in the products affected by the infringement, which is the final determinant for the amount of the penalty. As the Director points out in the *Guidance*, any other approach would mean that abuses by powerful companies in small relevant markets might not be appropriately sanctioned.

502. We agree with the thrust of the *Director's Guidance* that while the turnover in the products affected by the infringement may be an indicative starting point for the assessment of the penalty, the sum imposed must be such as to constitute a serious and effective deterrent, both to the undertaking concerned and to other undertakings tempted to engage in similar conduct. The policy objectives of the Act will not be achieved unless this Tribunal is prepared to uphold severe penalties for serious infringements. As the *Guidance* makes clear, the achievement of the necessary deterrent may well involve penalties above, often well above, 10 per cent of turnover in the products directly concerned by the infringement, subject only to the overall 'cap' imposed by the Maximum Penalties Order. The position in this respect is no different in principle under Article 15(2) of Council Regulation no. 17, albeit that the applicable maximum penalty under that provision is differently calculated.

503. We observe in parenthesis that since 1998 the European Commission has published *Guidelines on the Method of Setting Fines* OJ 1998 C9/3 ("the *Commission's Guidelines*") which have some similarities with, and some differences from, the *Director's Guidance*. The essential approach of the *Commission's Guidelines* is to indicate that the penalty will be made up of a fixed 'basic amount' depending on whether the infringement is categorised as 'minor', 'serious' or 'very serious'. The basic amount is then liable to be increased by reference to whether the infringement has lasted more than a year, and then further adjusted, upwards or downwards, according to whether there are aggravating or mitigating circumstances. Where there are differences between the *Director's Guidance* and the *Commission's Guidelines*, it seems to us that the differences are probably "relevant differences" for the purposes of section 60 of the Act, so that we are not required, at present, to take account of the *Commission's Guidelines*. Neither party has suggested that we should do so. However the principle of starting with a certain amount (either a percentage figure, as under the *Director's Guidance*, or a fixed sum, as under the *Commission's Guidelines*) and then adjusting that starting figure to meet the circumstances of the case, is common to both approaches.

*The issue of duration in relation to hospital pricing*

504. The infringement found in the Decision is the period from 1 March 2000 to 31 March 2001. However, in the event, Napp's abusively low prices to hospitals have continued not only during that period but up to the date of this judgment in January 2002. That is because, at the stage of Napp's application for interim relief, the Director consented to an order suspending the Directions: see [2001] CompAR 1. Although Napp gave certain undertakings relating to reimbursing the Department of Health if its case on prices in the community segment should turn out to be unfounded, those undertakings did not extend to the hospital segment. As a result, Napp's infringement in the hospital segment has in fact continued, or will have continued, for a period which is, in effect, at least 21 months from 1 March 2000 to the date of the Tribunal's judgment, rather than the 13 months found in the Decision. Taking account of the period of grace allowed by the Directions for the renegotiation of contracts, the infringement in the hospital segment is close to a duration of two years.

505. By virtue of Article 3 of the Maximum Penalties Order, Napp's applicable turnover for an infringement of (say) 21 months would be £51.2 million (UK turnover for 2000) plus $^{9}/_{12}$ of £53.9 million (UK turnover for 1999), that is to say £91.6 million. On that basis the maximum penalty to which Napp would now be subject would be £9.16 million.

506. However, since the point has not been raised by the Director, nor canvassed with Napp in the course of the proceedings, we think for the purposes of the penalty we are confined to treating Napp's hospital pricing as an infringement of 13 months duration which, on the basis of the Director's calculations, means that the maximum penalty is £5.56 million. There is, however, artificiality in this approach, since Article 3 of the Maximum Penalties Order proceeds on the basis that the infringement has ended whereas, in the case of Napp's policy of discounts to hospitals, it has not yet done so.

*"The gain" at Step 3*

507. We sympathise with the Director's intentions in increasing the penalty, at Step 3 of his calculation, by an amount representing Napp's 'gain' during the period of the infringement, in accordance with the *Director's Guidance* (see paragraph 260 of the Decision). However, in our view that approach presents certain difficulties. In the first place, there is the practical difficulty of assessing, in any

given case, what the gain is. That difficulty is illustrated by the present case. The Director did not disclose his original calculations which, according to him, showed a gain to Napp of £2 million. Since then, in the notice of appeal and the defence, and in a flurry of calculations and counter calculations exchanged between the parties in the days before the hearing, various different hypotheses and scenarios have been put forward by both sides. The Director's final figure (still £2 million) is some 100 per cent above Napp's final figure (some £1 million). The major difference between the parties are their different assumptions as to the rate at which Napp would have lost market share in the community segment if it had not priced below cost in the hospital segment from 1 March 2000 – 7 per cent over 3 years, according to Napp, and 25 per cent over 2 years, according to the Director.

508. Whatever our views as to which assumption is more plausible, neither assumption is verifiable. Other steps in the calculations, including the effect of taxation are more or less complex. This method of calculation, so it seems to us, is more suited to the process for assessing damages in civil litigation, rather than the fixing of a deterrent penalty. The fixing of the penalty under section 36 of the Act should in our view be done by methods which are as simple as possible, and easily verifiable by the Tribunal. In this case, the calculations submitted to us do not meet either criterion. Apart from anything else, once one changes, for the purposes of the calculation, one key parameter of competitive conditions – in this case Napp's ability to exclude competitors from the hospital market – one cannot assume that all other parameters remain static.

509. Secondly, we accept the Director's submission, albeit made at a very late stage, that the approach in the Decision which limits the 'gain' to the period of the infringement is extremely conservative, since in a case such as the present the consequences of the infringement for competition do not end on the date when the infringement ends. This is because, as Napp points out in its assumptions on the gain, even if the hospital pricing infringement had ended on 31 March 2001, it would still take some time for hospital contracts to be renegotiated, or hospitals to re-tender, for stocks to be run down, and for competitors to Napp to build up a sufficient 'presence' in the hospital segment. Only having established such a presence could those competitors then begin to make material gains in the community segment. Because of this "spill over" or "time lag" effect, we think it reasonable to assume that Napp's real "gain" from the infringement would have been likely to last for a considerable period after 31 March 2001.

510. Thirdly, and in our view more significantly, it seems to us that an arithmetical calculation of the 'gain' during the period of the infringement, of the kind carried out here, is likely to understate the real commercial gain from the infringing conduct, and thus risk being an ineffective penalty. In a case of predatory pricing, a significant part of the 'gain' made by the undertaking concerned is the deterrent effect it has on other undertakings which might have entered the market, or even other markets, where the dominant undertaking is active. That general effect, flowing from a general reputation for aggression, is not picked up in the calculations and is unquantifiable. Moreover the 'gain', as seen from the dominant undertaking's point of view, is not merely the market share it would otherwise have lost in some period determined arbitrarily by reference to when the Director chose to take his Decision. The real 'gain' is the long-term strategic advantage of protecting a monopoly market share and the profits that flow from that for as many years as possible. For example, Napp's calculations at Annex 26 to its skeleton argument show that Napp would have lost a minimal market share in the community segment up to the end of February 2001 if it had corrected its hospital prices on 1 March 2000, leading to a 'gain' after tax of just over £50,000. In our view it would be wholly unrealistic to fix a deterrent penalty by reference to that figure or anything resembling it, because such a figure does not reflect the real, but unquantifiable, commercial rationale behind Napp's hospital pricing policy. That rationale was to protect and preserve its monopoly revenues from the community segment, of over £10 million a year, for as long as possible.

511. For these reasons, we do not think that the calculation of a 'gain' should necessarily form the sole, or even the main, means of marking, for deterrent purposes, the seriousness of an infringement, notably in the context of Step 3 of the *Director's Guidance*, except perhaps in the clearest cases. We revert to the question of how market circumstances may develop in the future when we deal with the Directions below.

*Aggravation under Step 4*

512. At paragraph 262 of the Decision, the Director has increased the penalty by 10 per cent under 'Step 4' on the grounds that Napp did not alter its pricing policy, in particular after 25 August 2000, when it became "apparent to it that the Director regarded its behaviour as infringing the Chapter II prohibition". According to paragraph 2.11 of the *Director's Guidance* "continuing the infringement after the start of the investigation" is an aggravating circumstance. Although a comparable provision does not appear explicitly in the *Commission's Guidelines*, we can see that

continuing with infringing conduct after a clear warning of the illegality of the conduct in question could be an aggravating circumstance. Otherwise, the temptation might be to continue the illegal conduct for as long as possible, in the hope that the resulting commercial gain would outweigh any subsequent penalty. Nor, in our view, does such a possibility of taking account of such an aggravating circumstance necessarily contravene the "rights of the defence". The undertaking may still vigorously defend itself before the Director. The 'aggravating circumstance' is simply that continuing with conduct after an express warning of its illegality may be a worse offence than it would have been if no warning had been given.

513. On the other hand, we feel that some caution is called for on this aspect. The mere fact that the Director has commenced an investigation does not mean that an undertaking has committed an infringement, nor does the issue of a Rule 14 Notice. The threat that penalties may be increased if an undertaking does not "give in" on receipt of a Rule 14 Notice could perhaps, in some circumstances, inhibit the undertaking from defending itself or, perhaps, cause it to modify commercially defensible conduct without a finding of infringement having been made.

514. In these circumstances, we think the fact that an undertaking has continued an infringement after the start of an investigation can in many cases be sanctioned appropriately by simply taking into account the longer duration of the infringement thereby resulting. Further "aggravating circumstances" should be limited to cases where an undertaking has received a clear warning that it is engaging in a plain and obvious infringement of the Act, but has blatantly ignored that warning. Conversely, if an undertaking has, in fact, discontinued an infringement at the start of an investigation by the Director, that in our view is likely to be a mitigating factor.

515. In the present case, the first Rule 14 Notice, dated 25 August 2000, alleged both excessive prices in the community segment and prices below direct costs in the hospital segment. However, that Notice proposed as a remedy that Napp should not discriminate between customers in the community and hospital segments respectively – i.e. that the prices in the two segments should be the same, except for objectively justified reasons. That position was maintained in the second Rule 14 Notice sent to Napp on 2 February 2001, although the Director indicated his willingness to make certain alternative directions. In that second Rule 14 Notice, more prominence was given to the abuse in the hospital segment, and the Director included new material outlining his response to Napp's representations made in answer to the first Rule 14 Notice. In the third Rule 14 Notice of 13 March 2001, the Director dropped the direction he had originally proposed on 25 August 2000,

and instead proposed a direction to the effect that the NHS list price of MST in the community segment should be reduced by 20 per cent, with a floor price for MST sold in hospitals of 25 per cent of the reduced community price. Following further representations by Napp, the Directions, as finally made on 4 May 2001, imposed a reduction of 15 per cent in the NHS price of MST, plus a floor price for MST sold in hospitals of 20 per cent of that reduced community price.

516. The Director's willingness to modify his case following Napp's representations reflects credit on him and shows that the administrative procedure gave Napp a genuine opportunity to argue its case. However, the fact is that it was until March 2001 an integral part of the Director's case that Napp's hospital and community prices should be the same, which contention the Director has subsequently abandoned. In view of that modification to his case which the Director made at a very late stage of the administrative procedure, we do not think it right, in the present case, to regard it as an aggravating circumstance that Napp did not change its behaviour after the start of the investigation or the first Rule 14 Notice. We propose therefore to disregard the adjustment made in paragraph 262 of the Decision and to treat this case as if the Director had imposed a penalty of £2.92 million.

*Factors affecting the amount of the penalty in the present case*

517. We agree with the Director that it is artificial to regard the two abuses here in question as unconnected with each other. For ease of analysis, however, we deal first separately with the gravity of Napp's pricing in the hospital and community segments respectively, including our views on Napp's arguments in mitigation (paragraphs 487 et seq above).

— *Hospital pricing: seriousness*

518. We agree with the Director that predatory pricing, even of short duration, falls into the category of a serious abuse. Although it may, at first sight, seem anomalous that the application of competition law should result in higher, rather than lower prices, the present case vividly illustrates that the reason for predatory pricing is typically to exclude or neutralise competitors with a view to maintaining market share and/or high prices in sectors that would otherwise be threatened by competition. The "benefit" that some consumers (in this case hospital purchasing authorities) receive from below-cost predatory prices is wholly outweighed by the "disbenefit", in terms of high costs and lack of choice, which flows from the monopoly (in this case in the community

segment) that the predatory pricing is designed to protect or strengthen. Unless predatory pricing, and especially pricing below average variable cost, by dominant undertakings is rigorously penalised by competition law, new competitive entry may be thwarted, with the result that consumers never receive the benefit of competitive conditions, and the lower long-run price levels, wider choice and better quality which, in general, competition brings.

519. We therefore agree with the Director's view, at paragraph 2.4 of his *Guidance* that predatory pricing by a dominant undertaking is one of the most serious infringements of the Act.

520. As far as the present case is concerned, we regard Napp's conduct in the hospital segment as a serious abuse. We accept the Director's submission that Napp "consciously and very deliberately" priced below its direct costs in order to exclude competitors from the hospital segment and thus prevent them from gaining any form of toehold from which they might enter the community segment. Price reductions were not made across the board but were targeted selectively against competitors. Napp's pricing policy was in support of the monopoly already enjoyed by a "superdominant" undertaking. To borrow Mr Mountain's phrase, Napp had the key to the only viable point of entry into the whole of the relevant market, but chose to keep that gate locked.

521. As regards the various points made by Napp in mitigation, in the Decision the Director found that Napp had intentionally eliminated competition (paragraph 236(a), last sentence), and plainly proceeded on that basis when fixing the penalty. The infringement, in our view, was not novel as *AKZO* and *Tetra Pak II* show. In any event, the present case falls squarely within the principles of *Compagnie Maritime Belge* and *Irish Sugar*.

522. Although paragraphs 4.15 to 4.17 of OFT 414 are not entirely happily worded, we do not think in the circumstances of this particular case that Napp can credibly claim to have been misled by those paragraphs into believing that its hospital pricing policy in this case was not abusive (see paragraph 288 above).

523. Although it is true that the Director's case has not been wholly consistent as to what narrow "follow-on effect" he did or did not accept, we regard that as a side issue which does not affect the fundamental point that Napp's pricing policy was intended to, and in our judgment did, substantially hinder competition in the relevant market. As to the extent of foreclosure, we have already indicated our view that the whole of the relevant market was indirectly, or potentially,

affected by Napp's conduct: paragraphs 281 to 283 above. Nonetheless, we are prepared to make some slight allowance, by way of mitigation, to take account of the fact that OFT 414 is not drafted quite as clearly as it could have been, and the fact that the Director's case on follow-on effect and foreclosure has not been expressed entirely consistently.

524. We do not think that the Director's investigation in this case was unreasonably delayed, or that Napp can seriously claim that it did not know what to do to avoid infringing the Chapter II prohibition by its hospital pricing policy.

525. We reject Napp's argument that the effect of its hospital pricing policy on consumers was not great. On the contrary, we regard it as a serious feature of the present case that the product concerned is a pharmaceutical product for the treatment of patients in severe pain. Napp's conduct has, in practice, tended to limit the choice of prescribing doctors and in some cases to deny their seriously ill patients alternative oral sustained release morphine products (e.g. capsules). Napp has also made it more difficult for its competitors to bring new products to market. In so far as Napp's hospital pricing policy has tended to protect Napp's market share in the community segment and prevent market entry of cheaper products, it is the taxpayer who has suffered – in some cases paying on average a price over 1400 per cent higher depending on whether the product is dispensed by a retail pharmacist or in a hospital (see paragraph 420 above).

526. We agree with Napp that the exit of BIL should not be taken into account as such in fixing any penalty, but that matter is not mentioned by the Director as one of the factors that he has specifically taken into account. We do not take it specifically into account either, but do note that Napp's market shares in fact increased during the period of the infringement. The fact that price cutting was originally initiated by Farmitalia/BIL, and that hospital buyers allegedly 'encouraged' Napp (as to which we make no finding) are not in our view relevant to the abuse as committed during the period of infringement, especially in view of the case law cited at paragraphs 207 et seq above. The fact that we have not upheld paragraph 236(a)(i) of the Decision in our view merits only a nominal reduction in the penalty, since that point has hardly figured in the proceedings.

527. We add that we do not see Napp's alleged "co-operation" with the Director as going in any way beyond the normal, and thus not a mitigating factor. Napp has made no attempt to modify its conduct. We note that it is apparent from the documents disclosed to the Tribunal that there was material known to Napp which threw light on Napp's original motives in pursuing its hospital

pricing policy about which Napp chose, whether rightly or wrongly, to remain silent in the course of the administrative procedure and the early stages of this appeal. We see no mitigation there.

528. In the result, we have identified only slight mitigating factors in respect of Napp's serious abuse in the hospital segment.

— *Community pricing: seriousness*

529. As we have already held, we think that Napp ought to have known that it was charging prices in the community segment likely to be judged excessive. As will be seen, we do not regard the Directions as ungenerous towards Napp, in assuming as they do that the excessive pricing can be mitigated by a reduction of 15 per cent of the NHS List Price.

530. In this instance the issue of the duration of the abuse (1 March 2000 to 31 March 2001) does not arise in the same way as in regard to Napp's hospital pricing, since the period from 29 May 2001 is covered by Napp's undertaking to the Department of Health, given at the stage of interim relief, to reimburse the Department if this appeal should fail.

531. We take the view that the abuse of excessive pricing in the circumstances of this case is a serious matter. The size of Napp's margins, coupled with the extent of the differentials when the same product is sold in different segments of the same market, seem to us to be exceptional. For the reasons we have given, we do not think that Napp had any "legitimate expectation" that it would not be penalised if it remained within the limits on ROC under the PPRS, nor do we accept Napp's suggestion that Department of Health officials do not agree with the Director's case: see, on both points, Mr Brownlee's evidence.

532. Nor do we accept Napp's argument (paragraph 488 above) that the way the Director puts the matter in the defence virtually eliminates any penalty as far as the abuse of excessive pricing in the community segment is concerned. That abuse remains a separate abuse to which the Director was entitled to have regard in fixing the penalty: see paragraphs 428 to 442 above. We also entirely reject the suggestion, also made by Napp at paragraph 488 above, that the penalty should be in some way reduced "pro rata" on the basis of the volumes sold in the community and hospital segments respectively.

533. On the other hand, we see some mitigation in Napp's favour. First, it was not until the adoption of the Directions that Napp finally knew the Director's position as to the amount of reduction required to mitigate the "excess". Secondly, the existence of the PPRS, while not in our view sufficient to prevent Napp's infringement from being at least negligent, is in our view some mitigation. Although in our view Napp should have realised that the PPRS afforded no defence, it may not have been easy for Napp to come to terms with the fact that, as from 1 March 2000, the Chapter II prohibition imposes restraints on unfairly high prices charged by dominant undertakings, in addition to the constraints under the PPRS which, of course, applies to dominant and non-dominant firms alike. It is also true that the way the Director has characterised the abuse of excessive pricing before the Tribunal, linking it more explicitly to the abuse on hospital discounting, has to some extent "muddied the waters" as to the circumstances in which he (the Director) might consider the PPRS to be a defence to a charge of abuse of excessive pricing on pharmaceutical products. In addition there has been no decided case at Community level upholding an abuse of excessive pricing in circumstances comparable to the present case, and the principles upon which a price is to be judged "unfairly high" for the purposes of the Chapter II prohibition have not been considered in any previous decision of the Director or the Tribunal.

534. In all those circumstances, serious though the abuse of excessive pricing is, we think that the overall penalty imposed on Napp should take account of the mitigating factors we have identified.

***The Tribunal's assessment of the penalty***

535. This is the first occasion on which the Tribunal has considered the amount of a penalty under the Act. We propose to adopt a "broad brush" approach. Each case will depend on its own circumstances.

536. In this case the Director considered an appropriate penalty to be some £3.2 million. Omitting the "aggravating circumstance" that we are minded to exclude (paragraph 516 above) the Director's figure is £2.92 million.

537. We begin by taking the case as a whole. This is a serious case of predatory and selective pricing, lasting for thirteen months up to the date of the Decision, committed by a "superdominant" undertaking in one segment of the market (the hospital segment) and tending to protect high prices and margins in another segment of the market where that undertaking is also a virtual monopolist

(the community segment). In addition, Napp's prices in the community segment have been maintained well above the competitive level. If the objectives of the Act are to be achieved such conduct calls, in our judgment, for severe penalties. In those circumstances, absent any significant mitigating factors, we do not think that a penalty of £3 million, as a global figure, is outside the range of penalties that could reasonably be imposed, in a case such as the present, having regard to the permitted maximum of £5.56 million.

538. However, in view of the mitigating factors we have mentioned in paragraph 533 above, and to a slight extent those mentioned at paragraph 523 above, we have come to the conclusion that the overall penalty in this case should be fixed at the sum of £2.2 million.

539. If, as a "cross-check", we were to apply the methodology of the *Director's Guidance*, the same result would be reached by taking the Director's starting percentage under Step 1, applying to that percentage a multiplier of slightly over three to reach £2.92 million under Step 3, and then reducing that figure by some 25 per cent for mitigating factors under Step 4. That in our view would equally have been a reasonable approach.

540. For the reasons already indicated, in paragraphs 507 et seq above, we do not use the calculations of gain presented to us as the basis for our decision. However, we are satisfied that Napp's calculations of the gain do not adequately capture the full commercial advantage of the policy it has followed, for the reasons already given.

541. We consider that a penalty of £2.2 million is the lowest amount that can reasonably be arrived at to penalise Napp's conduct and to send an appropriate signal to the business community of the seriousness of infringements of the Competition Act 1998.

***Interest on the penalty***

542. Under Rule 27 of the Tribunal's Rules, if it confirms or varies any penalty the Tribunal may, in addition, add interest on the penalty from the date no earlier than the date on which the application was made, in this case 29 May 2001. We attach importance to this provision, since under section 37 of the Act the mere fact of making an appeal effectively postpones the obligation to pay until the appeal is determined.

543. We see no reason not to exercise this power in the present case. Subject to any observations by the parties, it seems to us that interest should be payable at a commercial rate on the penalty we have fixed from 30 June 2001 until payment by Napp or judgment under section 37. We will hear argument on the appropriate commercial rate of interest.

## X — THE DIRECTIONS

### *The letter of 4 May 2001*

544. The purpose of the Directions is to require Napp to bring the infringements to an end (paragraph 1), to reduce its NHS List Price by 15 per cent, and to sell to hospitals at a minimum price no lower than 20 per cent of that reduced NHS price (paragraph 2). A period of grace is allowed for the renegotiation of existing contracts (paragraphs 3 and 4). Various ancillary powers are included (paragraphs 5, 6 and 8).

545. The Director considers that such directions are necessary to bring to an end the infringements found in the Decision. In the letter of 4 May 2001 the Director states:

> "At paragraph 236 of the Decision two elements of Napp's conduct were found to infringe the Chapter II prohibition. First, Napp was found to have charged excessive prices to customers in the community segment of the market for the supply of sustained release morphine tablets and capsules in the United Kingdom (the relevant market). Second, Napp was found to have supplied sustained release morphine tablets to the hospital segment of the relevant market at discounts which have the object and effect of hindering competition in the relevant market.
>
> The Director considers that these two elements of Napp's pricing conduct are inter-related and must be considered as a whole in formulating directions which are appropriate to bring the infringement to an end. First, Napp's ability to sustain high prices in the community depends in large part on the effect of Napp's discounting behaviour to hospitals in hindering competition in the relevant market. Second, the fact that Napp's prices in the community segment of the relevant market are significantly above those of its rivals contributes to Napp's asymetrical advantage in bidding for hospital contracts."

546. As regards the reduction in Napp's NHS list price, the Director continues:

> "The Director considers that an immediate reduction in the NHS list price is appropriate in order to mitigate Napp's excessive prices in the community segment of the relevant market in the short to medium term. This reduction, coupled with a corresponding reduction in the ex-factory price of MST tablets sold to the community, will also reduce Napp's ability to cross-subsidise discounts in the hospital segment of the relevant market.

In the longer term, the Director considers that the best way to prevent Napp from pricing excessively is to maintain incentives, and to create opportunities, for competition to develop throughout the relevant market.

The Director considers that the appropriate level of reduction in the NHS list price would be fifteen per cent. This will significantly reduce the price of MST tablets to the community segment of the relevant market, while nevertheless allowing for a gap between the price of MST tablets and that of Napp's competitors, thus maintaining incentives for competition to develop. This is consistent with Napp's representations that a reasonable price premium on MST tablets should be allowed to reflect their current higher brand value relative to that of rival products."

547. As regards the restriction on discounting the price of MST tablets to hospitals, the Director states:

"Paragraph 2(d) of the directions provides that the price of each strength of MST tablet sold to hospitals in the UK shall not be less than twenty per cent of the NHS list price for that product strength of MST. The Director considers that this direction is appropriate in order to prevent Napp from restricting competition by supplying hospitals at excessively low prices.

The figure of twenty per cent represents the ratio between Napp's average cost of supplying MST tablets to hospitals and the average NHS list price for those products arrived at following the fifteen per cent reduction required by the direction at paragraph 2(a). The calculation of Napp's average cost of supplying MST tablets to hospitals for this purpose is based on the total delivered cost to Napp of supplying MST to hospitals in the UK over the period of March to May 2000. The calculation of Napp's average NHS list price, to which the fifteen per cent reduction is then applied, is based on the volumes of MST tablets supplied to hospitals in the UK over the same period.

The direction at paragraph 2(d) does not impose on Napp an absolute prohibition on supplying hospitals at prices below the average cost. In order to do so, however, Napp would need to reduce further its NHS list price for the product thus limiting its ability to cross-subsidise discounts in the hospital segment and so, by weakening the asymmetry between Napp's position and that of its competitors, increasing the opportunities for competition to develop.

In its representations, Napp has argued that in order to compete for hospital contracts it would have to reduce the list price of MST tablets to unnecessarily low levels. First, the Director does not consider that discounts to hospitals will remain at their current level following implementation of the direction. Second, MST tablets will maintain non-price advantages in competing for hospital contracts owing to Napp's position of dominance on the relevant market."

***Arguments of the parties***

548. According to Napp (i) the Directions go beyond the powers in section 33 of the Act in prohibiting Napp from setting its prices otherwise than in accordance with the Directions without the Director's consent, even in circumstances where Napp's prices were compatible with the Chapter II prohibition; (ii) the Directions unnecessarily replicate obligations imposed on Napp by the Chapter

II prohibition or the Act itself; (iii) paragraph 6 of the Directions gives the Director power to obtain information to which he is not entitled under the Act; (iv) paragraph 2(d) of the Directions wrongly extends to private hospitals and hospices; (v) there is no basis for requiring Napp to renegotiate its hospital contracts in order to bring to an end any supposed infringement; (vi) there is no basis for concluding that a reduction of at least 15 per cent in the current NHS list price of MST is necessary in order to end Napp's supposed infringement; (vii) there is no basis for concluding that it is appropriate to prohibit Napp from discounting its prices to hospitals to a level which falls below 20 per cent of the NHS list price in order to end Napp's supposed infringement; (viii) by publishing the floor price in full the Director is distorting competition, since its rivals will know at precisely what level to undercut Napp, making up any losses from follow-on linkages, while Napp is prevented from acting likewise.

549. In its skeleton argument Napp further submitted (i) since the Director no longer maintains that the abuse of excessive pricing is a stand-alone abuse, the remedy should focus on the hospital segment and not make a link between the community and hospital prices; (ii) Mr Hartley of Link opposes any reduction in Napp's community prices; (iii) the figure of 15 per cent is "plucked out of the air"; (iv) in so far as the Directions make transparent Napp's floor price, this distorts the tendering process in the hospital segment.

550. The Director submits that the Directions are properly made under the powers in section 33 of the Act and relies on the reasons given in the letter of 4 May 2001. The reduction of 15 per cent is a considered figure, designed to enable Napp to command a brand premium while reducing its excessive pricing. Since the abuse is a distinct infringement, any argument arising out of the wording of the defence is misplaced. As to Mr Hartley, under section 33 of the Act the Director must concentrate on directions "appropriate to bring the abuse to an end". The remaining price gap between Napp and its competitors should be sufficient for competition to develop. As to transparency, the Director considers that Napp will not suffer a significant competitive disadvantage because it will continue to have non-price advantages and competitors will have to overcome hospital switching costs.

551. Finally, as to the fact that paragraph 2(d) of the Directions permits Napp to sell below direct costs provided it also reduces its NHS prices proportionately, the Director considered that this was the least restrictive solution designed to remove Napp's ability to profit from its predatory behaviour by maintaining high prices in the community segment.

552. Mr Hartley of Link believes that if Napp's excessive discounting to hospitals is ended, this will enable Link to compete effectively and win hospital business. Once that is achieved, it is neither necessary nor appropriate to regulate the community price. If Napp is ordered to reduce its community price, Mr Hartley is concerned that it will reduce the competitive advantage that Link has fought hard to establish.

***Findings***

553. As to the various formal arguments put forward by Napp, section 33 of the Act empowers the Director to give "such directions as he considers appropriate to bring the infringement to an end". In our judgment it is within the Director's powers under that section to adopt the Directions in the form in which he has done so. The requirement not to set prices otherwise than in accordance with the Directions without the Director's consent (paragraph 2 of the Directions) is reasonably ancillary to the Director's purpose in putting an end to the infringements as is, in our judgment, the Director's power to require the information set out in paragraph 6 of the Directions. The requirement in paragraph 1 of the Directions to cease the infringements in question, and refrain from conduct of the same or equivalent effect, is a measure supplementary to the Chapter II prohibition and similar to orders made in decisions of the European Commission. Any doubt as to the scope of that obligation would fall to be resolved if and when the Director came to enforce the Directions before the court under section 34. The fact that the Directions extend to private hospitals and hospices does not seem to us to be open to objection.

554. On the substance of the Directions, it seems to us that the requirement to reduce the NHS List Price of MST by 15 per cent is at this stage the minimum necessary to mitigate the abuse of excessive pricing while at the same time allowing the development of competitive conditions. While we note the point made by Mr Hartley of Link, we think that the Director's duty, in the public interest, is to deal with the infringement. That must prevail over Link's private commercial interests. There will still remain a substantial difference between Napp's reduced NHS list price and Link's NHS list price, which Link can exploit in the market place. The figure of 15 per cent reduces the previous gap between Napp and its competitors, while allowing Napp some brand premium and according sufficient room to manoeuvre to Napp's competitors to allow competition to develop.

555. Nor do we think there is anything in the emphasis placed, in the Director's defence, as to the relationship between Napp's hospital prices and its community prices, which in any way removes



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or lessens the need for the requirement to reduce by 15 per cent the list price of MST. That requirement is necessary in order to remedy the distinct infringement of excess pricing found in the Decision. As at the date of the Directions, 4 May 2001, Napp's community prices were unfairly high, as we have found.

556. Indeed, in view of the exceptionally high margins and exceptional differentials enjoyed by Napp in the community segment, coupled with Napp's strong position in the hospital segment, our concern is not whether the reduction of 15 per cent in the NHS List Price of MST ordered by the Director is too much, but rather whether that reduction is really sufficient to reduce the price of MST to the competitive level.

557. As regards the floor price for sales of MST to hospitals, and given notably the fact that Napp is a superdominant undertaking, we think it is within the Director's powers, in the light of *Compagnie Maritime Belge,* to set the floor price at the level the Director has chosen, in order to eliminate the abuse in the hospital segment.

558. As to paragraph 2(d) of the Directions, as drafted it permits Napp to price below average total costs to hospitals if, at the same time, it makes a proportionate reduction in its NHS List Price. It is true that that possibility may be somewhat academic because the chances of Napp reducing its list price in that way may not be very great. Nonetheless the possibility is there. Our concern about paragraph 2(d) is, first, that the law, as expressed in *AKZO*, *Tetra Pak II*, and *Compagnie Maritime Belge* would not permit Napp to sell to hospitals at prices below either average total or average variable costs, even if it did at the same time reduce its NHS List Price. Secondly, we think there is some risk that Napp could use paragraph 2(d) to reduce its prices to hospitals below cost, thus once again blocking competitive entry. Accordingly we invite the Director to keep this aspect of the Directions under review.

559. As to transparency, it is true that the Director could simply have required Napp to set its prices no lower than some appropriate level of costs, subject to a system of verification. We see advantages, from the point of view of certainty and administrative convenience, in the form the Director has chosen. For the reasons he gives, and those we have given earlier in this judgment (paragraphs 342 to 349) we consider that Napp is not placed at a significant disadvantage or in an unreasonable position.

560. More generally, we are concerned, in the light of the evidence we have heard, as to whether the Directions, viewed as a whole will, in practice, be sufficient to encourage competitive conditions in the market for oral sustained release morphine in the United Kingdom, in view of Napp's strong position and reputation in both the community and hospital segments. We leave it, however, to the Director to carry out periodic reviews to ascertain whether or not the Directions are having the desired effect: see paragraph 8 of the Directions.

561. Finally, we remind the parties that the renegotiation of the hospital contracts is to be carried out as quickly as possible in accordance with paragraphs 2 to 5 of the undertaking given by Napp set out in the President's order dated 22 May 2001.

562. There will be liberty to apply in respect of any matter arising out of the Directions.

## XI — ORDERS MADE

563. On those grounds, the Tribunal hereby unanimously decides to confirm, in its result, and on the merits, the Director's Decision dated 30 March 2001 that Napp has committed the infringements of the Chapter II prohibition set out at paragraph 236 of that Decision, with the minor exception of paragraph 236(a)(i). As to the Director's reasoning, we have not felt it necessary to deal with every argument set out in the Decision. Where we have not referred to particular matters it is because we have not found it necessary to do so for the purposes of this judgment. Nonetheless we confirm, in substance, the essential features of the Director's reasoning. To the extent that we rely on other facts or matters, or express our finding in terms which differ from the Director, we take so far as necessary our own decision that Napp has infringed the Chapter II prohibition, pursuant to our powers in Schedule 8, paragraph 3(2) of the Act.

564. We vary the penalty and fix the amount of the penalty to be paid by Napp to the Director at £2.2 million. Interest will be payable on the penalty at a rate to be determined after hearing the parties, for the period from 30 June 2001 to the date of payment of the penalty, subject to any further observations by the parties on whether that is the relevant period. We confirm the Directions. Paragraph 1 of the President's interim order of 22 May 2001 ceases to have effect.

565. We have not yet heard submissions on costs. Our provisional view is that the proper order is for both sides to pay their own costs, including the costs of all interlocutory proceedings, but we will hear argument on any applications for costs, if made.

566. Subject to the foregoing, Napp's appeal is dismissed.

Christopher Bellamy Barry Colgate Peter Grinyer

Delivered in open court 15 January 2002

Charles Dhanowa

Registrar

*Note: This summary forms no part of the approved judgment but was produced by the Tribunal for the assistance of third parties seeking to understand the background to the proceedings. The full non-confidential text of the approved judgment will be published on the Tribunal's website www.competition-commission.org.uk.*

**NAPP PHARMACEUTICAL HOLDINGS LIMITED**

**-v-**

**DIRECTOR GENERAL OF FAIR TRADING**

---

## SUMMARY OF JUDGMENT

---

This is the first appeal to the Competition Commission Appeal Tribunal (the Tribunal) against the decision of the Director of Fair Trading (the Director) to impose a fine under section 36 of the Competition Act 1998 (the Act). The Act came into force on 1 March 2000. The decision was made following an investigation of a complaint to the Office of Fair Trading.

In his decision of 30 March 2001 the Director found that Napp Pharmaceutical Holdings Limited and subsidiaries (Napp), a pharmaceutical company based in Cambridge, had abused a dominant position in the supply of sustained release morphine tablets and capsules in the United Kingdom, contrary to section 18 of the Act, and imposed a fine of £3.21 million on the company. The Director's decision also included directions under section 33 of the Act regulating the prices at which Napp's sustained release morphine tablets, MST CONTINUS (MST), are to be sold.

MST was launched by Napp in 1980 and was the first sustained release morphine product to appear on the market. Napp has around 95 per cent of the total market for oral sustained release morphine tablets and capsules in the United Kingdom.

By far the majority of the supply of oral sustained release morphine is to the community segment of the market – ie. to patients under the care of their GP (86 to 90 per cent). The

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remainder of supply is to hospitals who either purchase by competitive tender, organised on a regional basis by NHS Purchasing and Supplies Agency, or its equivalent in Scotland or Northern Ireland, or directly from the manufacturer by independent tender.

In the Decision of 30 March 2001 the Director found that a number of factors made it difficult for new competitors to enter the market. According to the Director, the cumulative effect of these factors is to create significant barriers to entry into the community segment of the market, although that does not apply to the hospital segment where purchasers are price sensitive. In his decision the Director concluded that, for a new competitor, virtually the only viable means of gaining entry to the community segment of the market was through the "strategic gateway" of sales to hospitals. In his Decision the Director found two specific abuses of a dominant position:

- The first abuse of Napp's dominant position found by the Director related to its excessively low prices in the hospital segment of the market. By matching the prices offered by competitors with discounts of in excess of 90 per cent off its list prices Napp effectively foreclosed the hospital segment of the market. The Director found that Napp's prices in the hospital segment were below average direct cost and were intended to exclude competitors from this key strategic gateway to the larger and more profitable community segment of the market.

- The second abuse found by the Director was that the prices charged by Napp for MST in the community segment were above the competitive level and excessive. The prices that Napp was able to charge to the much larger community segment were on average well over 10 times higher than its price in the hospital segment and, at its highest level of discount, on some tablets even higher still. Napp's prices and margins were significantly higher than on its other products and significantly above those of its competitors. They were not subjected to competitive pressure and Napp was a virtual monopolist.

The directions imposed on Napp by the Director to bring the infringements to an end required Napp to reduce the NHS list price of MST tablets by at least 15 per cent and to sell MST tablets to hospitals in the UK at a price of not less than 20 per cent of the (reduced) NHS list price.

In its judgment handed down today the Tribunal has upheld the substance of the Director's decision on the question of infringement. The Tribunal considered that predatory pricing, even of short duration, is a serious abuse of a dominant position, especially when carried out by a virtual monopolist. The Tribunal considered that

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excessive prices was equally an abuse in this case, but that in that respect there were some mitigating factors, notably the existence of the voluntary Pharmaceutical Price Regulation Scheme (PPRS) agreed by the pharmaceutical industry, and the fact that this was the first case of excess pricing under the Act. Taking these mitigating factors into account, and excluding an aggravating circumstance relied on by the Director, the Tribunal has reduced the fine from £3.21 million to £2.2 million. The Tribunal also ordered interest to be payable on the fine from 30 June 2001 to the date of payment.

The Tribunal has also confirmed the Director's directions which will regulate MST's price to the hospital and community segments of the market. Under those directions Napp is required to reduce its NHS List Price by 15 per cent and to maintain its hospital prices at a minimum level. At the interim stage of these proceedings Napp gave an undertaking that, if Napp it were to lose the appeal, it would renegotiate the prices contained in its existing hospital supply contracts as quickly as possible, and reimburse the Department of Health for any excess costs which the Department has incurred in reimbursing community pharmacists for MST by reference to current NHS list prices from 29 May 2001.

15 January 2002

United States Court of Appeals,
District of Columbia Circuit.

UNITED STATES of America, Appellee,
v.
MICROSOFT CORPORATION, Appellant.

**Nos. 00-5212 and 00-5213.**

Argued Feb. 26 and 27, 2001.
Decided June 28, 2001.

Rehearing Denied Aug. 2, 2001.

Before: EDWARDS, Chief Judge, WILLIAMS, GINSBURG, SENTELLE, RANDOLPH, ROGERS and TATEL, Circuit Judges.

Opinion for the Court filed PER CURIAM.

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PER CURIAM:

Microsoft Corporation appeals from judgments of the District Court finding the company in violation of § § 1 and 2 of the Sherman Act and ordering various remedies.

The action against Microsoft arose pursuant to a complaint filed by the United States and separate complaints filed by individual States. The District Court determined that Microsoft had maintained a monopoly in the market for Intelcompatible PC operating systems in violation of § 2; attempted to gain a monopoly in the market for internet browsers in violation of § 2; and illegally tiedtwo purportedly separate products, Windows and Internet Explorer ("IE"), in violation of § 1. *United States v. Microsoft Corp.*, 87 F.Supp.2d 30 (D.D.C.2000) ("*Conclusions of Law*"). The District Court then found that the same facts that established liability under § § 1 and 2 of the Sherman Act mandated findings of liability under analogous state law antitrust provisions. *Id.* To remedy the Sherman Act violations, the District Court issued a Final Judgment requiring Microsoft to submit a proposed plan of divestiture, with the company to be split into an operating systems business and an applications business. *United States v. Microsoft Corp.*, 97 F.Supp.2d 59, 64-65 (D.D.C.2000) ("*Final Judgment*"). The District Court's remedial order also contains a number of interim restrictions on Microsoft's conduct. *Id.* at 66-69.

Microsoft's appeal contests both the legal conclusions and the resulting remedial order. There are three principal aspects of this appeal. First, Microsoft challenges the District Court's legal conclusions as to all three alleged antitrust violations and also a number of the procedural and factual foundations on which they rest. Second, Microsoft argues that the remedial order must be set aside, because the District Court failed to afford the company an evidentiary hearing on disputed facts and, also, because the substantive provisions of the order are flawed. Finally, Microsoft asserts that the trial judge committed ethical violations by engaging in impermissible *ex parte* contacts and making inappropriate public comments on the merits of the case while it was pending. Microsoft argues that these ethical violations compromised the District Judge's appearance of impartiality, thereby necessitating his disqualification and vacatur of his Findings of Fact, Conclusions of Law, and Final Judgment.

After carefully considering the voluminous record on appeal--including the District Court's Findings of Fact and Conclusions of Law, the testimony and exhibits submitted at trial, the parties' briefs, and the oral arguments before this court--we find that some but not all of Microsoft's liability challenges have merit. Accordingly, we affirm in part and reverse in part the District Court's judgment that Microsoft violated § 2 of the Sherman Act by employing anticompetitive means to maintain a monopoly in the operating system market; we reverse the District Court's determination that Microsoft violated § 2 of the Sherman Act by illegally attempting to monopolize the internet browser market; and we remand the District Court's finding that Microsoft violated § 1 of the Sherman Act by unlawfully tying its browser to its operating system. Our judgment extends to the District Court's findings with respect to the state law counterparts of the plaintiffs' Sherman Act claims.

We also find merit in Microsoft's challenge to the Final Judgment embracing the District Court's remedial order. There are several reasons supporting this conclusion. First, the District Court's Final Judgment rests on a number of liability determinations that do not survive appellate review; therefore, the remedial order as currently fashioned cannot stand. Furthermore, we would vacate and remand the remedial order even were we to uphold the District Court's liability determinations in their entirety, because the District Court failed to hold an evidentiary hearing to address remedies- specific factual disputes.

Finally, we vacate the Final Judgment on remedies,

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because the trial judge engaged in impermissible *ex parte* contacts by holding secret interviews with members of the media and made numerous offensive comments about Microsoft officials in public statements outside of the courtroom, giving rise to an appearance of partiality. Although we find no evidence of actual bias, we hold that the actions of the trial judge seriously tainted the proceedings before the District Court and called into question the integrity of the judicial process. We are therefore constrained to vacate the Final Judgment on remedies, remand the case for reconsideration of the remedial order, and require that the case be assigned to a different trial judge on remand. We believe that this disposition will be adequate to cure the cited improprieties.

In sum, for reasons more fully explained below, we affirm in part, reverse in part, and remand in part the District Court's judgment assessing liability. We vacate in full the Final Judgment embodying the remedial order and remand the case to a different trial judge for further proceedings consistent with this opinion.

## I. INTRODUCTION

*A. Background*

In July 1994, officials at the Department of Justice ("DOJ"), on behalf of the United States, filed suit against Microsoft, charging the company with, among other things, unlawfully maintaining a monopoly in the operating system market through anticompetitive terms in its licensing and software developer agreements. The parties subsequently entered into a consent decree, thus avoiding a trial on the merits. *See United States v. Microsoft Corp.*, 56 F.3d 1448 (D.C.Cir.1995) ("*Microsoft I*"). Three years later, the Justice Department filed a civil contempt action against Microsoft for allegedly violating one of the decree's provisions. On appeal from a grant of a preliminary injunction, this court held that Microsoft's technological bundling of IE 3.0 and 4.0 with Windows 95 did not violate the relevant provision of the consent decree. *United States v. Microsoft Corp.*, 147 F.3d 935 (D.C.Cir.1998) ("*Microsoft II*"). We expressly reserved the question whether such bundling might independently violate § § 1 or 2 of the Sherman Act. *Id.* at 950 n. 14.

On May 18, 1998, shortly before issuance of the *Microsoft II* decision, the United States and a group of State plaintiffs filed separate (and soon thereafter consolidated) complaints, asserting antitrust violations by Microsoft and seeking preliminary and permanent injunctions against the company's allegedly unlawful conduct. The complaints also sought any "other preliminary and permanent relief as is necessary and appropriate to restore competitive conditions in the markets affected by Microsoft's unlawful conduct." Gov't's Compl. at 53, *United States v. Microsoft Corp.*, No. 98- 1232 (D.D.C.1999). Relying almost exclusively on Microsoft's varied efforts to unseat Netscape Navigator as the preeminent internet browser, plaintiffs charged four distinct violations of the Sherman Act: (1) unlawful exclusive dealing arrangements in violation of § 1; (2) unlawful tying of IE to Windows 95 and Windows 98 in violation of § 1; (3) unlawful maintenance of a monopoly in the PC operating system market in violation of § 2; and (4) unlawful attempted monopolization of the internet browser market in violation of § 2. The States also brought pendent claims charging Microsoft with violations of various State antitrust laws.

* * *

Mediation failed after nearly four months of settlement talks between the parties. On April 3, 2000, with the parties' briefs having been submitted and considered, the District Court issued its conclusions of law. The District Court found Microsoft liable on the § 1 tying and § 2 monopoly maintenance and attempted monopolization claims, *Conclusions of Law*, at 35-51, while ruling that there was insufficient evidence to support a § 1 exclusive dealing violation, *id.* at 51-54. As to the pendent State actions, the District Court found the State antitrust laws conterminous with § § 1 and 2 of the Sherman Act, thereby obviating the need for further State-specific analysis. *Id.* at 54-56. In those few cases where a State's law required an additional showing of *intrastate* impact on competition, the District Court found the requirement easily satisfied on the evidence at hand. *Id.* at 55.

Having found Microsoft liable on all but one count, the District Court then asked plaintiffs to submit a proposed remedy. Plaintiffs' proposal for a remedial order was subsequently filed within four weeks, along with six supplemental declarations and over 50 new exhibits. In their proposal, plaintiffs sought specific conduct remedies, plus structural relief that would split Microsoft into an applications company and an operating systems company. The District Court rejected Microsoft's request for further evidentiary proceedings and, following a single hearing on the merits of the remedy question, issued its Final Judgment on June 7, 2000. The District

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Court adopted plaintiffs' proposed remedy without substantive change.

Microsoft filed a notice of appeal within a week after the District Court issued its Final Judgment. This court then ordered that any proceedings before it be heard by the court sitting *en banc*. . .

*B. Overview*

Before turning to the merits of Microsoft's various arguments, we pause to reflect briefly on two matters of note, one practical and one theoretical.

The practical matter relates to the temporal dimension of this case. The litigation timeline in this case is hardly problematic. Indeed, it is noteworthy that a case of this magnitude and complexity has proceeded from the filing of complaints through trial to appellate decision in a mere three years. *See, e.g., Data Gen. Corp. v. Grumman Sys. Support Corp.*, 36 F.3d 1147, 1155 (1st Cir.1994) (six years from filing of complaint to appellate decision); *Transamerica Computer Co., Inc. v. IBM*, 698 F.2d 1377, 1381 (9th Cir.1983) (over four years from start of trial to appellate decision); *United States v. United Shoe Mach. Corp.*, 110 F.Supp. 295, 298 (D.Mass.1953) (over five years from filing of complaint to trial court decision).

What is somewhat problematic, however, is that just over six years have passed since Microsoft engaged in the first conduct plaintiffs allege to be anticompetitive. As the record in this case indicates, six years seems like an eternity in the computer industry. By the time a court can assess liability, firms, products, and the marketplace are likely to have changed dramatically. This, in turn, threatens enormous practical difficulties for courts considering the appropriate measure of relief in equitable enforcement actions, both in crafting injunctive remedies in the first instance and reviewing those remedies in the second. Conduct remedies may be unavailing in such cases, because innovation to a large degree has already rendered the anticompetitive conduct obsolete (although by no means harmless). And broader structural remedies present their own set of problems, including how a court goes about *restoring* competition to a dramatically changed, and constantlychanging, marketplace. That is just one reason why we find the District Court's refusal in the present case to hold an evidentiary hearing on remedies--to update and flesh out the available information before seriously entertaining the possibility of dramatic structural relief--so problematic. *See infra* Section V.

We do not mean to say that enforcement actions will no longer play an important role in curbing infringements of the antitrust laws in technologically dynamic markets, nor do we assume this in assessing the merits of this case. Even in those cases where forward-looking remedies appear limited, the Government will continue to have an interest in defining the contours of the antitrust laws so that law-abiding firms will have a clear sense of what is permissible and what is not. And the threat of private damage actions will remain to deter those firms inclined to test the limits of the law.

The second matter of note is more theoretical in nature. We decide this case against a backdrop of significant debate amongst academics and practitioners over the extent to which "old economy" § 2 monopolization doctrines should apply to firms competing in dynamic technological markets characterized by network effects. In markets characterized by network effects, one product or standard tends towards dominance, because "the utility that a user derives from consumption of the good increases with the number of other agents consuming the good." Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424, 424 (1985). For example, "[a]n individual consumer's demand to use (and hence her benefit from) the telephone network ... increases with the number of other users on the network whom she can call or from whom she can receive calls." Howard A. Shelanski & J. Gregory Sidak, *Antitrust Divestiture in Network Industries*, 68 U. CHI. L. REV. 1, 8 (2001). Once a product or standard achieves wide acceptance, it becomes more or less entrenched. Competition in such industries is "for the field" rather than "within the field." *See* Harold Demsetz, *Why Regulate Utilities?*, 11 J.L. & ECON. 55, 57 & n.7 (1968) (emphasis omitted).

In technologically dynamic markets, however, such entrenchment may be temporary, because innovation may alter the field altogether. *See* JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 81-90 (Harper Perennial 1976) (1942). Rapid technological change leads to markets in which "firms compete through innovation for temporary market dominance, from which they may be displaced by the next wave of product advancements." Shelanski & Sidak, at 11-12 (discussing Schumpeterian competition, which proceeds "sequentially over time rather than

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simultaneously across a market"). Microsoft argues that the operating system market is just such a market.

Whether or not Microsoft's characterization of the operating system market is correct does not appreciably alter our mission in assessing the alleged antitrust violations in the present case. As an initial matter, we note that there is no consensus among commentators on the question of whether, and to what extent, current monopolization doctrine should be amended to account for competition in technologically dynamic markets characterized by network effects. *Compare* Steven C. Salop & R. Craig Romaine, *Preserving Monopoly: Economic Analysis, Legal Standards, and Microsoft,* 7 GEO. MASON L. REV. 617, 654-55, 663-64 (1999) (arguing that exclusionary conduct in high-tech networked industries deserves heightened antitrust scrutiny in part because it may threaten to deter innovation), *with* Ronald A. Cass & Keith N. Hylton, *Preserving Competition: Economic Analysis, Legal Standards and Microsoft,* 8 GEO. MASON L. REV. 1, 36-39 (1999) (equivocating on the antitrust implications of network effects and noting that the presence of network externalities may actually encourage innovation by guaranteeing more durable monopolies to innovating winners). Indeed, there is some suggestion that the economic consequences of network effects and technological dynamism act to offset one another, thereby making it difficult to formulate categorical antitrust rules absent a particularized analysis of a given market. *See* Shelanski & Sidak, at 6-7 ("High profit margins might appear to be the benign and necessary recovery of legitimate investment returns in a Schumpeterian framework, but they might represent exploitation of customer lock-in and monopoly power when viewed through the lens of network economics.... The issue is particularly complex because, in network industries characterized by rapid innovation, both forces may be operating and can be difficult to isolate.").

Moreover, it should be clear that Microsoft makes no claim that anticompetitive conduct should be assessed differently in technologically dynamic markets. It claims only that the measure of monopoly power should be different. For reasons fully discussed below, we reject Microsoft's monopoly power argument. *See infra* Section II.A.

With this backdrop in mind, we turn to the specific challenges raised in Microsoft's appeal.

## II. MONOPOLIZATION

Section 2 of the Sherman Act makes it unlawful for a firm to "monopolize." 15 U.S.C. § 2. The offense of monopolization has two elements: "(1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident." *United States v. Grinnell Corp.,* 384 U.S. 563, 570- 71, 86 S.Ct. 1698, 16 L.Ed.2d 778 (1966). The District Court applied this test and found that Microsoft possesses monopoly power in the market for Intel- compatible PC operating systems. Focusing primarily on Microsoft's efforts to suppress Netscape Navigator's threat to its operating system monopoly, the court also found that Microsoft maintained its power not through competition on the merits, but through unlawful means. Microsoft challenges both conclusions. We defer to the District Court's findings of fact, setting them aside only if clearly erroneous. Fed R. Civ. P. 52(a). We review legal questions *de novo*. *United States ex rel. Modern Elec., Inc. v. Ideal Elec. Sec. Co.,* 81 F.3d 240, 244 (D.C.Cir.1996).

We begin by considering whether Microsoft possesses monopoly power, *see infra* Section II.A, and finding that it does, we turn to the question whether it maintained this power through anticompetitive means. Agreeing with the District Court that the company behaved anticompetitively, *see infra* Section II.B, and that these actions contributed to the maintenance of its monopoly power, *see infra* Section II.C, we affirm the court's finding of liability for monopolization.

### *A. Monopoly Power*

While merely possessing monopoly power is not itself an antitrust violation, *see Northeastern Tel. Co. v. AT & T,* 651 F.2d 76, 84- 85 (2d Cir.1981) , it is a necessary element of a monopolization charge, *see Grinnell,* 384 U.S. at 570, 86 S.Ct. 1698. The Supreme Court defines monopoly power as "the power to control prices or exclude competition." *United States v. E.I. du Pont de Nemours & Co.,* 351 U.S. 377, 391, 76 S.Ct. 994, 100 L.Ed. 1264 (1956). More precisely, a firm is a monopolist if it can profitably raise prices substantially above the competitive level. 2A PHILLIP E. AREEDA ET AL., ANTITRUST LAW ¶ 501, at 85 (1995); *cf. Ball Mem'l Hosp., Inc. v. Mut. Hosp. Ins., Inc.,* 784 F.2d 1325, 1335 (7th Cir.1986) (defining market power as "the ability to cut back the market's total output and so raise price"). Where evidence

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indicates that a firm has in fact profitably done so, the existence of monopoly power is clear. *See Rebel Oil Co. v. Atl. Richfield Co.*, 51 F.3d 1421, 1434 (9th Cir.1995); *see also FTC v. Indiana Fed'n of Dentists*, 476 U.S. 447, 460-61, 106 S.Ct. 2009, 90 L.Ed.2d 445 (1986) (using direct proof to show market power in Sherman Act § 1 unreasonable restraint of trade action). Because such direct proof is only rarely available, courts more typically examine market structure in search of circumstantial evidence of monopoly power. 2A AREEDA ET AL., ANTITRUST LAW ¶ 531a, at 156; *see also, e.g., Grinnell*, 384 U.S. at 571, 86 S.Ct. 1698. Under this structural approach, monopoly power may be inferred from a firm's possession of a dominant share of a relevant market that is protected by entry barriers. *See Rebel Oil*, 51 F.3d at 1434. "Entry barriers" are factors (such as certain regulatory requirements) that prevent new rivals from timely responding to an increase in price above the competitive level. *See S. Pac. Communications Co. v. AT & T*, 740 F.2d 980, 1001-02 (D.C.Cir.1984).

The District Court considered these structural factors and concluded that Microsoft possesses monopoly power in a relevant market. Defining the market as Intel-compatible PC operating systems, the District Court found that Microsoft has a greater than 95% share. It also found the company's market position protected by a substantial entry barrier. *Conclusions of Law*, at 36.

Microsoft argues that the District Court incorrectly defined the relevant market. It also claims that there is no barrier to entry in that market. Alternatively, Microsoft argues that because the software industry is uniquely dynamic, direct proof, rather than circumstantial evidence, more appropriately indicates whether it possesses monopoly power. Rejecting each argument, we uphold the District Court's finding of monopoly power in its entirety.

**1. Market Structure**

a. Market definition

"Because the ability of consumers to turn to other suppliers restrains a firm from raising prices above the competitive level," *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210, 218 (D.C.Cir.1986) , the relevant market must include all products " reasonably interchangeable by consumers for the same purposes." *du Pont*, 351 U.S. at 395, 76 S.Ct. 994. In this case, the District Court defined the market as "the licensing of all Intel-compatible PC operating systems worldwide," finding that there are "currently no products--and ... there are not likely to be any in the near future--that a significant percentage of computer users worldwide could substitute for [these operating systems] without incurring substantial costs." *Conclusions of Law*, at 36. Calling this market definition "far too narrow," Appellant's Opening Br. at 84, Microsoft argues that the District Court improperly excluded three types of products: non-Intel compatible operating systems (primarily Apple's Macintosh operating system, Mac OS), operating systems for non-PC devices (such as handheld computers and portal websites), and "middleware" products, which are not operating systems at all.

We begin with Mac OS. Microsoft's argument that Mac OS should have been included in the relevant market suffers from a flaw that infects many of the company's monopoly power claims: the company fails to challenge the District Court's factual findings, or to argue that these findings do not support the court's conclusions. The District Court found that consumers would not switch from Windows to Mac OS in response to a substantial price increase because of the costs of acquiring the new hardware needed to run Mac OS (an Apple computer and peripherals) and compatible software applications, as well as because of the effort involved in learning the new system and transferring files to its format. *Findings of Fact* ¶ 20. The court also found the Apple system less appealing to consumers because it costs considerably more and supports fewer applications. *Id.* ¶ 21. Microsoft responds only by saying: "the district court's market definition is so narrow that it excludes Apple's Mac OS, which has competed with Windows for years, simply because the Mac OS runs on a different microprocessor." Appellant's Opening Br. at 84. This general, conclusory statement falls far short of what is required to challenge findings as clearly erroneous. *Pendleton v. Rumsfeld*, 628 F.2d 102, 106 (D.C.Cir.1980); *see also Terry v. Reno*, 101 F.3d 1412, 1415 (D.C.Cir.1996) (holding that claims made but not argued in a brief are waived). Microsoft neither points to evidence contradicting the District Court's findings nor alleges that supporting record evidence is insufficient. And since Microsoft does not argue that even if we accept these findings, they do not support the District Court's conclusion, we have no basis for upsetting the court's decision to exclude Mac OS from the relevant market.

Microsoft's challenge to the District Court's exclusion of non-PC based competitors, such as information appliances (handheld devices, etc.) and

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portal websites that host serverbased software applications, suffers from the same defect: the company fails to challenge the District Court's key factual findings. In particular, the District Court found that because information appliances fall far short of performing all of the functions of a PC, most consumers will buy them only as a supplement to their PCs. *Findings of Fact* ¶ 23. The District Court also found that portal websites do not presently host enough applications to induce consumers to switch, nor are they likely to do so in the near future. *Id.* ¶ 27. Again, because Microsoft does not argue that the District Court's findings do not support its conclusion that information appliances and portal websites are outside the relevant market, we adhere to that conclusion.

This brings us to Microsoft's main challenge to the District Court's market definition: the exclusion of middleware. Because of the importance of middleware to this case, we pause to explain what it is and how it relates to the issue before us.

Operating systems perform many functions, including allocating computer memory and controlling peripherals such as printers and keyboards. *See* Direct Testimony of Frederick Warren-Boulton ¶ 20, *reprinted in* 5 J.A. at 3172-73. Operating systems also function as platforms for software applications. They do this by "exposing"--*i.e.,* making available to software developers--routines or protocols that perform certain widely-used functions. These are known as Application Programming Interfaces, or "APIs." *See* Direct Testimony of James Barksdale ¶ 70, *reprinted in* 5 J.A. at 2895-96. For example, Windows contains an API that enables users to draw a box on the screen. *See* Direct Testimony of Michael T. Devlin ¶ 12, *reprinted in* 5 J.A. at 3525. Software developers wishing to include that function in an application need not duplicate it in their own code. Instead, they can "call"--*i.e.*, use--the Windows API. *See* Direct Testimony of James Barksdale ¶ ¶ 70-71, *reprinted in* 5 J.A. at 2895-97. Windows contains thousands of APIs, controlling everything from data storage to font display. *See* Direct Testimony of Michael Devlin ¶ 12, *reprinted in* 5 J.A. at 3525.

Every operating system has different APIs. Accordingly, a developer who writes an application for one operating system and wishes to sell the application to users of another must modify, or "port," the application to the second operating system. *Findings of Fact* ¶ 4. This process is both timeconsuming and expensive. *Id.* ¶ 30.

"Middleware" refers to software products that expose their own APIs. *Id.* ¶ 28; Direct Testimony of Paul Maritz ¶ ¶ 234-36, *reprinted in* 6 J.A. at 3727-29. Because of this, a middleware product written for Windows could take over some or all of Windows's valuable platform functions--that is, developers might begin to rely upon APIs exposed by the middleware for basic routines rather than relying upon the API set included in Windows. If middleware were written for multiple operating systems, its impact could be even greater. The more developers could rely upon APIs exposed by such middleware, the less expensive porting to different operating systems would be. Ultimately, if developers could write applications relying exclusively on APIs exposed by middleware, their applications would run on any operating system on which the middleware was also present. *See* Direct Testimony of Avadis Tevanian, Jr. ¶ 45, *reprinted in* 5 J.A. at 3113. Netscape Navigator and Java--both at issue in this case--are middleware products written for multiple operating systems. *Findings of Fact* ¶ 28.

Microsoft argues that, because middleware could usurp the operating system's platform function and might eventually take over other operating system functions (for instance, by controlling peripherals), the District Court erred in excluding Navigator and Java from the relevant market. The District Court found, however, that neither Navigator, Java, nor any other middleware product could now, or would soon, expose enough APIs to serve as a platform for popular applications, much less take over all operating system functions. *Id.* ¶ ¶ 28-29. Again, Microsoft fails to challenge these findings, instead simply asserting middleware's "potential" as a competitor. Appellant's Opening Br. at 86. The test of reasonable interchangeability, however, required the District Court to consider only substitutes that constrain pricing in the reasonably foreseeable future, and only products that can enter the market in a relatively short time can perform this function. *See* Rothery, 792 F.2d at 218 ("Because the ability of consumers to turn to other suppliers restrains a firm from raising prices above the competitive level, the definition of the 'relevant market' rests on a determination of available substitutes."); *see also Findings of Fact* ¶ 29 ("[I]t would take several years for middleware ... to evolve" into a product that can constrain operating system pricing.). Whatever middleware's ultimate potential, the District Court found that consumers could not now abandon their operating systems and switch to

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middleware in response to a sustained price for Windows above the competitive level. *Findings of Fact* ¶ ¶ 28, 29. Nor is middleware likely to overtake the operating system as the primary platform for software development any time in the near future. *Id.*

Alternatively, Microsoft argues that the District Court should not have excluded middleware from the relevant market because the primary focus of the plaintiffs' § 2 charge is on Microsoft's attempts to suppress middleware's threat to its operating system monopoly. According to Microsoft, it is "contradict[ory]," 2/26/2001 Ct. Appeals Tr. at 20, to define the relevant market to exclude the "very competitive threats that gave rise" to the action. Appellant's Opening Br. at 84. The purported contradiction lies between plaintiffs' § 2 theory, under which Microsoft preserved its monopoly against middleware technologies that threatened to become viable substitutes for Windows, and its theory of the relevant market, under which middleware is not presently a viable substitute for Windows. Because middleware's threat is only nascent, however, no contradiction exists. Nothing in § 2 of the Sherman Act limits its prohibition to actions taken against threats that are already well-developed enough to serve as present substitutes. *See infra* Section II.C. Because market definition is meant to identify products "reasonably interchangeable by consumers," *du Pont,* 351 U.S. at 395, 76 S.Ct. 994, and because middleware is not now interchangeable with Windows, the District Court had good reason for excluding middleware from the relevant market.

b. Market power

Having thus properly defined the relevant market, the District Court found that Windows accounts for a greater than 95% share. *Findings of Fact* ¶ 35. The court also found that even if Mac OS wereincluded, Microsoft's share would exceed 80%. *Id.* Microsoft challenges neither finding, nor does it argue that such a market share is not predominant. *Cf. Grinnell,* 384 U.S. at 571, 86 S.Ct. 1698 (87% is predominant); *Eastman Kodak Co. v. Image Technical Servs., Inc.,* 504 U.S. 451, 481, 112 S.Ct. 2072, 119 L.Ed.2d 265 (1992) (80%); *du Pont,* 351 U.S. at 379, 391, 76 S.Ct. 994 (75%).

Instead, Microsoft claims that even a predominant market share does not by itself indicate monopoly power. Although the "existence of [monopoly] power ordinarily may be inferred from the predominant share of the market," *Grinnell,* 384 U.S. at 571, 86 S.Ct. 1698, we agree with Microsoft that because of the possibility of competition from new entrants, *see Ball Mem'l Hosp., Inc.,* 784 F.2d at 1336, looking to current market share alone can be "misleading." *Hunt-Wesson Foods, Inc. v. Ragu Foods, Inc.,* 627 F.2d 919, 924 (9th Cir.1980); *see also Ball Mem'l Hosp., Inc.,* 784 F.2d at 1336 ("Market share reflects current sales, but today's sales do not always indicate power over sales and price tomorrow.") In this case, however, the District Court was not misled. Considering the possibility of new rivals, the court focused not only on Microsoft's present market share, but also on the structural barrier that protects the company's future position. *Conclusions of Law,* at 36. That barrier--the "applications barrier to entry"--stems from two characteristics of the software market: (1) most consumers prefer operating systems for which a large number of applications have already been written; and (2) most developers prefer to write for operating systems that already have a substantial consumer base. *See Findings of Fact* ¶ ¶ 30, 36. This "chicken-and-egg" situation ensures that applications will continue to be written for the already dominant Windows, which in turn ensures that consumers will continue to prefer it over other operating systems. *Id.*

Challenging the existence of the applications barrier to entry, Microsoft observes that software developers do write applications for other operating systems, pointing out that at its peak IBM's OS/2 supported approximately 2,500 applications. *Id.* ¶ 46. This misses the point. That some developers write applications for other operating systems is not at all inconsistent with the finding that the applications barrier to entry discourages many from writing for these less popular platforms. Indeed, the District Court found that IBM's difficulty in attracting a larger number of software developers to write for its platform seriously impeded OS/2's success. *Id.* ¶ 46.

Microsoft does not dispute that Windows supports many more applications than any other operating system. It argues instead that "[i]t defies common sense" to suggest that an operating system must support as many applications as Windows does (more than 70,000, according to the District Court, *id.* ¶ 40) to be competitive. Appellant's Opening Br. at 96. Consumers, Microsoft points out, can only use a very small percentage of these applications. *Id.* As the District Court explained, however, the applications barrier to entry gives consumers reason to prefer the dominant operating system even if they have no need to use all applications written for it:

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> The consumer wants an operating system that runs not only types of applications that he knows he will want to use, but also those types in which he might develop an interest later. Also, the consumer knows that if he chooses an operating system with enough demand to support multiple applications in each product category, he will be less likely to find himself straitened later by having to use an application whose features disappoint him. Finally, the average user knows that, generally speaking, applications improve through successive versions. He thus wants an operating system for which successive generations of his favorite applications will be released--promptly at that. The fact that a vastly larger number of applications are written for Windows than for other PC operating systems attracts consumers to Windows, because it reassures them that their interests will be met as long as they use Microsoft's product.

*Findings of Fact* ¶ 37. Thus, despite the limited success of its rivals, Microsoft benefits from the applications barrier to entry.

Of course, were middleware to succeed, it would erode the applications barrier to entry. Because applications written for multiple operating systems could run on any operating system on which the middleware product was present with little, if any, porting, the operating system market would become competitive. *Id.* ¶ ¶ 29, 72. But as the District Court found, middleware will not expose a sufficient number of APIs to erode the applications barrier to entry in the foreseeable future. *See id.* ¶ ¶ 28-29.

Microsoft next argues that the applications barrier to entry is not an entry barrier at all, but a reflection of Windows' popularity. It is certainly true that Windows may have gained its initial dominance in the operating system market competitively--through superior foresight or quality. But this case is not about Microsoft's initial acquisition of monopoly power. It is about Microsoft's efforts to maintain this position through means other than competition on the merits. Because the applications barrier to entry protects a dominant operating system irrespective of quality, it gives Microsoft power to stave off even superior new rivals. The barrier is thus a characteristic of the operating system market, not of Microsoft's popularity, or, as asserted by a Microsoft witness, the company's efficiency. *See* Direct Testimony of Richard Schmalensee ¶ 115, *reprinted in* 25 J.A. at 16153-14.

Finally, Microsoft argues that the District Court should not have considered the applications barrier to entry because it reflects not a cost borne disproportionately by new entrants, but one borne by all participants in the operating system market. According to Microsoft, it had to make major investments to convince software developers to write for its new operating system, and it continues to "evangelize" the Windows platform today. Whether costs borne by all market participants should be considered entry barriers is the subject of much debate. Compare 2A AREEDA & HOVENKAMP, ANTITRUST LAW § 420c, at 61 (arguing that these costs are entry barriers), *and* JOE S. BAIN, BARRIERS TO NEW COMPETITION: THEIR CHARACTER AND CONSEQUENCES IN MANUFACTURING INDUSTRIES 6-7 (1956) (considering these costs entry barriers), *with* *L.A. Land Co. v. Brunswick Corp.*, 6 F.3d 1422, 1428 (9thCir.1993) (evaluating cost based on "[t]he disadvantage of new entrants as compared to incumbents"), *and* GEORGE STIGLER, THE ORGANIZATION OF INDUSTRY 67 (1968) (excluding these costs). We need not resolve this issue, however, for even under the more narrow definition it is clear that there are barriers. When Microsoft entered the operating system market with MS-DOS and the first version of Windows, it did not confront a dominant rival operating system with as massive an installed base and as vast an existing array of applications as the Windows operating systems have since enjoyed. *Findings of Fact* ¶ ¶ 6, 7, 43. Moreover, when Microsoft introduced Windows 95 and 98, it was able to bypass the applications barrier to entry that protected the incumbent Windows by including APIs from the earlier version in the new operating systems. *See id.* ¶ 44. This made porting existing Windows applications to the new version of Windows much less costly than porting them to the operating systems of other entrants who could not freely include APIs from the incumbent Windows with their own.

**2. Direct Proof**

Having sustained the District Court's conclusion that circumstantial evidence proves that Microsoft possesses monopoly power, we turn to Microsoft's alternative argument that it does not behave like a monopolist. Claiming that software competition is uniquely "dynamic," Appellant's Opening Br. at 84 (quoting *Findings of Fact* ¶ 59), the company suggests a new rule: that monopoly power in the software industry should be proven directly, that is, by examining a company's actual behavior to determine if it reveals the existence of monopoly power. According to Microsoft, not only does no

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such proof of its power exist, but record evidence demonstrates the absence of monopoly power. The company claims that it invests heavily in research and development, *id.* at 88-89 (citing Direct Testimony of Paul Maritz ¶ 155, *reprinted in* 6 J.A. at 3698 (testifying that Microsoft invests approximately 17% of its revenue in R&D)), and charges a low price for Windows (a small percentage of the price of an Intel-compatible PC system and less than the price of its rivals, *id.* at 90 (citing *Findings of Fact* ¶ ¶ 19, 21, 46)).

Microsoft's argument fails because, even assuming that the software market is uniquely dynamic in the long term, the District Court correctly applied the structural approach to determine if the company faces competition in the short term. Structural market power analyses are meant to determine whether potential substitutes constrain a firm's ability to raise prices above the competitive level; only threats that are likely to materialize in the relatively near future perform this function to any significant degree. Rothery, 792 F.2d at 218 (quoting LAWRENCE SULLIVAN, ANTITRUST § 12, at 41 (1977)) (only substitutes that can enter the market "promptly" should be considered). The District Court expressly considered and rejected Microsoft's claims that innovations such as handheld devices and portal websites would soon expand the relevant market beyond Intel-compatible PC operating systems. Because the company does not challenge these findings, we have no reason to believe that prompt substitutes are available. The structural approach, as applied by the District Court, is thus capable of fulfilling its purpose even in a changing market. Microsoft cites no case, nor are we aware of one, requiring direct evidence to show monopoly power in any market. We decline to adopt such a rule now.

Even if we were to require direct proof, moreover, Microsoft's behavior may well be sufficient to show the existence of monopoly power. Certainly, none of the conduct Microsoft points to--its investment in R&D and the relatively low price of Windows--is inconsistent with the possession of such power. *Conclusions of Law,* at 37. The R&D expenditures Microsoft points to are not simply for Windows, but for its entire company, which most likely does not possess a monopoly for all of its products. Moreover, because innovation can increase an already dominant market share and further delay the emergence of competition, even monopolists have reason to invest in R&D. *Findings of Fact* ¶ 61. Microsoft's pricing behavior is similarly equivocal. The company claims only that it never charged the short-term profit-maximizing price for Windows. Faced with conflicting expert testimony, the District Court found that it could not accurately determine what this price would be. *Id.* ¶ 65. In any event, the court found, a price lower than the short-term profit-maximizing price is not inconsistent with possession or improper use of monopoly power. *Id.* ¶ ¶ 65-66. *Cf.* Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263, 274 (2d Cir.1979) ("[I]f monopoly power has been acquired or maintained through improper means, the fact that the power has not been used to extract [a monopoly price] provides no succor to the monopolist."). Microsoft never claims that it did not charge the long-term monopoly price. Micosoft does argue that the price of Windows is a fraction of the price of an Intel- compatible PC system and lower than that of rival operating systems, but these facts are not inconsistent with the District Court's finding that Microsoft has monopoly power. *See Findings of Fact* ¶ 36 ("Intel-compatible PC operating systems other than Windows [would not] attract[ ] significant demand .... even if Micosoft held its prices substantially above the competitive level.").

More telling, the District Court found that some aspects of Microsoft's behavior are difficult to explain unless Windows is a monopoly product. For instance, according to the District Court, the company set the price of Windows without considering rivals' prices, *Findings of Fact* ¶ 62, something a firm without a monopoly would have been unable to do. The District Court also found that Microsoft's pattern of exclusionary conduct could only be rational "if the firm knew that it possessed monopoly power." *Conclusions of Law,* at 37. It is to that conduct that we now turn.

*B. Anticompetitive Conduct*

As discussed above, having a monopoly does not by itself violate § 2. A firm violates § 2 only when it acquires or maintains, or attempts to acquire or maintain, a monopoly by engaging in exclusionary conduct "as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident." Grinnell, 384 U.S. at 571, 86 S.Ct. 1698; *see also* United States v. Aluminum Co. of Am., 148 F.2d 416, 430 (2d Cir.1945) (Hand, J.) ("The successful competitor, having been urged to compete, must not be turned upon when he wins.").

In this case, after concluding that Microsoft had monopoly power, the District Court held that Microsoft had violated § 2 by engaging in a variety

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of exclusionary acts (not including predatory pricing), to maintain its monopoly by preventing the effective distribution and use of products that might threaten that monopoly. Specifically, the District Court held Microsoft liable for: (1) the way in which it integrated IE into Windows; (2) its various dealings with Original Equipment Manufacturers ("OEMs"), Internet Access Providers ("IAPs"), Internet Content Providers ("ICPs"), Independent Software Vendors ("ISVs"), and Apple Computer; (3) its efforts to contain and to subvert Java technologies; and (4) its course of conduct as a whole. Upon appeal, Microsoft argues that it did not engage in any exclusionary conduct.

Whether any particular act of a monopolist is exclusionary, rather than merely a form of vigorous competition, can be difficult to discern: the means of illicit exclusion, like the means of legitimate competition, are myriad. The challenge for an antitrust court lies in stating a general rule for distinguishing between exclusionary acts, which reduce social welfare, and competitive acts, which increase it.

From a century of case law on monopolization under § 2, however, several principles do emerge. First, to be condemned as exclusionary, a monopolist's act must have an "anticompetitive effect." That is, it must harm the competitive *process* and thereby harm consumers. In contrast, harm to one or more *competitors* will not suffice. "The [Sherman Act] directs itself not against conduct which is competitive, even severely so, but against conduct which unfairly tends to destroy competition itself." *Spectrum Sports, Inc. v. McQuillan,* 506 U.S. 447, 458, 113 S.Ct. 884, 122 L.Ed.2d 247 (1993); *see also Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.,* 509 U.S. 209, 225, 113 S.Ct. 2578, 125 L.Ed.2d 168 (1993) ("Even an act of pure malice by one business competitor against another does not, without more, state a claim under the federal antitrust laws....").

Second, the plaintiff, on whom the burden of proof of course rests, *see, e.g., Monsanto Co. v. Spray-Rite Serv. Corp.,* 465 U.S. 752, 763, 104 S.Ct. 1464, 79 L.Ed.2d 775 (1984); *see also United States v. Arnold, Schwinn & Co.,* 388 U.S. 365, 374 n. 5, 87 S.Ct. 1856, 18 L.Ed.2d 1249 (1967), *overruled on other grounds, Cont'l T.V., Inc. v. GTE Sylvania Inc.,* 433 U.S. 36, 97 S.Ct. 2549, 53 L.Ed.2d 568 (1977), must demonstrate that the monopolist's conduct indeed has the requisite anticompetitive effect. *See generally Brooke Group,* 509 U.S. at 225-26, 113 S.Ct. 2578. In a case brought by a private plaintiff, the plaintiff must show that its injury is "of 'the type that the statute was intended to forestall,' " *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.,* 429 U.S. 477, 487-88, 97 S.Ct. 690, 50 L.Ed.2d 701 (1977) (quoting *Wyandotte Transp. v. United States,* 389 U.S. 191, 202, 88 S.Ct. 379, 19 L.Ed.2d 407 (1967)); no less in a case brought by the Government, it must demonstrate that the monopolist's conduct harmed competition, not just a competitor.

Third, if a plaintiff successfully establishes a *prima facie* case under § 2 by demonstrating anticompetitive effect, then the monopolist may proffer a "procompetitive justification" for its conduct. *See Eastman Kodak,* 504 U.S. at 483, 112 S.Ct. 2072. If the monopolist asserts a procompetitive justification--a nonpretextual claim that its conduct is indeed a form of competition on the merits because it involves, for example, greater efficiency or enhanced consumer appeal--then the burden shifts back to the plaintiff to rebut that claim. *Cf. Capital Imaging Assocs., P.C. v. Mohawk Valley Med. Assocs., Inc.,* 996 F.2d 537, 543 (2d Cir.1993).

Fourth, if the monopolist's procompetitive justification stands unrebutted, then the plaintiff must demonstrate that the anticompetitive harm of the conduct outweighs the procompetitive benefit. In cases arising under § 1 of the Sherman Act, the courts routinely apply a similar balancing approach under the rubric of the "rule of reason." The source of the rule of reason is *Standard Oil Co. v. United States,* 221 U.S. 1, 31 S.Ct. 502, 55 L.Ed. 619 (1911), in which the Supreme Court used that term to describe the proper inquiry under both sections of the Act. *See id.* at 61-62, 31 S.Ct. 502 ("[W]hen the second section [of the Sherman Act] is thus harmonized with ... the first, it becomes obvious that the criteria to be resorted to in any given case for the purpose of ascertaining whether violations of the section have been committed, is the rule of reason guided by the established law...."). As the Fifth Circuit more recently explained, "[i]t is clear ... that the analysis under section 2 is similar to that under section 1 regardless whether the rule of reason label is applied...." *Mid-Texas Communications Sys., Inc. v. AT & T,* 615 F.2d 1372, 1389 n. 13 (5th Cir.1980) (citing *Byars v. Bluff City News Co.,* 609 F.2d 843, 860 (6th Cir.1979)); *see also Cal. Computer Prods., Inc. v. IBM Corp.,* 613 F.2d 727, 737 (9th Cir.1979).

Finally, in considering whether the monopolist's conduct on balance harms competition and is

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therefore condemned as exclusionary for purposes of § 2, our focus is upon the effect of that conduct, not upon the intent behind it. Evidence of the intent behind the conduct of a monopolist is relevant only to the extent it helps us understand the likely effect of the monopolist's conduct. *See, e.g., Chicago Bd. of Trade v. United States,* 246 U.S. 231, 238, 38 S.Ct. 242, 62 L.Ed. 683 (1918) ("knowledge of intent may help the court to interpret facts and to predict consequences"); *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.,* 472 U.S. 585, 603, 105 S.Ct. 2847, 86 L.Ed.2d 467 (1985).

With these principles in mind, we now consider Microsoft's objections to the District Court's holding that Microsoft violated § 2 of the Sherman Act in a variety of ways.

**1. Licenses Issued to Original Equipment Manufacturers**

The District Court condemned a number of provisions in Microsoft's agreements licensing Windows to OEMs, because it found that Microsoft's imposition of those provisions (like many of Microsoft's other actions at issue in this case) serves to reduce usage share of Netscape's browser and, hence, protect Microsoft's operating system monopoly. The reason market share in the browser market affects market power in the operating system market is complex, and warrants some explanation.

Browser usage share is important because, as we explained in Section II.A above, a browser (or any middleware product, for that matter) must have a critical mass of users in order to attract software developers to write applications relying upon the APIs it exposes, and away from the APIs exposed by Windows. Applications written to a particular browser's APIs, however, would run on any computer with that browser, regardless of the underlying operating system. "The overwhelming majority of consumers will only use a PC operating system for which there already exists a large and varied set of ... applications, and for which it seems relatively certain that new types of applications and new versions of existing applications will continue to be marketed...." *Findings of Fact* ¶ 30. If a consumer could have access to the applications he desired--regardless of the operating system he uses--simply by installing a particular browser on his computer, then he would no longer feel compelled to select Windows in order to have access to those applications; he could select an operating system other than Windows based solely upon its quality and price. In other words, the market for operating systems would be competitive.

Therefore, Microsoft's efforts to gain market share in one market (browsers) served to meet the threat to Microsoft's monopoly in another market (operating systems) by keeping rival browsers from gaining the critical mass of users necessary to attract developer attention away from Windows as the platform for software development. Plaintiffs also argue that Microsoft's actions injured competition in the browser market--an argument we will examine below in relation to their specific claims that Microsoft attempted to monopolize the browser market and unlawfully tied its browser to its operating system so as to foreclose competition in the browser market. In evaluating the § 2 monopoly maintenance claim, however, our immediate concern is with the anticompetitive effect of Microsoft's conduct in preserving its monopoly in the operating system market.

In evaluating the restrictions in Microsoft's agreements licensing Windows to OEMs, we first consider whether plaintiffs have made out a *prima facie* case by demonstrating that the restrictions have an anticompetitive effect. In the next subsection, we conclude that plaintiffs have met this burden as to all the restrictions. We then consider Microsoft's proffered justifications for the restrictions and, for the most part, hold those justifications insufficient.

a. *Anticompetitive effect of the license restrictions*

The restrictions Microsoft places upon Original Equipment Manufacturers are of particular importance in determining browser usage share because having an OEM pre-install a browser on a computer is one of the two most cost-effective methods by far of distributing browsing software. (The other is bundling the browser with internet access software distributed by an IAP.) *Findings of Fact* ¶ 145. The District Court found that the restrictions Microsoft imposed in licensing Windows to OEMs prevented many OEMs from distributing browsers other than IE. *Conclusions of Law,* at 39-40. In particular, the District Court condemned the license provisions prohibiting the OEMs from: (1) removing any desktop icons, folders, or "Start" menu entries; (2) altering the initial boot sequence; and (3) otherwise altering the appearance of the Windows desktop. *Findings of Fact* ¶ 213.

The District Court concluded that the first license restriction--the prohibition upon the removal of desktop icons, folders, and Start menu entries--

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thwarts the distribution of a rival browser by preventing OEMs from removing visible means of user access to IE. *Id.* ¶ 203. The OEMs cannot practically install a second browser in addition to IE, the court found, in part because "[p]re-installing more than one product in a given category ... can significantly increase an OEM's support costs, for the redundancy can lead to confusion among novice users." *Id.* ¶ 159; *see also id.* ¶ 217. That is, a certain number of novice computer users, seeing two browser icons, will wonder which to use when and will call the OEM's support line. Support calls are extremely expensive and, in the highly competitive original equipment market, firms have a strong incentive to minimize costs. *Id.* ¶ 210.

Microsoft denies the "consumer confusion" story; it observes that some OEMs do install multiple browsers and that executives from two OEMs that do so denied any knowledge of consumers being confused by multiple icons. *See* 11/5/98 pm Tr. at 41-42 (trial testimony of Avadis Tevanian of Apple), *reprinted in* 9 J.A. at 5493-94; 11/18/99 am Tr. at 69 (trial testimony of John Soyring of IBM), *reprinted in* 10 J.A. at 6222.

Other testimony, however, supports the District Court's finding that fear of such confusion deters many OEMs from pre-installing multiple browsers. *See, e.g.,* 01/13/99 pm Tr. at 614-15 (deposition of Microsoft's Gayle McClain played to the court) (explaining that redundancy of icons may be confusing to end users); 02/18/99 pm Tr. at 46-47 (trial testimony of John Rose of Compaq), *reprinted in* 21 J.A. at 14237-38 (same); 11/17/98 am Tr. at 68 (deposition of John Kies of Packard Bell-NEC played to the court), *reprinted in* 9 J.A. at 6016 (same); 11/17/98 am Tr. at 67-72 (trial testimony of Glenn Weadock), *reprinted in* 9 J.A. at 6015-20 (same). Most telling, in presentations to OEMs, Microsoft itself represented that having only one icon in a particular category would be "less confusing for endusers." *See* Government's Trial Exhibit ("GX") 319 at MS98 0109453. Accordingly, we reject Microsoft's argument that we should vacate the District Court's Finding of Fact 159 as it relates to consumer confusion.

As noted above, the OEM channel is one of the two primary channels for distribution of browsers. By preventing OEMs from removing visible means of user access to IE, the license restriction prevents many OEMs from pre- installing a rival browser and, therefore, protects Microsoft's monopoly from the competition that middleware might otherwise present. Therefore, we conclude that the license restriction at issue is anticompetitive. We defer for the moment the question whether that anticompetitive effect is outweighed by Microsoft's proffered justifications.

The second license provision at issue prohibits OEMs from modifying the initial boot sequence--the process that occurs the first time a consumer turns on the computer. Prior to the imposition of that restriction, "among the programs that many OEMs inserted into the boot sequence were Internet sign-up procedures that encouraged users to choose from a list of IAPs assembled by the OEM." *Findings of Fact* ¶ 210. Microsoft's prohibition on any alteration of the boot sequence thus prevents OEMs from using that process to promote the services of IAPs, many of which--at least at the time Microsoft imposed the restriction--used Navigator rather than IE in their internet access software. *See id.* ¶ 212; GX 295, *reprinted in* 12 J.A. at 14533 (Upon learning of OEM practices including boot sequence modification, Microsoft's Chairman, Bill Gates, wrote: "Apparently a lot of OEMs are bundling non-Microsoft browsers and coming up with offerings together with [IAPs] that get displayed on their machines in a FAR more prominent way than MSN or our Internet browser."). Microsoft does not deny that the prohibition on modifying the boot sequence has the effect of decreasing competition against IE by preventing OEMs from promoting rivals' browsers. Because this prohibition has a substantial effect in protecting Microsoft's market power, and does so through a means other than competition on the merits, it is anticompetitive. Again the question whether the provision is nonetheless justified awaits later treatment.

Finally, Microsoft imposes several additional provisions that, like the prohibition on removal of icons, prevent OEMs from making various alterations to the desktop: Microsoft prohibits OEMs from causing any user interface other than the Windows desktop to launch automatically, from adding icons or folders different in size or shape from those supplied by Microsoft, and from using the "Active Desktop" feature to promote third-party brands. These restrictions impose significant costs upon the OEMs; prior to Microsoft's prohibiting the practice, many OEMs would change the appearance of the desktop in ways they found beneficial. *See, e.g., Findings of Fact* ¶ 214; GX 309, *reprinted in* 22 J.A. at 14551 (March 1997 letter from Hewlett-Packard to Microsoft: "We are responsible for the cost of technical support of our customers, including

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the 33% of calls we get related to the lack of quality or confusion generated by your product.... We must have more ability to decide how our system is presented to our end users. If we had a choice of another supplier, based on your actions in this area, I assure you [that you] would not be our supplier of choice.").

The dissatisfaction of the OEM customers does not, of course, mean the restrictions are anticompetitive. The anticompetitive effect of the license restrictions is, as Microsoft itself recognizes, that OEMs are not able to promote rival browsers, which keeps developers focused upon the APIs in Windows. *Findings of Fact* ¶ 212 (quoting Microsoft's Gates as writing, "[w]inning Internet browser share is a very very important goal for us," and emphasizing the need to prevent OEMs from promoting both rival browsers and IAPs that might use rivals' browsers); *see also* 01/13/99 Tr. at 305-06 (excerpts from deposition of James Von Holle of Gateway) (prior to restriction Gateway had pre-installed non-IE internet registration icon that was larger than other desktop icons). This kind of promotion is not a zero-sum game; but for the restrictions in their licenses to use Windows, OEMs could promote multiple IAPs and browsers. By preventing the OEMs from doing so, this type of license restriction, like the first two restrictions, is anticompetitive: Microsoft reduced rival browsers' usage share not by improving its own product but, rather, by preventing OEMs from taking actions that could increase rivals' share of usage.

b. *Microsoft's justifications for the license restrictions*

Microsoft argues that the license restrictions are legally justified because, in imposing them, Microsoft is simply "exercising its rights as the holder of valid copyrights." Appellant's Opening Br. at 102. Microsoft also argues that the licenses "do not unduly restrict the opportunities of Netscape to distribute Navigator in any event." *Id.*

Microsoft's primary copyright argument borders upon the frivolous. The company claims an absolute and unfettered right to use its intellectual property as it wishes: "[I]f intellectual property rights have been lawfully acquired," it says, then "their subsequent exercise cannot give rise to antitrust liability." Appellant's Opening Br. at 105. That is no more correct than the proposition that use of one's personal property, such as a baseball bat, cannot give rise to tort liability. As the Federal Circuit succinctly stated: "Intellectual property rights do not confer a privilege to violate the antitrust laws." *In re Indep. Serv. Orgs. Antitrust Litig.*, 203 F.3d 1322, 1325 (Fed.Cir.2000).

Although Microsoft never overtly retreats from its bold and incorrect position on the law, it also makes two arguments to the effect that it is not exercising its copyright in an unreasonable manner, despite the anticompetitive consequences of the license restrictions discussed above. In the first variation upon its unqualified copyright defense, Microsoft cites two cases indicating that a copyright holder may limit a licensee's ability to engage in significant and deleterious alterations of a copyrighted work. *See Gilliam v. ABC*, 538 F.2d 14, 21 (2d Cir.1976); *WGN Cont'l Broad. Co. v. United Video, Inc.*, 693 F.2d 622, 625 (7th Cir.1982) . The relevance of those two cases for the present one is limited, however, both because those cases involved substantial alterations of a copyrighted work, *see Gilliam*, 538 F.2d at 18, and because in neither case was there any claim that the copyright holder was, in asserting its rights, violating the antitrust laws, *see WGN Cont'l Broad.*, 693 F.2d at 626; *see also Cmty. for Creative Non-Violence v. Reid*, 846 F.2d 1485, 1498 (D.C.Cir.1988) (noting, again in a context free of any antitrust concern, that "an author [ ] may have rights against" a licensee that "excessively mutilated or altered" the copyrighted work).

The only license restriction Microsoft seriously defends as necessary to prevent a "substantial alteration" of its copyrighted work is the prohibition on OEMs automatically launching a substitute user interface upon completion of the boot process. *See Findings of Fact* ¶ 211 ("[A] few large OEMs developed programs that ran automatically at the conclusion of a new PC system's first boot sequence. These programs replaced the Windows desktop either with a user interface designed by the OEM or with Navigator's user interface."). We agree that a shell that automatically prevents the Windows desktop from ever being seen by the user is a drastic alteration of Microsoft's copyrighted work, and outweighs the marginal anticompetitive effect of prohibiting the OEMs from substituting a different interface automatically upon completion of the initial boot process. We therefore hold that this particular restriction is not an exclusionary practice that violates § 2 of the Sherman Act.

In a second variation upon its copyright defense, Microsoft argues that the license restrictions merely prevent OEMs from taking actions that would reduce substantially the value of Microsoft's copyrighted

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work: that is, Microsoft claims each license restriction in question is necessary to prevent OEMs from so altering Windows as to undermine "the principal value of Windows as a stable and consistent platform that supports a broad range of applications and that is familiar to users." Appellant's Opening Br. at 102. Microsoft, however, never substantiates this claim, and, because an OEM's altering the appearance of the desktop or promoting programs in the boot sequence does not affect the code already in the product, the practice does not self-evidently affect either the "stability" or the " consistency" of the platform. *See Conclusions of Law,* at 41; *Findings of Fact* ¶ 227. Microsoft cites only one item of evidence in support of its claim that the OEMs' alterations were decreasing the value of Windows. Defendant's Trial Exhibit ("DX") 2395 at MSV0009378A, *reprinted in* 19 J.A. at 12575. That document, prepared by Microsoft itself, states: "there are quality issues created by OEMs who are too liberal with the pre-install process," referring to the OEMs' installation of Windows and additional software on their PCs, which the document says may result in "user concerns and confusion." To the extent the OEMs' modifications cause consumer confusion, of course, the OEMs bear the additional support costs. *See Findings of Fact* ¶ 159. Therefore, we conclude Microsoft has not shown that the OEMs' liberality reduces the value of Windows except in the sense that their promotion of rival browsers undermines Microsoft's monopoly--and that is not a permissible justification for the license restrictions.

Apart from copyright, Microsoft raises one other defense of the OEM license agreements: It argues that, despite the restrictions in the OEM license, Netscape is not completely blocked from distributing its product. That claim is insufficient to shield Microsoft from liability for those restrictions because, although Microsoft did not bar its rivals from all means of distribution, it did bar them from the cost-efficient ones.

In sum, we hold that with the exception of the one restriction prohibiting automatically launched alternative interfaces, all the OEM license restrictions at issue represent uses of Microsoft's market power to protect its monopoly, unredeemed by any legitimate justification. The restrictions therefore violate § 2 of the Sherman Act.

**2. Integration of IE and Windows**

Although Microsoft's license restrictions have a significant effect in closing rival browsers out of one of the two primary channels of distribution, the District Court found that "Microsoft's executives believed ... its contractual restrictions placed on OEMs would not be sufficient in themselves to reverse the direction of Navigator's usage share. Consequently, in late 1995 or early 1996, Microsoft set out to bind [IE] more tightly to Windows 95 as a technical matter." *Findings of Fact* ¶ 160.

Technologically binding IE to Windows, the District Court found, both prevented OEMs from pre-installing other browsers and deterred consumers from using them. In particular, having the IE software code as an irremovable part of Windows meant that pre-installing a second browser would "increase an OEM's product testing costs," because an OEM must test and train its support staff to answer calls related to every software product preinstalled on the machine; moreover, pre-installing a browser in addition to IE would to many OEMs be "a questionable use of the scarce and valuable space on a PC's hard drive." *Id.* ¶ 159.

Although the District Court, in its Conclusions of Law, broadly condemned Microsoft's decision to bind "Internet Explorer to Windows with ... technological shackles," *Conclusions of Law,* at 39, its findings of fact in support of that conclusion center upon three specific actions Microsoft took to weld IE to Windows: excluding IE from the "Add/Remove Programs" utility; designing Windows so as in certain circumstances to override the user's choice of a default browser other than IE; and commingling code related to browsing and other code in the same files, so that any attempt to delete the files containing IE would, at the same time, cripple the operating system. As with the license restrictions, we consider first whether the suspect actions had an anticompetitive effect, and then whether Microsoft has provided a procompetitive justification for them.

a. *Anticompetitive effect of integration*

As a general rule, courts are properly very skeptical about claims that competition has been harmed by a dominant firm's product design changes. *See, e.g., Foremost Pro Color, Inc. v. Eastman Kodak Co.,* 703 F.2d 534, 544- 45 (9th Cir.1983) . In a competitive market, firms routinely innovate in the hope of appealing to consumers, sometimes in the process making their products incompatible with those of rivals; the imposition of liability when a monopolist does the same thing will inevitably deter a certain amount of innovation. This is all the more true in a

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market, such as this one, in which the product itself is rapidly changing. *See Findings of Fact* ¶ 59. Judicial deference to product innovation, however, does not mean that a monopolist's product design decisions are per se lawful. *See* Foremost Pro Color, 703 F.2d at 545; *see also* Cal. Computer Prods., 613 F.2d at 739, 744; *In re IBM Peripheral EDP Devices Antitrust Litig.*, 481 F.Supp. 965, 1007-08 (N.D.Cal.1979).

The District Court first condemned as anticompetitive Microsoft's decision to exclude IE from the "Add/Remove Programs" utility in Windows 98. *Findings of Fact* ¶ 170. Microsoft had included IE in the Add/Remove Programs utility in Windows 95, *see id.* ¶ ¶ 175-76, but when it modified Windows 95 to produce Windows 98, it took IE out of the Add/Remove Programs utility. This change reduces the usage share of rival browsers not by making Microsoft's own browser more attractive to consumers but, rather, by discouraging OEMs from distributing rival products. *See id.* ¶ 159. Because Microsoft's conduct, through something other than competition on the merits, has the effect of significantly reducing usage of rivals' products and hence protecting its own operating system monopoly, it is anticompetitive; we defer for the moment the question whether it is nonetheless justified.

Second, the District Court found that Microsoft designed Windows 98 "so that using Navigator on Windows 98 would have unpleasant consequences for users" by, in some circumstances, overriding the user's choice of a browser other than IE as his or her default browser. *Id.* ¶ ¶ 171-72. Plaintiffs argue that this override harms the competitive process by deterring consumers from using a browser other than IE even though they might prefer to do so, thereby reducing rival browsers' usage share and, hence, the ability of rival browsers to draw developer attention away from the APIs exposed by Windows. Microsoft does not deny, of course, that overriding the user's preference prevents some people from using other browsers. Because the override reduces rivals' usage share and protects Microsoft's monopoly, it too is anticompetitive.

Finally, the District Court condemned Microsoft's decision to bind IE to Windows 98 "by placing code specific to Web browsing in the same files as code that provided operating system functions." *Id.* ¶ 161; *see also id.* ¶ ¶ 174, 192. Putting code supplying browsing functionality into a file with code supplying operating system functionality "ensure[s] that the deletion of any file containing browsing-specific routines would also delete vital operating system routines and thus cripple Windows...." *Id.* ¶ 164. As noted above, preventing an OEM from removing IE deters it from installing a second browser because doing so increases the OEM's product testing and support costs; by contrast, had OEMs been able to remove IE, they might have chosen to pre-install Navigator alone. *See id.* ¶ 159.

Microsoft denies, as a factual matter, that it commingled browsing and non- browsing code, and it maintains the District Court's findings to the contrary are clearly erroneous. According to Microsoft, its expert "testified without contradiction that '[t]he very same code in Windows 98 that provides Web browsing functionality' also performs essential operating system functions--not code in the same files, but the very same software code." Appellant's Opening Br. at 79 (citing 5 J.A. 3291-92).

Microsoft's expert did not testify to that effect "without contradiction," however. A Government expert, Glenn Weadock, testified that Microsoft "design [ed] [IE] so that some of the code that it uses co-resides in the same library files as other code needed for Windows." Direct Testimony ¶ 30. Another Government expert likewise testified that one library file, SHDOCVW.DLL, "is really a bundle of separate functions. It contains some functions that have to do specifically with Web browsing, and it contains some general user interface functions as well." 12/14/98 am Tr. at 60-61 (trial testimony of Edward Felten), *reprinted in* 11 J.A. at 6953-54. One of Microsoft's own documents suggests as much. *See* Plaintiffs' Proposed Findings of Fact ¶ 131.2.vii (citing GX 1686 (under seal) (Microsoft document indicating some functions in SHDOCVW.DLL can be described as "IE only," others can be described as "shell only" and still others can be described as providing both "IE" and "shell" functions)).

In view of the contradictory testimony in the record, some of which supports the District Court's finding that Microsoft commingled browsing and non-browsing code, we cannot conclude that the finding was clearly erroneous. *See* Anderson v. City of Bessemer City, 470 U.S. 564, 573-74, 105 S.Ct. 1504, 84 L.Ed.2d 518 (1985) ("If the district court's account of the evidence is plausible in light of the record viewed in its entirety, the court of appeals may not reverse it even though convinced that had it been sitting as the trier of fact, it would have weighed the evidence differently."). Accordingly, we reject Microsoft's argument that we should vacate Finding

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of Fact 159 as it relates to the commingling of code, and we conclude that such commingling has an anticompetitive effect; as noted above, the commingling deters OEMs from pre-installing rival browsers, thereby reducing the rivals' usage share and, hence, developers' interest in rivals' APIs as an alternative to the API set exposed by Microsoft's operating system.

b. *Microsoft's justifications for integration*

Microsoft proffers no justification for two of the three challenged actions that it took in integrating IE into Windows--excluding IE from the Add/Remove Programs utility and commingling browser and operating system code. Although Microsoft does make some general claims regarding the benefits of integrating the browser and the operating system, *see, e.g.*, Direct Testimony of James Allchin ¶ 94, *reprinted in* 5 J.A. at 3321 ("Our vision of deeper levels of technical integration is highly efficient and provides substantial benefits to customers and developers."), it neither specifies nor substantiates those claims. Nor does it argue that either excluding IE from the Add/Remove Programs utility or commingling code achieves any integrative benefit. Plaintiffs plainly made out a *prima facie* case of harm to competition in the operating system market by demonstrating that Microsoft's actions increased its browser usage share and thus protected its operating system monopoly from a middleware threat and, for its part, Microsoft failed to meet its burden of showing that its conduct serves a purpose other than protecting its operating system monopoly. Accordingly, we hold that Microsoft's exclusion of IE from the Add/Remove Programs utility and its commingling of browser and operating system code constitute exclusionary conduct, in violation of § 2.

As for the other challenged act that Microsoft took in integrating IE into Windows--causing Windows to override the user's choice of a default browser in certain circumstances--Microsoft argues that it has "valid technical reasons." Specifically, Microsoft claims that it was necessary to design Windows to override the user's preferences when he or she invokes one of "a few" out "of the nearly 30 means of accessing the Internet." Appellant's Opening Br. at 82. According to Microsoft:

> The Windows 98 Help system and Windows Update feature depend on ActiveX controls not supported by Navigator, and the now-discontinued Channel Bar utilized Microsoft's Channel Definition Format, which Navigator also did not support. Lastly, Windows 98 does not invoke Navigator if a user accesses the Internet through "My Computer" or "Windows Explorer" because doing so would defeat one of the purposes of those features--enabling users to move seamlessly from local storage devices to the Web *in the same browsing window*.

*Id*. (internal citations omitted). The plaintiff bears the burden not only of rebutting a proffered justification but also of demonstrating that the anticompetitive effect of the challenged action outweighs it. In the District Court, plaintiffs appear to have done neither, let alone both; in any event, upon appeal, plaintiffs offer no rebuttal whatsoever. Accordingly, Microsoft may not be held liable for this aspect of its product design.

**3. Agreements with Internet Access Providers**

The District Court also condemned as exclusionary Microsoft's agreements with various IAPs. The IAPs include both Internet Service Providers, which offer consumers internet access, and Online Services ("OLSs") such as America Online ("AOL"), which offer proprietary content in addition to internet access and other services. *Findings of Fact* ¶ 15. The District Court deemed Microsoft's agreements with the IAPs unlawful because:

> Microsoft licensed [IE] and the [IE] Access Kit [ (of which, more below) ] to hundreds of IAPs for no charge. [*Findings of Fact*] ¶ ¶ 250-51. Then, Microsoft extended valuable promotional treatment to the ten most important IAPs in exchange for their commitment to promote and distribute [IE] and to exile Navigator from the desktop. *Id.* ¶ ¶ 255-58, 261, 272, 288-90, 305- 06. Finally, in exchange for efforts to upgrade existing subscribers to client software that came bundled with [IE] instead of Navigator, Microsoft granted rebates--and in some cases made outright payments--to those same IAPs. *Id.* ¶ ¶ 259-60, 295.

*Conclusions of Law*, at 41.

The District Court condemned Microsoft's actions in (1) offering IE free of charge to IAPs and (2) offering IAPs a bounty for each customer the IAP signs up for service using the IE browser. In effect, the court concluded that Microsoft is acting to preserve its monopoly by offering IE to IAPs at an attractive price. Similarly, the District Court held Microsoft liable for (3) developing the IE Access Kit ("IEAK"), a software package that allows an IAP to "create a distinctive identity for its service in as little as a few hours by customizing the [IE] title bar, icon, start and search pages," *Findings of Fact* ¶ 249, and

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(4) offering the IEAK to IAPs free of charge, on the ground that those acts, too, helped Microsoft preserve its monopoly. *Conclusions of Law,* at 41-42. Finally, the District Court found that (5) Microsoft agreed to provide easy access to IAPs' services from the Windows desktop in return for the IAPs' agreement to promote IE exclusively and to keep shipments of internet access software using Navigator under a specific percentage, typically 25%. *See Conclusions of Law,* at 42 (citing *Findings of Fact* ¶ ¶ 258, 262, 289). We address the first four items-- Microsoft's inducements--and then its exclusive agreements with IAPs.

Although offering a customer an attractive deal is the hallmark of competition, the Supreme Court has indicated that in very rare circumstances a price may be unlawfully low, or "predatory." *See generally* Brooke Group, 509 U.S. at 220-27, 113 S.Ct. 2578. Plaintiffs argued before the District Court that Microsoft's pricing was indeed predatory; but instead of making the usual predatory pricing argument--that the predator would drive out its rivals by pricing below cost on a particular product and then, sometime in the future, raise its prices on that product above the competitive level in order to recoup its earlier losses--plaintiffs argued that by pricing below cost on IE (indeed, even paying people to take it), Microsoft was able simultaneously to preserve its stream of monopoly profits on Windows, thereby more than recouping its investment in below-cost pricing on IE. The District Court did not assign liability for predatory pricing, however, and plaintiffs do not press this theory on appeal.

The rare case of price predation aside, the antitrust laws do not condemn even a monopolist for offering its product at an attractive price, and we therefore have no warrant to condemn Microsoft for offering either IE or the IEAK free of charge or even at a negative price. Likewise, as we said above, a monopolist does not violate the Sherman Act simply by developing an attractive product. *See* Grinnell, 384 U.S. at 571, 86 S.Ct. 1698 ("[G]rowth or development as a consequence of a superior product [or] business acumen" is no violation.). Therefore, Microsoft's development of the IEAK does not violate the Sherman Act.

We turn now to Microsoft's deals with IAPs concerning desktop placement. Microsoft concluded these exclusive agreements with all "the leading IAPs," *Findings of Fact* ¶ 244, including the major OLSs. *Id.* ¶ 245; *see also id.* ¶ ¶ 305, 306. The most significant of the OLS deals is with AOL, which, when the deal was reached, "accounted for a substantial portion of all existing Internet access subscriptions and ... attracted a very large percentage of new IAP subscribers." *Id.* ¶ 272. Under that agreement Microsoft puts the AOL icon in the OLS folder on the Windows desktop and AOL does not promote any non-Microsoft browser, nor provide software using any non- Microsoft browser except at the customer's request, and even then AOL will not supply more than 15% of its subscribers with a browser other than IE. *Id.* ¶ 289.

The Supreme Court most recently considered an antitrust challenge to an exclusive contract in Tampa Electric Co. v. Nashville Coal Co., 365 U.S. 320, 81 S.Ct. 623, 5 L.Ed.2d 580 (1961). That case, which involved a challenge to a requirements contract, was brought under § 3 of the Clayton Act and § § 1 and 2 of the Sherman Act. The Court held that an exclusive contract does not violate the Clayton Act unless its probable effect is to "foreclose competition in a substantial share of the line of commerce affected." *Id.* at 327, 81 S.Ct. 623. The share of the market foreclosed is important because, for the contract to have an adverse effect upon competition, "the opportunities for other traders to enter into or remain in that market must be significantly limited." *Id.* at 328, 81 S.Ct. 623. Although "[n]either the Court of Appeals nor the District Court [had] considered in detail the question of the relevant market," *id.* at 330, 81 S.Ct. 623, the Court in *Tampa Electric* examined the record and, after defining the relevant market, determined that the contract affected less than one percent of that market. *Id.* at 333, 81 S.Ct. 623. After concluding, under the Clayton Act, that this share was "conservatively speaking, quite insubstantial," *id.*, the Court went on summarily to reject the Sherman Act claims. *Id.* at 335, 81 S.Ct. 623 ("[I]f [the contract] does not fall within the broader prescription of § 3 of the Clayton Act it follows that it is not forbidden by those of the [Sherman Act].").

Following *Tampa Electric,* courts considering antitrust challenges to exclusive contracts have taken care to identify the share of the market foreclosed. Some courts have indicated that § 3 of the Clayton Act and § 1 of the Sherman Act require an equal degree of foreclosure before prohibiting exclusive contracts. *See, e.g.,* Roland Mach. Co. v. Dresser Indus., Inc., 749 F.2d 380, 393 (7th Cir.1984) (Posner, J.). Other courts, however, have held that a higher market share must be foreclosed in order to establish a violation of the Sherman Act as compared to the Clayton Act. *See, e.g.,* Barr Labs. v. Abbott

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*Labs.*, 978 F.2d 98, 110 (3d Cir.1992) ; 11 HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1800c4 (1998) ("[T]he cases are divided, with a likely majority stating that the Clayton Act requires a smaller showing of anticompetitive effects.").

Though what is "significant" may vary depending upon the antitrust provision under which an exclusive deal is challenged, it is clear that in all cases the plaintiff must both define the relevant market and prove the degree of foreclosure. This is a prudential requirement; exclusivity provisions in contracts may serve many useful purposes. *See, e.g.*, *Omega Envtl., Inc. v. Gilbarco, Inc.*, 127 F.3d 1157, 1162 (9th Cir.1997) ("There are, however, well-recognized economic benefits to exclusive dealing arrangements, including the enhancement of interbrand competition."); *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 236 (1st Cir.1983) (Breyer, J.) ("[V]irtually *every* contract to buy 'forecloses' or 'excludes' alternative sellers from *some* portion of the market, namely the portion consisting of what was bought."). Permitting an antitrust action to proceed any time a firm enters into an exclusive deal would both discourage a presumptively legitimate business practice and encourage costly antitrust actions. Because an exclusive deal affecting a small fraction of a market clearly cannot have the requisite harmful effect upon competition, the requirement of a significant degree of foreclosure serves a useful screening function. *Cf.* Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 21-23 (1984) (discussing use of presumptions in antitrust law to screen out cases in which loss to consumers and economy is likely outweighed by cost of inquiry and risk of deterring procompetitive behavior).

In this case, plaintiffs challenged Microsoft's exclusive dealing arrangements with the IAPs under both § § 1 and 2 of the Sherman Act. The District Court, in analyzing the § 1 claim, stated, "unless the evidence demonstrates that Microsoft's agreements excluded Netscape altogether from access to roughly forty percent of the browser market, the Court should decline to find such agreements in violation of § 1." *Conclusions of Law*, at 52. The court recognized that Microsoft had substantially excluded Netscape from "the most efficient channels for Navigator to achieve browser usage share," *id.* at 53; *see also Findings of Fact* ¶ 145 ("[N]o other distribution channel for browsing software even approaches the efficiency of OEM pre-installation and IAP bundling."), and had relegated it to more costly and less effective methods (such as mass mailing its browser on a disk or offering it for download over the internet); but because Microsoft has not "completely excluded Netscape" from reaching any potential user by some means of distribution, however ineffective, the court concluded the agreements do not violate § 1. *Conclusions of Law*, at 53. Plaintiffs did not cross-appeal this holding.

Turning to § 2, the court stated: "the fact that Microsoft's arrangements with various [IAPs and other] firms did not foreclose enough of the relevant market to constitute a § 1 violation in no way detracts from the Court's assignment of liability for the same arrangements under § 2.... [A]ll of Microsoft's agreements, including the non-exclusive ones, severely restricted Netscape's access to those distribution channels leading most efficiently to the acquisition of browser usage share." *Conclusions of Law*, at 53.

On appeal Microsoft argues that "courts have applied the same standard to alleged exclusive dealing agreements under both Section 1 *and* Section 2," Appellant's Opening Br. at 109, and it argues that the District Court's holding of no liability under § 1 necessarily precludes holding it liable under § 2. The District Court appears to have based its holding with respect to § 1 upon a "total exclusion test" rather than the 40% standard drawn from the caselaw. Even assuming the holding is correct, however, we nonetheless reject Microsoft's contention.

The basic prudential concerns relevant to § § 1 and 2 are admittedly the same: exclusive contracts are commonplace--particularly in the field of distribution--in our competitive, market economy, and imposing upon a firm with market power the risk of an antitrust suit every time it enters into such a contract, no matter how small the effect, would create an unacceptable and unjustified burden upon any such firm. At the same time, however, we agree with plaintiffs that a monopolist's use of exclusive contracts, in certain circumstances, may give rise to a § 2 violation even though the contracts foreclose less than the roughly 40% or 50% share usually required in order to establish a § 1 violation. *See generally* Dennis W. Carlton, *A General Analysis of Exclusionary Conduct and Refusal to Deal--Why Aspen and Kodak Are Misguided*, 68 ANTITRUST L.J. 659 (2001) (explaining various scenarios under which exclusive dealing, particularly by a dominant firm, may raise legitimate concernsabout harm to competition).

In this case, plaintiffs allege that, by closing to rivals

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a substantial percentage of the available opportunities for browser distribution, Microsoft managed to preserve its monopoly in the market for operating systems. The IAPs constitute one of the two major channels by which browsers can be distributed. *Findings of Fact* ¶ 242. Microsoft has exclusive deals with "fourteen of the top fifteen access providers in North America[, which] account for a large majority of all Internet access subscriptions in this part of the world." *Id.* ¶ 308. By ensuring that the "majority" of all IAP subscribers are offered IE either as the default browser or as the only browser, Microsoft's deals with the IAPs clearly have a significant effect in preserving its monopoly; they help keep usage of Navigator below the critical level necessary for Navigator or any other rival to pose a real threat to Microsoft's monopoly. *See, e.g., id.* ¶ 143 (Microsoft sought to "divert enough browser usage from Navigator to neutralize it as a platform."); *see also* Carlton, at 670.

Plaintiffs having demonstrated a harm to competition, the burden falls upon Microsoft to defend its exclusive dealing contracts with IAPs by providing a procompetitive justification for them. Significantly, Microsoft's only explanation for its exclusive dealing is that it wants to keep developers focused upon its APIs--which is to say, it wants to preserve its power in the operating system market. 02/26/01 Ct. Appeals Tr. at 45-47. That is not an unlawful end, but neither is it a procompetitive justification for the specific means here in question, namely exclusive dealing contracts with IAPs. Accordingly, we affirm the District Court's decision holding that Microsoft's exclusive contracts with IAPs are exclusionary devices, in violation of § 2 of the Sherman Act.

**4. Dealings with Internet Content Providers, Independent Software Vendors, and Apple Computer**

The District Court held that Microsoft engages in exclusionary conduct in its dealings with ICPs, which develop websites; ISVs, which develop software; and Apple, which is both an OEM and a software developer. *See Conclusions of Law,* at 42-43 (deals with ICPs, ISVs, and Apple "supplemented Microsoft's efforts in the OEM and IAP channels"). The District Court condemned Microsoft's deals with ICPs and ISVs, stating: "By granting ICPs and ISVs free licenses to bundle [IE] with their offerings, and by exchanging other valuable inducements for their agreement to distribute, promote[,] and rely on [IE] rather than Navigator, Microsoft directly induced developers to focus on its own APIs rather than ones exposed by Navigator." *Id.* (citing *Findings of Fact* ¶ ¶ 334-35, 340).

With respect to the deals with ICPs, the District Court's findings do not support liability. After reviewing the ICP agreements, the District Court specifically stated that "there is not sufficient evidence to support a finding that Microsoft's promotional restrictions actually had a substantial, deleterious impact on Navigator's usage share." *Findings of Fact* ¶ 332. Because plaintiffs failed to demonstrate that Microsoft's deals with the ICPs have a substantial effect upon competition, they have not proved the violation of the Sherman Act.

As for Microsoft's ISV agreements, however, the District Court did not enter a similar finding of no substantial effect. The District Court described Microsoft's deals with ISVs as follows:

> In dozens of "First Wave" agreements signed between the fall of 1997 and the spring of 1998, Microsoft has promised to give preferential support, in the form of early Windows 98 and Windows NT betas, other technical information, and the right to use certain Microsoft seals of approval, to important ISVs that agree to certain conditions. One of these conditions is that the ISVs use Internet Explorer as the default browsing software for any software they develop with a hypertext-based user interface. Another condition is that the ISVs use Microsoft's "HTML Help," which is accessible only with Internet Explorer, to implement their applications' help systems.

*Id.* ¶ 339. The District Court further found that the effect of these deals is to "ensure [ ] that many of the most popular Web-centric applications will rely on browsing technologies found only in Windows," *id.* ¶ 340, and that Microsoft's deals with ISVs therefore "increase[ ] the likelihood that the millions of consumers using [applications designed by ISVs that entered into agreements with Microsoft] will use Internet Explorer rather than Navigator." *Id.* ¶ 340.

The District Court did not specifically identify what share of the market for browser distribution the exclusive deals with the ISVs foreclose. Although the ISVs are a relatively small channel for browser distribution, they take on greater significance because, as discussed above, Microsoft had largely foreclosed the two primary channels to its rivals. In that light, one can tell from the record that by affecting the applications used by "millions" of consumers, Microsoft's exclusive deals with the ISVs had a substantial effect in further foreclosing rival

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browsers from the market. (Data introduced by Microsoft, *see* Direct Testimony of Cameron Myhrvold ¶ 84, *reprinted in* 6 J.A. at 3922-23, and subsequently relied upon by the District Court in its findings, *see, e.g., Findings of Fact* ¶ 270, indicate that over the two-year period 1997-98, when Microsoft entered into the First Wave agreements, there were 40 million new users of the internet.) Because, by keeping rival browsers from gaining widespread distribution (and potentially attracting the attention of developers away from the APIs in Windows), the deals have a substantial effect in preserving Microsoft's monopoly, we hold that plaintiffs have made a *prima facie* showing that the deals have an anticompetitive effect.

Of course, that Microsoft's exclusive deals have the anticompetitive effect of preserving Microsoft's monopoly does not, in itself, make them unlawful. A monopolist, like a competitive firm, may have a perfectly legitimate reason for wanting an exclusive arrangement with its distributors. Accordingly, Microsoft had an opportunity to, but did not, present the District Court with evidence demonstrating that the exclusivity provisions have some such procompetitive justification. *See Conclusions of Law,* at 43 (citing *Findings of Fact* ¶ ¶ 339-40) ("With respect to the ISV agreements, Microsoft has put forward no procompetitive business ends whatsoever to justify their exclusionary terms."). On appeal Microsoft likewise does not claim that the exclusivity required by the deals serves any legitimate purpose; instead, it states only that its ISV agreements reflect an attempt "to persuade ISVs to utilize Internet-related system services in Windows rather than Navigator." Appellant's Opening Br. at 114. As we explained before, however, keeping developers focused upon Windows--that is, preserving the Windows monopoly--is a competitively neutral goal. Microsoft having offered no procompetitive justification for its exclusive dealing arrangements with the ISVs, we hold that those arrangements violate § 2 of the Sherman Act.

Finally, the District Court held that Microsoft's dealings with Apple violated the Sherman Act. *See Conclusions of Law,* at 42-43. Apple is vertically integrated: it makes both software (including an operating system, Mac OS), and hardware (the Macintosh line of computers). Microsoft primarily makes software, including, in addition to its operating system, a number of popular applications. One, called "Office," is a suite of business productivity applications that Microsoft has ported to Mac OS. The District Court found that "ninety percent of Mac OS users running a suite of office productivity applications [use] Microsoft's Mac Office." *Findings of Fact* ¶ 344. Further, the District Court found that:

> In 1997, Apple's business was in steep decline, and many doubted that the company would survive much longer.... [M]any ISVs questioned the wisdom of continuing to spend time and money developing applications for the Mac OS. Had Microsoft announced in the midst of this atmosphere that it was ceasing to develop new versions of Mac Office, a great number of ISVs, customers, developers, and investors would have interpreted the announcement as Apple's death notice.

*Id.* ¶ 344. Microsoft recognized the importance to Apple of its continued support of Mac Office. *See id.* ¶ 347 (quoting internal Microsoft e-mail) ("[We] need a way to push these guys[, *i.e.*, Apple] and [threatening to cancel Mac Office] is the only one that seems to make them move."); *see also id.* ("[Microsoft Chairman Bill] Gates asked whether Microsoft could conceal from Apple in the coming month the fact that Microsoft was almost finished developing Mac Office 97."); *id.* at ¶ 354 ("I think ... Apple should be using [IE] everywhere and if they don't do it, then we can use Office as a club.").

In June 1997 Microsoft Chairman Bill Gates determined that the company's negotiations with Apple " 'have not been going well at all.... Apple let us down on the browser by making Netscape the standard install.' Gates then reported that he had already called Apple's CEO ... to ask 'how we should announce the cancellation of Mac Office....' " *Id.* at ¶ 349. The District Court further found that, within a month of Gates' call, Apple and Microsoft had reached an agreement pursuant to which

> Microsoft's primary obligation is to continue releasing up-to-date versions of Mac Office for at least five years.... [and] Apple has agreed ... to "bundle the most current version of [IE] ... with [Mac OS]"... [and to] "make [IE] the default [browser]".... Navigator is not installed on the computer hard drive during the default installation, which is the type of installation most users elect to employ.... [The] Agreement further provides that ... Apple may not position icons for nonMicrosoft browsing software on the desktop of new Macintosh PC systems or Mac OS upgrades.

*Id.* ¶ ¶ 350-52. The agreement also prohibits Apple from encouraging users to substitute another browser for IE, and states that Apple will "encourage its employees to use [IE]." *Id.* ¶ 352.

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This exclusive deal between Microsoft and Apple has a substantial effect upon the distribution of rival browsers. If a browser developer ports its product to a second operating system, such as the Mac OS, it can continue to display a common set of APIs. Thus, usage share, not the underlying operating system, is the primary determinant of the platform challenge a browser may pose. Pre-installation of a browser (which can be accomplished either by including the browser with the operating system or by the OEM installing the browser) is one of the two most important methods of browser distribution, and Apple had a not insignificant share of worldwide sales of operating systems. *See id.* ¶ 35 (Microsoft has 95% of the market not counting Apple and "well above" 80% with Apple included in the relevant market). Because Microsoft's exclusive contract with Apple has a substantial effect in restricting distribution of rival browsers, and because (as we have described several times above) reducing usage share of rival browsers serves to protect Microsoft's monopoly, its deal with Apple must be regarded as anticompetitive. *See Conclusions of Law,* at 42 (citing *Findings of Fact* ¶ 356) ("By extracting from Apple terms that significantly diminished the usage of Navigator on the Mac OS, Microsoft helped to ensure that developers would not view Navigator as truly cross-platform middleware.").

Microsoft offers no procompetitive justification for the exclusive dealing arrangement. It makes only the irrelevant claim that the IE-for-Mac Office deal is part of a multifaceted set of agreements between itself and Apple, *see* Appellant's Opening Br. at 61 ("Apple's 'browsing software' obligation was [not] the quid pro quo for Microsoft's Mac Office obligation[;] ... *all* of the various obligations ... were part of one 'overall agreement' between the two companies."); that does not mean it has any procompetitive justification. Accordingly, we hold that the exclusive deal with Apple is exclusionary, in violation of § 2 of the Sherman Act.

**5. Java**

Java, a set of technologies developed by Sun Microsystems, is another type of middleware posing a potential threat to Windows' position as the ubiquitous platform for software development. *Findings of Fact* ¶ 28. The Java technologies include: (1) a programming language; (2) a set of programs written in that language, called the "Java class libraries," which expose APIs; (3) a compiler, which translates code written by a developer into "bytecode"; and (4) a Java Virtual Machine ("JVM"), which translates bytecode into instructions to the operating system. *Id.* ¶ 73. Programs calling upon the Java APIs will run on any machine with a "Java runtime environment," that is, Java class libraries and a JVM. *Id.* ¶ ¶ 73, 74.

In May 1995 Netscape agreed with Sun to distribute a copy of the Java runtime environment with every copy of Navigator, and "Navigator quickly became the principal vehicle by which Sun placed copies of its Java runtime environment on the PC systems of Windows users." *Id.* ¶ 76. Microsoft, too, agreed to promote the Java technologies--or so it seemed. For at the same time, Microsoft took steps "to maximize the difficulty with which applications written in Java could be ported from Windows to other platforms, and vice versa." *Conclusions of Law,* at 43. Specifically, the District Court found that Microsoft took four steps to exclude Java from developing as a viable cross-platform threat: (a) designing a JVM incompatible with the one developed by Sun; (b) entering into contracts, the so-called "First Wave Agreements," requiring major ISVs to promote Microsoft's JVM exclusively; (c) deceiving Java developers about the Windows-specific nature of the tools it distributed to them; and (d) coercing Intel to stop aiding Sun in improving the Java technologies.

a. *The incompatible JVM*

The District Court held that Microsoft engaged in exclusionary conduct by developing and promoting its own JVM. *Conclusions of Law,* at 43- 44. Sun had already developed a JVM for the Windows operating system when Microsoft began work on its version. The JVM developed by Microsoft allows Java applications to run faster on Windows than does Sun's JVM, *Findings of Fact* ¶ 389, but a Java application designed to work with Microsoft's JVM does not work with Sun's JVM and vice versa. *Id.* ¶ 390. The District Court found that Microsoft "made a large investment of engineering resources to develop a high-performance Windows JVM," *id.* ¶ 396, and, " [b]y bundling its ... JVM with every copy of [IE] ... Microsoft endowed its Java runtime environment with the unique attribute of guaranteed, enduring ubiquity across the enormous Windows installed base," *id.* ¶ 397. As explained above, however, a monopolist does not violate the antitrust laws simply by developing a product that is incompatible with those of its rivals. *See supra* Section II.B.1. In order to violate the antitrust laws, the incompatible product must have an anticompetitive effect that outweighs any procompetitive justification for the design.

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Microsoft's JVM is not only incompatible with Sun's, it allows Java applications to run faster on Windows than does Sun's JVM. Microsoft's faster JVM lured Java developers into using Microsoft's developer tools, and Microsoft offered those tools deceptively, as we discuss below. The JVM, however, does allow applications to run more swiftly and does not itself have any anticompetitive effect. Therefore, we reverse the District Court's imposition of liability for Microsoft's development and promotion of its JVM.

b. *The First Wave Agreements*

The District Court also found that Microsoft entered into First Wave Agreements with dozens of ISVs to use Microsoft's JVM. *See Findings of Fact* ¶ 401 ("[I]n exchange for costly technical support and other blandishments, Microsoft induced dozens of important ISVs to make their Java applications reliant on Windows-specific technologies and to refrain from distributing to Windows users JVMs that complied with Sun's standards."). Again, we reject the District Court's condemnation of low but non-predatory pricing by Microsoft.

To the extent Microsoft's First Wave Agreements with the ISVs conditioned receipt of Windows technical information upon the ISVs' agreement to promote Microsoft's JVM exclusively, they raise a different competitive concern. The District Court found that, although not literally exclusive, the deals were exclusive in practice because they required developers to make Microsoft's JVM the default in the software they developed. *Id.* ¶ 401.

While the District Court did not enter precise findings as to the effect of the First Wave Agreements upon the overall distribution of rival JVMs, the record indicates that Microsoft's deals with the major ISVs had a significant effect upon JVM promotion. As discussed above, the products of First Wave ISVs reached millions of consumers. *Id.* ¶ 340. The First Wave ISVs included such prominent developers as Rational Software, *see* GX 970, *reprinted in* 15 J.A. at 9994-10000, "a world leader" in software development tools, *see* Direct Testimony of Michael Devlin ¶ 2, *reprinted in* 5 J.A. at 3520, andSymantec, *see* GX 2071, *reprinted in* 22 J.A. at 14960-66 (sealed), which, according to Microsoft itself, is "the leading supplier of utilities such as anti-virus software," Defendant's Proposed Findings of Fact ¶ 276, *reprinted in* 3 J.A. at 1689. Moreover, Microsoft's exclusive deals with the leading ISVs took place against a backdrop of foreclosure: the District Court found that "[w]hen Netscape announced in May 1995 [prior to Microsoft's execution of the First Wave Agreements] that it would include with every copy of Navigator a copy of a Windows JVM that complied with Sun's standards, it appeared that Sun's Java implementation would achieve the necessary ubiquity on Windows." *Findings of Fact* ¶ 394. As discussed above, however, Microsoft undertook a number of anticompetitive actions that seriously reduced the distribution of Navigator, and the District ***76 **372** Court found that those actions thereby seriously impeded distribution of Sun's JVM. *Conclusions of Law,* at 43-44. Because Microsoft's agreements foreclosed a substantial portion of the field for JVM distribution and because, in so doing, they protected Microsoft's monopoly from a middleware threat, they are anticompetitive.

Microsoft offered no procompetitive justification for the default clause that made the First Wave Agreements exclusive as a practical matter. *See Findings of Fact* ¶ 401. Because the cumulative effect of the deals is anticompetitive and because Microsoft has no procompetitive justification for them, we hold that the provisions in the First Wave Agreements requiring use of Microsoft's JVM as the default are exclusionary, in violation of the Sherman Act.

c. *Deception of Java developers*

Microsoft's "Java implementation" included, in addition to a JVM, a set of software development tools it created to assist ISVs in designing Java applications. The District Court found that, not only were these tools incompatible with Sun's cross-platform aspirations for Java--no violation, to be sure--but Microsoft deceived Java developers regarding the Windows-specific nature of the tools. Microsoft's tools included "certain 'keywords' and 'compiler directives' that could only be executed properly by Microsoft's version of the Java runtime environment for Windows." *Id.* ¶ 394; *see also* Direct Testimony of James Gosling ¶ 58, *reprinted in* 21 J.A. at 13959 (Microsoft added "programming instructions ... that alter the behavior of the code."). As a result, even Java "developers who were opting for portability over performance ... unwittingly [wrote] Java applications that [ran] only on Windows." *Conclusions of Law,* at 43. That is, developers who relied upon Microsoft's public commitment to cooperate with Sun and who used Microsoft's tools to develop what Microsoft led them to believe were cross-platform applications ended up producing applications that would run only on the

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Windows operating system.

When specifically accused by a *PC Week* reporter of fragmenting Java standards so as to prevent cross-platform uses, Microsoft denied the accusation and indicated it was only "adding rich platform support" to what remained a crossplatform implementation. An e-mail message internal to Microsoft, written shortly after the conversation with the reporter, shows otherwise:

> [O]k, i just did a followup call.... [The reporter] liked that i kept pointing customers to w3c standards [ (commonly observed internet protocols) ].... [but] he accused us of being schizo with this vs. our java approach, i said he misunderstood [--] that [with Java] we are merely trying to add rich platform support to an interop layer.... this plays well.... at this point its [sic] not good to create MORE noise around our win32 java classes. instead we should just quietly grow j++ [ (Microsoft's development tools) ] share and assume that people will take more advantage of our classes without ever realizing they are building win32-only java apps.

GX 1332, *reprinted in* 22 J.A. at 14922-23.

Finally, other Microsoft documents confirm that Microsoft intended to deceive Java developers, and predicted that the effect of its actions would be to generate Windows-dependent Java applications that their developers believed would be cross-platform; these documents also indicate that Microsoft's ultimate objective was to thwart Java's threat to Microsoft's monopoly in the market for operating systems. One Microsoft document, for example, states as a strategic goal: "Kill cross-platform Java by grow[ing] the polluted Java market." GX 259, *reprinted in* 22 J.A. at 14514; *see also id.* ("Cross-platform capability is by far *the* number one reason for choosing/using Java.") (emphasis in original).

Microsoft's conduct related to its Java developer tools served to protect its monopoly of the operating system in a manner not attributable either to the superiority of the operating system or to the acumen of its makers, and therefore was anticompetitive. Unsurprisingly, Microsoft offers no procompetitive explanation for its campaign to deceive developers. Accordingly, we conclude this conduct is exclusionary, in violation of § 2 of the Sherman Act.

d. *The threat to Intel*

The District Court held that Microsoft also acted unlawfully with respect to Java by using its "monopoly power to prevent firms such as Intel from aiding in the creation of cross-platform interfaces." *Conclusions of Law,* at 43. In 1995 Intel was in the process of developing a highperformance, Windows-compatible JVM. Microsoft wanted Intel to abandon that effort because a fast, cross-platform JVM would threaten Microsoft's monopoly in the operating system market. At an August 1995 meeting, Microsoft's Gates told Intel that its "cooperation with Sun and Netscape to develop a Java runtime environment ... was one of the issues threatening to undermine cooperation between Intel and Microsoft." *Findings of Fact* ¶ 396. Three months later, "Microsoft's Paul Maritz told a senior Intel executive that Intel's [adaptation of its multimedia software to comply with] Sun's Java standards was as inimical to Microsoft as Microsoft's support for non-Intel microprocessors would be to Intel." *Id.* ¶ 405.

Intel nonetheless continued to undertake initiatives related to Java. By 1996 "Intel had developed a JVM designed to run well ... while complying with Sun's cross-platform standards." *Id.* ¶ 396. In April of that year, Microsoft again urged Intel not to help Sun by distributing Intel's fast, Suncompliant JVM. *Id.* And Microsoft threatened Intel that if it did not stop aiding Sun on the multimedia front, then Microsoft would refuse to distribute Intel technologies bundled with Windows. *Id.* ¶ 404.

Intel finally capitulated in 1997, after Microsoft delivered the *coup de grace*.

> [O]ne of Intel's competitors, called AMD, solicited support from Microsoft for its "3DX" technology.... Microsoft's Allchin asked Gates whether Microsoft should support 3DX, despite the fact that Intel would oppose it. Gates responded: "If Intel has a real problem with us supporting this then they will have to stop supporting Java Multimedia the way they are. I would gladly give up supporting this if they would back off from their work on JAVA."

*Id.* ¶ 406.

Microsoft's internal documents and deposition testimony confirm both the anticompetitive effect and intent of its actions. *See, e.g.,* GX 235, *reprinted in* 22 J.A. at 14502 (Microsoft executive, Eric Engstrom, included among Microsoft's goals for Intel: "Intel to stop helping Sun create Java Multimedia APIs, especially ones that run well ... on Windows."); Deposition of Eric Engstrom at 179 ("We were successful [in convincing Intel to stop aiding Sun] for some period of time.").

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Microsoft does not deny the facts found by the District Court, nor does it offer any procompetitive justification for pressuring Intel not to support cross-platform Java. Microsoft lamely characterizes its threat to Intel as "advice." The District Court, however, found that Microsoft's "advice" to Intel to stop aiding cross-platform Java was backed by the threat of retaliation, and this conclusion is supported by the evidence cited above. Therefore we affirm the conclusion that Microsoft's threats to Intel were exclusionary, in violation of § 2 of the Sherman Act.

**6. Course of Conduct**

The District Court held that, apart from Microsoft's specific acts, Microsoft was liable under § 2 based upon its general "course of conduct." In reaching this conclusion the court relied upon *Continental Ore Co. v. Union Carbide & Carbon Corp.*, 370 U.S. 690, 699, 82 S.Ct. 1404, 8 L.Ed.2d 777 (1962), where the Supreme Court stated, "[i]n [Sherman Act cases], plaintiffs should be given the full benefit of their proof without tightly compartmentalizing the various factual components and wiping the slate clean after scrutiny of each."

Microsoft points out that *Continental Ore* and the other cases cited by plaintiffs in support of "course of conduct" liability all involve conspiracies among multiple firms, not the conduct of a single firm; in that setting the "course of conduct" is the conspiracy itself, for which all the participants may be held liable. *See* Appellant's Opening Br. at 112-13. Plaintiffs respond that, as a policy matter, a monopolist's unilateral "campaign of [acts intended to exclude a rival] that in the aggregate has the requisite impact" warrants liability even if the acts viewed individually would be lawful for want of a significant effect upon competition. Appellees' Br. at 82-83.

We need not pass upon plaintiffs' argument, however, because the District Court did not point to any series of acts, each of which harms competition only slightly but the cumulative effect of which is significant enough to form an independent basis for liability. The "course of conduct" section of the District Court's opinion contains, with one exception, only broad, summarizing conclusions. *See, e.g., Conclusions of Law,* at 44 ("Microsoft placed an oppressive thumb on the scale of competitive fortune...."). The only specific acts to which the court refers are Microsoft's expenditures in promoting its browser, *see id.* ("Microsoft has expended wealth and foresworn opportunities to realize more...."), which we have explained are not in themselves unlawful. Because the District Court identifies no other specific acts as a basis for "course of conduct" liability, we reverse its conclusion that Microsoft's course of conduct separately violates § 2 of the Sherman Act.

*C. Causation*

As a final parry, Microsoft urges this court to reverse on the monopoly maintenance claim, because plaintiffs never established a causal link between Microsoft's anticompetitive conduct, in particular its foreclosure of Netscape's and Java's distribution channels, and the maintenance of Microsoft's operating system monopoly. *See Findings of Fact* ¶ 411 ("There is insufficient evidence to find that, absent Microsoft's actions, Navigator and Java already would have ignited genuine competition in the market for Intel-compatible PC operating systems."). This is the flip side of Microsoft's earlier argument that the District Court should have included middleware in the relevant market. According to Microsoft, the District Court cannot simultaneously find that middleware is not a reasonable substitute *and* that Microsoft's exclusionary conduct contributed to the maintenance of monopoly power in the operating system market. Microsoft claims that the first finding depended on the court's view that middleware does not pose a serious threat to Windows, *see supra* Section II.A, while the second finding required the court to find that Navigator and Java would have developed into serious enough cross-platform threats to erode the applications barrier to entry. We disagree.

Microsoft points to no case, and we can find none, standing for the proposition that, as to § 2 *liability* in an equitable enforcement action, plaintiffs must present direct proof that a defendant's continued monopoly power is precisely attributable to its anticompetitive conduct. As its lone authority, Microsoft cites the following passage from Professor Areeda's antitrust treatise: "The plaintiff has the burden of pleading, introducing evidence, and presumably proving by a preponderance of the evidence that reprehensible behavior has *contributed significantly* to the ... maintenance of the monopoly." 3 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 650c, at 69 (1996) (emphasis added).

But, with respect to actions seeking injunctive relief, the authors of that treatise also recognize the need for

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courts to infer "causation" from the fact that a defendant has engaged in anticompetitive conduct that "reasonably appear[s] capable of making a significant contribution to ... maintaining monopoly power." *Id.* ¶ 651c, at 78; *see also* Morgan v. Ponder, 892 F.2d 1355, 1363 (8th Cir.1989); Barry Wright, 724 F.2d at 230. To require that § 2 liability turn on a plaintiff's ability or inability to reconstruct the hypothetical marketplace absent a defendant's anticompetitive conduct would only encourage monopolists to take more and earlier anticompetitive action.

We may infer causation when exclusionary conduct is aimed at producers of nascent competitive technologies as well as when it is aimed at producers of established substitutes. Admittedly, in the former case there is added uncertainty, inasmuch as nascent threats are merely *potential* substitutes. But the underlying proof problem is the same--neither plaintiffs nor the court can confidently reconstruct a product's hypothetical technological development in a world absent the defendant's exclusionary conduct. To some degree, "the defendant is made to suffer the uncertain consequences of its own undesirable conduct." 3 AREEDA & HOVENKAMP, ANTITRUST LAW ¶ 651c, at 78.

Given this rather edentulous test for causation, the question in this case is not whether Java or Navigator would actually have developed into viable platform substitutes, but (1) whether as a general matter the exclusion of nascent threats is the type of conduct that is reasonably capable of contributing significantly to a defendant's continued monopoly power and (2) whether Java and Navigator reasonably constituted nascent threats at the time Microsoft engaged in the anticompetitive conduct at issue. As to the first, suffice it to say that it would be inimical to the purpose of the Sherman Act to allow monopolists free reign to squash nascent, albeit unproven, competitors at will--particularly in industries marked by rapid technological advance and frequent paradigm shifts. *Findings of Fact* ¶ ¶ 59-60. As to the second, the District Court made ample findings that both Navigator and Java showed potential as middleware platform threats. *Findings of Fact* ¶ ¶ 68-77. Counsel for Microsoft admitted as much at oral argument. 02/26/01 Ct. Appeals Tr. at 27 ("There are no constraints on output. Marginal costs are essentially zero. And there are to some extent network effects. So a company like Netscape founded in 1994 can be by the middle of 1995 clearly a potentially lethal competitor to Windows because it can supplant its position in the market because of the characteristics of these markets.").

Microsoft's concerns over causation have more purchase in connection with the appropriate remedy issue, *i.e.*, whether the court should impose a structural remedy or merely enjoin the offensive conduct at issue. As we point out later in this opinion, divestiture is a remedy that is imposed only with great caution, in part because its long-term efficacy is rarely certain. *See infra* Section V.E. Absent some measure of confidence that there has been an actual loss to competition that needs to be restored, wisdom counsels against adopting radical structural relief. *See* 3 AREEDA & HOVENKAMP, ANTITRUST LAW ¶ 653b, at 91-92 ("[M]ore extensive equitable relief, particularly remedies such as divestiture designed to eliminate the monopoly altogether, raise more serious questions and require a clearer indication of a significant causal connection between the conduct and creation or maintenance of the market power."). But these queries go to questions of remedy, not liability. In short, causation affords Microsoft no defense to liability for its unlawful actions undertaken to maintain its monopoly in the operating system market.

## III. ATTEMPTED MONOPOLIZATION

[Plaintiffs had alleged that Microsoft was attempting to monopolize the browser market, in violation of section 2 of the Sherman Act. The district court agreed, but the Court of Appeals reversed this part of the case. It found that the plaintiffs had not established a proper relevant market, nor had they shown that substantial barriers to entry protected any such market.].

## IV. TYING

Microsoft also contests the District Court's determination of liability under § 1 of the Sherman Act. The District Court concluded that Microsoft's contractual and technological bundling of the IE web browser (the "tied" product) with its Windows operating system ("OS") (the "tying" product) resulted in a tying arrangement that was per se unlawful. *Conclusions of Law*, at 47-51. We hold that the rule of reason, rather than per se analysis, should govern the legality of tying arrangements involving platform software products. The Supreme Court has warned that " '[i]t is only after considerable experience with certain business relationships that courts classify them as *per se* violations....' " Broad. Music, Inc. v. CBS, 441 U.S. 1, 9, 99 S.Ct. 1551, 60

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L.Ed.2d 1 (1979) (quoting *United States v. Topco Assocs.*, 405 U.S. 596, 607-08, 92 S.Ct. 1126, 31 L.Ed.2d 515 (1972)). While every "business relationship" will in some sense have unique features, some represent entire, novel categories of dealings. As we shall explain, the arrangement before us is an example of the latter, offering the first up-close look at the technological integration of added functionality into software that serves as a platform for third-party applications. There being no close parallel in prior antitrust cases, simplistic application of per se tying rules carries a serious risk of harm. Accordingly, we vacate the District Court's finding of a per se tying violation and remand the case. Plaintiffs may on remand pursue their tying claim under the rule of reason.

* * *

*C. On Remand*

Should plaintiffs choose to pursue a tying claim under the rule of reason, we note the following for the benefit of the trial court:

First, on remand, plaintiffs must show that Microsoft's conduct unreasonably restrained competition. Meeting that burden "involves an inquiry into the actual effect" of Microsoft's conduct on competition in the tied good market, *Jefferson Parish*, 466 U.S. at 29, 104 S.Ct. 1551, the putative market for browsers. To the extent that certain aspects of tying injury may depend on a careful definition of the tied good market and a showing of barriers to entry other than the tying arrangement itself, plaintiffs would have to establish these points. *See Jefferson Parish*, 466 U.S. at 29, 104 S.Ct. 1551 ("This competition [among anesthesiologists] takes place in a market that has not been defined."); *id.* at 29 n. 48, 104 S.Ct. 1551 ("[N]either the District Court nor the Court of Appeals made any findings concerning the contract's effect on entry barriers."). But plaintiffs were required--and had every incentive--to provide both a definition of the browser market and barriers to entry to that market as part of their § 2 attempted monopolization claim; yet they failed to do so. *See supra* Section III. Accordingly, on remand of the § 1 tying claim, plaintiffs will be precluded from arguing any theory of harm that depends on a precise definition of browsers or barriers to entry (for example, network effects from Internet protocols and extensions embedded in a browser) other than what may be implicit in Microsoft's tying arrangement.

Of the harms left, plaintiffs must show that Microsoft's conduct was, on balance, anticompetitive. Microsoft may of course offer procompetitive justifications, and it is plaintiffs' burden to show that the anticompetitive effect of the conduct outweighs its benefit.

Second, the fact that we have already considered some of the behavior plaintiffs allege to constitute tying violations in the monopoly maintenance section does not resolve the § 1 inquiry. The two practices that plaintiffs have most ardently claimed as tying violations are, indeed, a basis for liability under plaintiffs' § 2 monopoly maintenance claim. These are Microsoft's refusal to allow OEMs to uninstall IEor remove it from the Windows desktop, *Findings of Fact* ¶ ¶ 158, 203, 213, and its removal of the IE entry from the Add/Remove Programs utility in Windows 98, *id.* ¶ 170. *See supra* Section II.B. In order for the District Court to conclude these practices also constitute § 1 tying violations, plaintiffs must demonstrate that their benefits--if any, *see supra* Sections II.B.1.b and II.B.2.b; *Findings of Fact* ¶ ¶ 176, 186, 193--are outweighed by the harms in the *tied product* market. *See Jefferson Parish*, 466 U.S. at 29, 104 S.Ct. 1551. If the District Court is convinced of net harm, it must then consider whether any additional remedy is necessary.

In Section II.B we also considered another alleged tying violation--the Windows 98 override of a consumer's choice of default web browser. We concluded that this behavior does not provide a distinct basis for § 2 liability because plaintiffs failed to rebut Microsoft's proffered justification by demonstrating that harms in the operating system market outweigh Microsoft's claimed benefits. *See supra* Section II.B. On remand, however, although Microsoft may offer the same procompetitive justification for the override, plaintiffs must have a new opportunity to rebut this claim, by demonstrating that the anticompetitive effect in the *browser* market is greater than these benefits.

Finally, the District Court must also consider an alleged tying violation that we did not consider under § 2 monopoly maintenance: price bundling. First, the court must determine if Microsoft indeed price bundled-- that is, was Microsoft's charge for Windows and IE higher than its charge would have been for Windows alone? This will require plaintiffs to resolve the tension between *Findings of Fact* ¶ ¶ 136-37, which Microsoft interprets as saying that no part of the bundled price of Windows can be attributed to IE, and *Conclusions of Law*, at 50,

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which says the opposite. *Compare* Direct Testimony of Paul Maritz ¶ ¶ 37, 296, *reprinted in* 6 J.A. at 3656, 3753-54 (Microsoft did not "charge separately" for IE, but like all other major OS vendors included browsing software at "no extra charge"), *with* GX 202 at MS7 004343, esp. 004347, *reprinted in* 22 J.A. at 14459, esp. 14463 (memo from Christian Wildfeuer describing focus group test used to price Windows 98 with IE 4), *and* GX 1371 at MS7 003729-30, 003746, 003748, esp. 003750, *reprinted in* 15 J.A. at 10306-07, 10323, 10325, esp. 10327 (Windows 98 pricing and marketing memo), *and Findings of Fact* ¶ 63 (identifying GX 202 as the *basis* for Windows 98 pricing).

If there is a positive price increment in Windows associated with IE (we know there is no claim of price predation), plaintiffs must demonstrate that the anticompetitive effects of Microsoft's price bundling outweigh any procompetitive justifications the company provides for it. In striking this balance, the District Court should consider, among other things, indirect evidence of efficiency provided by "the competitive fringe." *See supra* Section IV.A. Although this inquiry may overlap with the separate-products screen under the per se rule, that is not its role here. Because courts applying the rule of reason are free to look at both direct and indirect evidence of efficiencies from a tie, there is no need for a screening device as such; thus the separate-products inquiry serves merely to classify arrangements as subject to tying law, as opposed to, say, liability for exclusive dealing. . . . .

If OS vendors without market power also sell their software bundled with a browser, the natural inference is that sale of the items as a bundle serves consumer demand and that unbundled sale would not, for otherwise a competitor could profitably offer the two products separately and capture sales of the tying good from vendors that bundle. *See* 10 AREEDA ET AL., ANTITRUST LAW ¶ 1744b, at 197-98. It does appear that most if not all firms have sold a browser with their OSs at a bundled price, beginning with IBM and its OS/2 Warp OS in September 1994, *Findings of Fact* ¶ 140; *see also* Direct Testimony of Richard Schmalensee ¶ 212, *reprinted in* 7 J.A. at 4300-01, and running to current versions of Apple's Mac OS, Caldera and Red Hat's Linux OS, Sun's Solaris OS, Be's BeOS, Santa Cruz Operation's UnixWare, Novell's NetWare OS, and others, *see Findings of Fact* ¶ 153; Direct Testimony of Richard Schmalensee ¶ ¶ 215-23, 230, esp. table 5, *reprinted in* 7 J.A. at 4302-05, 4310; Direct Testimony of James Allchin ¶ ¶ 261-77, *reprinted in* 5 J.A. at 3384-92.

Of course price bundling by competitive OS makers would tend to exonerate Microsoft only if the sellers in question sold their browser/OS combinations *exclusively* at a bundled price. If a competitive seller offers a discount for a browserless version, then--at least as to *its* OS and browser--the gains from bundling are outweighed by those from separate choice. The evidence on discounts appears to be in conflict. *Compare* Direct Testimony of Richard Schmalensee ¶ 241, *reprinted in* 7 J.A. at 4315, *with* 1/6/99 pm Tr. at 42 (trial testimony of Franklin Fisher). If Schmalensee is correct that nearly all OS makers do not offer a discount, then the harm from tying--obstruction of direct consumer choice--would be theoretically created by virtually all sellers: a customer who would prefer an alternate browser is forced to pay the full price of that browser even though its value to him is only the increment in value over the bundled browser. (The result is similar to that from non- removal, which forces consumers who want the alternate browser to surrender disk space taken up by the unused, bundled browser.) If the failure to offer a price discount were universal, any impediment to direct consumer choice created by Microsoft's price-bundled sale of IE with Windows would be matched throughout the market; yet these OS suppliers on the competitive fringe would have evidently found this price bundling on balance efficient. If Schmalensee's assertions are ill-founded, of course, no such inference could be drawn.

## V. TRIAL PROCEEDINGS AND REMEDY

* * *

We conclude . . . that the District Court's remedies decree must be vacated for three independent reasons: (1) the court failed to hold a remedies-specific evidentiary hearing when there were disputed facts; (2) the court failed to provide adequate reasons for its decreed remedies; and (3) this Court has revised the scope of Microsoft's liability and it is impossible to determine to what extent that should affect the remedies provisions.

* * *

The substance of the District Court's remedies order is nearly identical to plaintiffs' proposal. The decree's centerpiece is the requirement that Microsoft submit a proposed plan of divestiture, with the company to be split into an "Operating Systems

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Business," or "OpsCo," and an " Applications Business," or "AppsCo." *Final Judgment,* Decree § § 1.a, l.c.i, at 64. OpsCo would receive all of Microsoft's operating systems, such as Windows 98 and Windows 2000, while AppsCo would receive the remainder of Microsoft's businesses, including IE and Office. The District Court identified four reasons for its "reluctant[ ]" conclusion that "a structural remedy has become imperative." *Id* . at 62. First, Microsoft "does not yet concede that any of its business practices violated the Sherman Act." *Id.* Second, the company consequently "continues to do business as it has in the past." *Id* . Third, Microsoft "has proved untrustworthy in the past." *Id.* And fourth, the Government, whose officials "are by reason of office obliged and expected to consider--and to act in--the public interest," won the case, "and for that reason alone have some entitlement to a remedy of their choice." *Id.* at 62-63.

The decree also contains a number of interim restrictions on Microsoft's conduct. For instance, Decree § 3.b requires Microsoft to disclose to third-party developers the APIs and other technical information necessary to ensure that software effectively interoperates with Windows. *Id.* at 67. "To facilitate compliance," § 3.b further requires that Microsoft establish "a secure facility" at which third-party representatives may "study, interrogate and interact with relevant and necessary portions of [Microsoft platform software] source code." *Id.* Section 3.e, entitled "Ban on Exclusive Dealing," forbids Microsoft from entering contracts which oblige third parties to restrict their "development, production, distribution, promotion or use of, or payment for" non-Microsoft platformlevel software. *Id.* at 68. Under Decree § 3.f--"Ban on Contractual Tying"--the company may not condition its grant of a Windows license on a party's agreement "to license, promote, or distribute any other Microsoft software product." *Id.* And § 3.g imposes a "Restriction on Binding Middleware Products to Operating System Products" unless Microsoft also offers consumers "an otherwise identical version" of the operating system without the middleware. *Id.*

* * *

In sum, the District Court erred when it resolved the parties' remedies-phase factual disputes by consulting only the evidence introduced during trial and plaintiffs' remedies phase submissions, without considering the evidence Microsoft sought to introduce. We therefore vacate the District Court's final judgment, and remand with instructions to conduct a remedies- specific evidentiary hearing.

*D. Failure to Provide an Adequate Explanation*

We vacate the District Court's remedies decree for the additional reason that the court has failed to provide an adequate explanation for the relief it ordered. . . .

*E. Modification of Liability*

Quite apart from its procedural difficulties, we vacate the District Court's final judgment in its entirety for the additional, independent reason that we have modified the underlying bases of liability. Of the three antitrust violations originally identified by the District Court, one is no longer viable: attempted monopolization of the browser market in violation of Sherman Act § 2. One will be remanded for liability proceedings under a different legal standard: unlawful tying in violation of § 1. Only liability for the § 2 monopoly maintenance violation has been affirmed--and even that we have revised. . . . We cannot determine whether the District Court has abused its discretion in remedying a wrong where the court did not exercise that discretion in order to remedy the properly determined wrong. . . .

In short, we must vacate the remedies decree in its entirety and remand the case for a new determination. This court has drastically altered the District Court's conclusions on liability. . . .

*F. On Remand*

As a general matter, a district court is afforded broad discretion to enter that relief it calculates will best remedy the conduct it has found to be unlawful. . . . . This is no less true in antitrust cases. . . . And divestiture is a common form of relief in successful antitrust prosecutions: it is indeed "the most important of antitrust remedies." *See, e.g., United States v. E.I. du Pont de Nemours & Co.,* 366 U.S. 316, 331, 81 S.Ct. 1243, 6 L.Ed.2d 318 (1961).

On remand, the District Court must reconsider whether the use of the structural remedy of divestiture is appropriate with respect to Microsoft, which argues that it is a unitary company. By and large, cases upon which plaintiffs rely in arguing for the split of Microsoft have involved the dissolution of entities formed by mergers and acquisitions. On the

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contrary, the Supreme Court has clarified that divestiture "has traditionally been the remedy for Sherman Act violations whose heart is intercorporate *combination and control,*" *du Pont,* 366 U.S. at 329, 81 S.Ct. 1243 (emphasis added), and that "[c]omplete divestiture is particularly appropriate where asset or stock *acquisitions* violate the antitrust laws," *Ford Motor Co.,* 405 U.S. at 573, 92 S.Ct. 1142 (emphasis added).

One apparent reason why courts have not ordered the dissolution of unitary companies is logistical difficulty. As the court explained in *United States v. ALCOA,* 91 F.Supp. 333, 416 (S.D.N.Y.1950) , a "corporation, designed to operate effectively as a single entity, cannot readily be dismembered of parts of its various operations without a marked loss of efficiency." A corporation that has expanded by acquiring its competitors often has preexisting internal lines of division along which it may more easily be split than a corporation that has expanded from natural growth. Although time and corporate modifications and developments may eventually fade those lines, at least the identifiable entities preexisted to create a template for such division as the court might later decree. With reference to those corporations that are not acquired by merger and acquisition, Judge Wyzanski accurately opined in *United Shoe*:

> United conducts all machine manufacture at one plant in Beverly, with one set of jigs and tools, one foundry, one laboratory for machinery problems, one managerial staff, and one labor force. It takes no Solomon to see that this organism cannot be cut into three equal and viable parts.

*United States v. United Shoe Machine Corp.,* 110 F.Supp. 295, 348 (D.Mass.1953).

Depending upon the evidence, the District Court may find in a remedies proceeding that it would be no easier to split Microsoft in two than United Shoe in three. Microsoft's Offer of Proof in response to the court's denial of an evidentiary hearing included proffered testimony from its President and CEO Steve Ballmer that the company "is, and always has been, a unified company without free-standing business units. Microsoft is not the result of mergers or acquisitions." Microsoft further offered evidence that it is "not organized along product lines," but rather is housed in a single corporate headquarters and that it has

> only one sales and marketing organization which is responsible for selling all of the company's products, one basic research organization, one product support organization, one operations department, one information technology department, one facilities department, one purchasing department, one human resources department, one finance department, one legal department and one public relations department.

Defendant's Offer of Proof at 23-26, *reprinted in* 4 J.A. at 2764-67. If indeed Microsoft is a unitary company, division might very well require Microsoft to reproduce each of these departments in each new entity rather than simply allocate the differing departments among them.

In devising an appropriate remedy, the District Court also should consider whether plaintiffs have established a sufficient causal connection between Microsoft's anticompetitive conduct and its dominant position in the OS market. "Mere existence of an exclusionary act does not itself justify full feasible relief against the monopolist to create maximum competition." 3 AREEDA & HOVENKAMP, ANTITRUST LAW ¶ 650a, at 67. Rather, structural relief, which is "designed to eliminate the monopoly altogether ... require[s] a clearer indication of a *significant causal connection* between the conduct and creation or maintenance of the market power." *Id.* ¶ 653b, at 91-92 (emphasis added). Absent such causation, the antitrust defendant's unlawful behavior should be remedied by "an injunction against continuation of that conduct." *Id.* ¶ 650a, at 67.

As noted above, *see supra* Section II.C, we have found a causal connection between Microsoft's exclusionary conduct and its continuing position in the operating systems market only through inference. *See* 3 AREEDA & HOVENKAMP, ANTITRUST LAW ¶ 653(b), at 91-92 (suggesting that "more extensive equitable relief, particularly remedies such as divestiture designed to eliminate the monopoly altogether, ... require a clearer indication of significant causal connection between the conduct and creation or maintenance of the market power"). Indeed, the District Court expressly did not adopt the position that Microsoft would have lost its position in the OS market but for its anticompetitive behavior. *Findings of Fact* ¶ 411 ("There is insufficient evidence to find that, absent Microsoft's actions, Navigator and Java already would have ignited genuine competition in the market for Intel-compatible PC operating systems."). If the court on remand is unconvinced of the causal connection between Microsoft's exclusionary conduct and the company's position in the OS market, it may well conclude that divestiture is not an appropriate remedy.

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While we do not undertake to dictate to the District Court the precise form that relief should take on remand, we note again that it should be tailored to fit the wrong creating the occasion for the remedy.

*G. Conclusion*

In sum, we vacate the District Court's remedies decree for three reasons. First, the District Court failed to hold an evidentiary hearing despite the presence of remedies-specific factual disputes. Second, the court did not provide adequate reasons for its decreed remedies. Finally, we have drastically altered the scope of Microsoft's liability, and it is for the District Court in the first instance to determine the propriety of a specific remedy for the limited ground of liability which we have upheld.

## VI. JUDICIAL MISCONDUCT

[Omitted: This section of the opinion discussed certain conduct of the district court judge which, the Court of Appeals concluded, gave rise to at least the appearance of bias on the part of the judge. For example, the judge had spoken extensively to the press, in violation of Canon 3A(6) of the Code of Conduct for United States Judges. The Court of Appeals reprimanded the district judge for this, and ordered that the case had to be assigned to a new district judge on remand. Nonetheless, it decided that the problematic conduct had affected only the remedies phase, which was being entirely reconsidered in any event; it therefore left standing all other actions the judge had taken that had not been revised on appeal. In so doing, it rejected Microsoft's argument that the judge' s conduct had been so egregious that it required virtually everything to be set aside for new proceedings.]

## VII. CONCLUSION

The judgment of the District Court is affirmed in part, reversed in part, and remanded in part. We vacate in full the Final Judgment embodying the remedial order, and remand the case to the District Court for reassignment to a different trial judge for further proceedings consistent with this opinion.

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United States District Court,
District of Columbia.

FEDERAL TRADE COMMISSION, Plaintiff,
v.
STAPLES, INC., and Office Depot, Inc., Defendants.

**Civil No. 97-701 (TFH).**

June 30, 1997.

***REDACTED MEMORANDUM OPINION***

THOMAS F. HOGAN, District Judge.

Plaintiff, the Federal Trade Commission ("FTC" or "Commission"), seeks a preliminary injunction pursuant to Section 13(b) of the Federal Trade Commission Act, 15 U.S.C. § 53(b), to enjoin the consummation of any acquisition by defendant Staples, Inc., of defendant Office Depot, Inc., pending final disposition before the Commission of administrative proceedings to determine whether such acquisition may substantially lessen competition in violation of Section 7 of the Clayton Act, 15 U.S.C. § 18, and Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45. The proposed acquisition has been postponed pending the Court's decision on the motion for a preliminary injunction, which is now before the Court for decision after a five-day evidentiary hearing and the filing of proposed findings of fact and conclusions of law. For the reasons set forth below, the Court will grant the plaintiff's motion. This Memorandum Opinion constitutes the Court's findings of fact and conclusions of law.

***BACKGROUND***

The FTC is an administrative agency of the United States organized and existing pursuant to the Federal Trade Commission Act, 15 U.S.C. § § 41- 77. The Commission is responsible, *inter alia,* for enforcing federal antitrust laws particularly Section 7 of the Clayton Act and Sections 5 and 13(b) of the Federal Trade Commission Act.

Defendants are both corporations which sell office products--including office supplies, business machines, computers and furniture--through retail stores, commonly described as office supply superstores, as well as through direct mail delivery and contract stationer operations. Staples is the second largest office superstore chain in the United States with approximately 550 retail stores located in 28 states and the District of Columbia, primarily in the Northeast and California. In 1996 Staples' revenues from those stores were approximately $4 billion through all operations. Office Depot, the largest office superstore chain, operates over 500 retail office supply superstores that are located in 38 states and the District of Columbia, primarily in the South and Midwest. Office Depot's 1996 sales were approximately $6.1 billion. OfficeMax, Inc., is the only other office supply superstore firm in the United States.

On September 4, 1996, defendants Staples and Office Depot, and Marlin Acquisition Corp. ("Marlin"), a wholly-owned subsidiary of Staples, entered into an "Agreement and Plan of Merger" whereby Marlin would merge with and into Office Depot, and Office Depot would become a wholly-owned subsidiary of Staples. According to the Agreement and Plan of Merger, the transaction would be structured as a pooling of interests, in which each share of Office Depot common stock would be exchanged for 1.14 shares of Staples' common stock. Pursuant to the Hart-Scott-Rodino Improvements Act of 1976, 15 U.S.C. § 18a, Staples and Office Depot filed a Premerger Notification and Report Form with the FTC and Department of Justice on October 2, 1996. This was followed by a seven month investigation by the FTC. The FTC issued a Second Request for Information on November 1, 1996, to both Staples and Office Depot. The Commission further initiated a second Second Request on January 10, 1997. In addition to the hundreds of boxes of documents produced to the FTC during this time, the FTC took depositions of 18 Staples and Office Depot officers and employees. The FTC also undertook extensive *ex parte* discovery of third-party documents and, in lieu of subpoenas, obtained at least 36 declarations from third parties.

On March 10, 1997, the Commission voted 4-1 to challenge the merger and authorized commencement of an action under Section 13(b) of the Federal Trade Commission Act, 15 U.S.C. § 53(b), to seek a temporary restraining order and a preliminary injunction barring the merger. Following this vote, the defendants and the FTC staff negotiated a consent decree that would have authorized the merger to proceed on the condition that Staples and Office Depot sell 63 stores to OfficeMax. However, the Commission voted 3-2 to reject the proposed consent decree on April 4, 1997. The FTC then filed this suit on April 9, 1997, seeking a temporary retraining

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order and preliminary injunction against the merger pursuant to Section 13(b) of the Federal Trade Commission Act, 15 U.S.C. § 53(b), pending the completion of an administrative proceeding pursuant to Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45, and Sections 7 and 11 of the Clayton Act, 15 U.S.C. § § 12, 21.

Because of the urgency of this matter, the Court authorized expedited discovery and held a five-day evidentiary hearing beginning on May 19, 1997. Closing arguments were heard on June 5, 1997. In the meantime, the defendants agreed to postpone the merger pending the Court's decision on the motion for a preliminary injunction, thus making the plaintiff's motion for a temporary restraining order moot. At the hearing, the FTC called a number of live witnesses, including three industry witnesses and two economic experts, Dr. Frederick R. Warren-Boulton and Dr. Orley Ashenfelter. Defendants offered testimony from eight live witnesses, including one economic expert, Dr. Jerry Hausman, as well as an expert in retailing, Maurice Segall. In addition to these live witnesses, the plaintiff and the defendants combined submitted over six thousand exhibits including declarations from consumers, industry analysts, economic experts, suppliers, and other sellers of office supplies. Following the conclusion of the hearing, nine states filed a joint amicus brief in support of the FTC's motion. [FN1] [omitted]

## *DISCUSSION*

### I. Section 13(B) Standard for Preliminary Injunctive Relief

Section 7 of the Clayton Act, 15 U.S.C. § 18, makes it illegal for two companies to merge "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." Whenever the Commission has reason to believe that a corporation is violating, or is about to violate, Section 7 of the Clayton Act, the FTC may seek a preliminary injunction to prevent a merger pending the Commission's administrative adjudication of the merger's legality. *See* Section 13(b) of the Federal Trade Commission Act, 15 U.S.C. § 53(b). However, in a suit for preliminary relief, the FTC is not required to prove, nor is the Court required to find, that the proposed merger would in fact violate Section 7 of the Clayton Act. *FTC v. Alliant Techsystems Inc.*, 808 F.Supp. 9, 19 (D.D.C.1992), *FTC v. PPG Indus.*, 628 F.Supp. 881, 883, n. 3 (D.D.C.), *aff'd in part rev'd in part*, 798 F.2d 1500 (D.C.Cir.1986). The determination of whether the acquisition actually violates the antitrust laws is reserved for the Commission and is, therefore, not before this Court. *See Alliant*, 808 F.Supp. at 19. The only question before this Court is whether the FTC has made a showing which justifies preliminary injunctive relief.

Section 13(b) of the Federal Trade Commission Act, 15 U.S.C. § 53(b), provides that "[u]pon a proper showing that, weighing the equities and considering the Commission's likelihood of ultimate success, such action would be in the public interest, and after notice to the defendant, a temporary restraining order or a preliminary injunction may be granted without bond" [FN2] Courts have interpreted this to mean that a court must engage in a two-part analysis in determining whether to grant an injunction under section 13(b). (1) First, the Court must determine the Commission's likelihood of success on the merits in its case under Section 7 of the Clayton Act, and (2) Second, the Court must balance the equities. *See FTC v. Freeman Hospital*, 69 F.3d 260, 267 (8th Cir.1995), *FTC v. University Health, Inc.*, 938 F.2d 1206, 1217-18 (11th Cir.1991), *FTC v. Warner Communications Inc.*, 742 F.2d 1156, 1160 (9th Cir.1984); *FTC v. Occidental Petroleum Corp.*, 1986-1 Trade Cases ¶ 67.071, 1986 WL 952 (D.D.C.1986).

FN2. The traditional "irreparable harm" element is absent from the Section 13(b) standard. In this respect, the section 13(b) standard is "lesser" than that which courts normally impose on private litigants seeking a preliminary injunction.

#### A. Likelihood of Success on the Merits

Likelihood of success on the merits in cases such as this means the likelihood that the Commission will succeed in proving, after a full administrative trial on the merits, that the effect of a merger between Staples and Office Depot "may be substantially to lessen competition, or to tend to create a monopoly" in violation of Section 7 of the Clayton Act. The Commission satisfies its burden to show likelihood of success if it "raises questions going to the merits so serious, substantial, difficult, and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the Commission in

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the first instance and ultimately by the Court of Appeals." *FTC v. University Health, Inc.*, 938 F.2d 1206, 1218 (11th Cir.1991) ("To show a likelihood of ultimate success, the FTC must 'raise [ ] questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instance and ultimately by the Court of Appeals' "). *FTC v. Warner Communications, Inc.*, 742 F.2d 1156, 1162 (9th Cir.1984) ("The Commission meets its burden if it 'raise[s] questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instance and ultimately by the Court of Appeals' "), *FTC v. National Tea Co.*, 603 F.2d 694, 698 (8th Cir.1979) (same language); *FTC v. Alliant Techsystems Inc.*, 808 F.Supp. 9, 19 (D.D.C.1992) (same language). *See also* *FTC v. Beatrice Foods Company*, 587 F.2d 1225 (D.C.Cir.1978). [FN3] [omitted]

It is not enough for the FTC to show merely that it has a "fair and tenable chance" of ultimate success on the merits as has been argued and rejected in other cases. *See* *FTC v. Freeman Hospital*, 69 F.3d 260, 267 (8th Cir.1995) (rejecting the Commission's argument that it need only show a "fair and tenable chance of ultimate success on the merits" in order to qualify for injunctive relief because such a standard would run contrary to Congressional intent and reduce the judicial function to a mere "rubber stamp" of the FTC's decisions.) *See also* *FTC v. National Tea Co.*, 603 F.2d 694, 698 (8th Cir.1979) (reaching the same conclusions under the same reasoning). [FN4] [omitted] However, the FTC need not prove to a certainty that the merger will have an anti-competitive effect. That is a question left to the Commission after a full administrative hearing. Instead, in a suit for a preliminary injunction, the government need only show that there is a "reasonable probability" that the challenged transaction will substantially impair competition. *FTC v. University Health*, 938 F.2d 1206, 1218 (11th Cir.1991) ("[T]he government must show a reasonable probability that the proposed transaction would substantially lessen competition in the future"), *Fruehauf Corp. v. FTC*, 603 F.2d 345, 351 (2d Cir.1979) ("There must be 'the reasonable probability' of a substantial impairment of competition to render a merger illegal"). *See also* *United States v. Penn-Olin Chemical Co.*, 378 U.S. 158, 171, 84 S.Ct. 1710, 1717, 12 L.Ed.2d 775 (1964) ("The requirements of [Section 7] are satisfied when a tendency toward monopoly of the reasonable likelihood of a substantial lessening of competition in the relevant market is shown"). *FTC v. Great Lakes Chemical Corp.*, 528 F.Supp. 84, 86 (N.D.Ill.1981) ("The government must prove not that the merger in question may possibly have an anti-competitive effect, but rather that it will probably have such as effect.").

In order to determine whether the Commission has met its burden with respect to showing its likelihood of success on the merits, that is, whether the FTC has raised questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instance and ultimately by the Court of Appeals and that there is a "reasonable probability" that the challenged transaction will substantially impair competition, the Court must consider the likely competitive effects of the merger, if any. Analysis of the likely competitive effects of a merger requires determinations of (1) the "line of commerce" or product market in which to assess the transaction, (2) the "section of the country" or geographic market in which to assess the transaction, and (3) the transaction's probable effect on competition in the product and geographic markets. *See* *United States v. Marine Bancorporation*, 418 U.S. 602, 618-23, 94 S.Ct. 2856, 2868-71, 41 L.Ed.2d 978 (1974), *FTC v. Harbour Group Investments, L.P.*, 1990-2 Trade Cas (CCH) ¶ 69,247 at 64,914 n. 3, 1990 WL 198819 (D.D.C.1990).

**II. The Geographic Market**

One of the few issue about which the parties to this case do not disagree is that metropolitan areas are the appropriate geographic markets for analyzing the competitive effects of the proposed merger. A geographic market is that geographic area "to which consumers can practically turn for alternative sources of the product and in which the antitrust defendant faces competition." *Morgenstern v. Wilson*, 29 F.3d 1291, 1296 (8th Cir.1994), *cert. denied*, 513 U.S. 1150, 115 S.Ct. 1100, 130 L.Ed.2d 1068 (1995). In its first amended complaint, the FTC identified forty-two such metropolitan areas [FN5] [omitted] as well as future areas which could suffer anti-competitive effects from the proposed merger. [FN6] [omitted] Defendants have not challenged the FTC's geographic market definition in this proceeding. Therefore, the Court will accept the relevant geographic markets identified by the Commission.

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**III. The Relevant Product Market**

In contrast to the parties' agreement with respect to the relevant geographic market, the Commission and the defendants sharply disagree with respect to the appropriate definition of the relevant product market or line of commerce. As with many antitrust cases, the definition of the relevant product market in this case is crucial. In fact, to a great extent, this case hinges on the proper definition of the relevant product market.

The Commission defines the relevant product market as "the sale of consumable office supplies through office superstores," [FN7] with "consumable" meaning products that consumers buy recurrently, i.e., items which "get used up" or discarded. For example, under the Commission's definition, "consumable office supplies" would not include capital goods such as computers, fax machines, and other business machines or office furniture, but does include such products as paper, pens, file folders, post-it notes, computer disks, and toner cartridges. The defendants characterize the FTC's product market definition as "contrived" with no basis in law or fact, and counter that the appropriate product market within which to assess the likely competitive consequences of a Staples-Office Depot combination is simply the overall sale of office products, of which a combined Staples-Office Depot accounted for 5.5% of total sales in North America in 1996. In addition, the defendants argue that the challenged combination is not likely "substantially to lessen competition" however the product market is defined. After considering the arguments on both sides and all of the evidence in this case and making evaluations of each witness's credibility as well as the weight that the Court should give certain evidence and testimony, the Court finds that the appropriate relevant product market definition in this case is, as the Commission has argued, the sale of consumable office supplies through office supply superstores.

FN7. The Commission also offered an alternative product market, that of the sale of consumable office supplies through retail stores to small businesses and individuals with home offices.

The general rule when determining a relevant product market is that "[t]he outer boundaries of a product market are determined by the reasonable interchangeability of use [by consumers] or the cross-elasticity of demand between the product itself and substitutes for it." *Brown Shoe v. United States*, 370 U.S. 294, 325, 82 S.Ct. 1502, 1523-24, 8 L.Ed.2d 510 (1962); *see also United States v. E.I. du Pont de Nemours and Co.*, 351 U.S. 377, 395, 76 S.Ct. 994, 1007-08, 100 L.Ed. 1264 (1956). Interchangeability of use and cross-elasticity of demand look to the availability of substitute commodities, i.e. whether there are other products offered to consumers which are similar in character or use to the product or products in question, as well as how far buyers will go to substitute one commodity for another. *E.I. du Pont de Nemours*, 351 U.S. at 393, 76 S.Ct. at 1006. In other words, the general question is "whether two products can be used for the same purpose, and if so, whether and to what extent purchasers are willing to substitute one for the other." *Hayden Pub. Co. v. Cox Broadcasting Corp.*, 730 F.2d 64, 70 n.8 (2d Cir.1984).

Whether there are other products available to consumers which are similar in character or use to the products in question may be termed "functional interchangeability." *See, e.g., E.I. du Pont de Nemours*, 351 U.S. at 399, 76 S.Ct. at 1009 (recognizing "functional interchangeability" between cellophane and other flexible wrappings). *United States v. Archer- Daniels-Midland Co.*, 866 F.2d 242, 246 (8th Cir.1988) (discussing "functional interchangeability" between sugar and high fructose corn syrup), *cert. denied*, 493 U.S. 809, 110 S.Ct. 51, 107 L.Ed.2d 20 (1989). This case, of course, is an example of perfect "functional interchangeability." The consumable office products at issue here are identical whether they are sold by Staples or Office Depot or another seller of office supplies. A legal pad sold by Staples or Office Depot is "functionally interchangeable" with a legal pad sold by Wal-Mart. A post-it note sold by Staples or Office Depot is "functionally interchangeable" with a post-it note sold by Viking or Quill. A computer disk sold by Staples-Office Depot is "functionally interchangeable" with a computer disk sold by CompUSA. No one disputes the functional interchangeability of consumable office supplies. However, as the government has argued, functional interchangeability should not end the Court's analysis.

The Supreme Court did not stop after finding a high degree of functional interchangeability between cellophane and other wrapping materials in the *E.I. du Pont de Nemours* case. Instead, the Court also found that "an element for consideration as to cross-

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elasticity of demand between products is the responsiveness of the sales of one product to price changes of the other." *Id.* at 400, 76 S.Ct. at 1010. For example, in that case, the Court explained, "[i]f a slight decrease in the price of cellophane causes a considerable number of customers of other flexible wrappings to switch to cellophane, it would be an indication that a high cross-elasticity of demand exists between [cellophane and other flexible wrappings], [and therefore] that the products compete in the same market." *Id.* Following that reasoning in this case, the Commission has argued that a slight but significant increase in Staples-Office Depot's prices will not cause a considerable number of Staples-Office Depot's customers to purchase consumable office supplies from other non- superstore alternatives such as Wal-Mart, Best Buy, Quill, or Viking. On the other hand, the Commission has argued that an increase in price by Staples would result in consumers turning to another office superstore, especially Office Depot, if the consumers had that option. Therefore, the Commission concludes that the sale of consumable office supplies by office supply superstores is the appropriate relevant product market in this case, and products sold by competitors such as Wal-Mart, Best Buy, Viking, Quill, and others should be excluded.

The Court recognizes that it is difficult to overcome the first blush or initial gut reaction of many people to the definition of the relevant product market as the sale of consumable office supplies through office supply superstores. The products in question are undeniably the same no matter who sells them, and no one denies that many different types of retailers sell these products. After all, a combined Staples-Office Depot would only have a 5.5% share of the overall market in consumable office supplies. Therefore, it is logical to conclude that, of course, all these retailers compete, and that if a combined Staples-Office Depot raised prices after the merger, or at least did not lower them as much as they would have as separate companies, that consumers, with such a plethora of options, would shop elsewhere.

The Court acknowledges that there is, in fact, a broad market encompassing the sale of consumable office supplies by all sellers of such supplies, and that those sellers must, at some level, compete with one another. However, the mere fact that a firm may be termed a competitor in the overall marketplace does not necessarily require that it be included in the relevant product market for antitrust purposes. The Supreme Court has recognized that within a broad market, "well-defined submarkets may exist which, in themselves, constitute product markets for antitrust purposes." *Brown Shoe Co. v. United States,* 370 U.S. 294, 325, 82 S.Ct. 1502, 1524, 8 L.Ed.2d 510 (1962), *see also Rothery Storage & Van Co. v. Atlas Van Lines, Inc.,* 792 F.2d 210, 218 (D.C.Cir.1986) (Bork, J.), *cert. denied,* 479 U.S. 1033, 107 S.Ct. 880, 93 L.Ed.2d 834 (1987). With respect to such submarkets, the Court explained "[b]ecause Section 7 of the Clayton Act prohibits any merger which may substantially lessen competition 'in any line of commerce,' it is necessary to examine the effects of a merger in each such economically significant submarket to determine if there is a reasonable probability that the merger will substantially lessen competition. If such a probability is found to exist, the merger is proscribed." *Id.* There is a possibility, therefore, that the sale of consumable office supplies by office superstores may qualify as a submarket within a larger market of retailers of office supplies in general.

The Court in *Brown Shoe* provided a series of factors or "practical indicia" for determining whether a submarket exists including "industry or public recognition of the submarket as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors." *Id.* Since the Court described these factors as "practical indicia" rather than requirements, subsequent cases have found that submarkets can exist even if only some of these factors are present. *See, e.g., Beatrice Foods Co. v. FTC,* 540 F.2d 303 (7th Cir.1976) (finding submarket based on industry recognition, peculiar characteristics of the product, and differences in production methods and prices). *International Telephone and Telegraph Corp. v. General Telephone & Electronics Corp.,* 518 F.2d 913, 932 (9th Cir.1975) (explaining that *Brown Shoe's* practical indicia were meant as "practical aids rather than with the view that their presence or absence would dispose, in talismanic fashion, of the submarket issue").

The Commission discussed several of the *Brown Shoe* "practical indicia" in its case, such as industry recognition, and the special characteristics of superstores which make them different from other sellers of office supplies, including distinct formats, customers, and prices. Primarily, however, the FTC focused on what it termed the "pricing evidence," which the Court finds corresponds with *Brown Shoe's* "sensitivity to price changes" factor. First, the FTC presented evidence comparing Staples' prices in

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geographic markets where Staples is the only office superstore, to markets where Staples competes with Office Depot or OfficeMax, or both. Based on the FTC's calculations, in markets where Staples faces no office superstore competition at all, something which was termed a one firm market during the hearing, prices are 13% higher than in three firm markets where it competes with both Office Depot and OfficeMax. The data which underly this conclusion make it compelling evidence. Prices were compared as of January 1997, which, admittedly, only provides data for one specific point in time. However, rather than comparing prices from only a small sampling or "basket" of goods, the FTC used an office supply sample accounting for 90% of Staples' sales and comprised of both price sensitive and non price sensitive items. The FTC presented similar evidence based on Office Depot's prices of a sample of 500 items, also as of January 1997. Similarly, the evidence showed that Office Depot's prices are significantly higher--well over 5% higher, [FN8] in Depot-only markets than they are in three firm markets.

FN8. The analytical framework set forth in the *Merger Guidelines* approaches the inquiry regarding the reasonable interchangeability of use or cross-elasticity of demand by asking whether a "hypothetical monopolist would profitably impose at least a 'small but significant and nontransitory' [price] increase." *Merger Guidelines* at § 111. The *Merger Guidelines* use 5% of the usual approximation of a "small but significant and nontransatory price increase." *Id.* For this reason, the Court's analysis will often refer to this 5% number.

Other pricing evidence presented by the FTC is less convincing on its own, due to limitations in the underlying data. For example, relatively small samplings or "baskets" of goods may have been used or it may not be clear how many stock keeping units ("SKUs") of supplies were included. For example, the FTC also presented evidence comparing Staples' prices in Staples-only markets with Staples' prices in three-firm markets for four different time periods, August 1994, January 1995, August 1995, and May 1996. The result is startlingly similar to that found in the first two examples. Where Staples does not compete with other office superstores, it charges prices well over 5% higher than where it does so compete. While having the advantage of showing a trend over time, the Court recognizes that this evidence has some problems. These particular calculations were made based on a "basket" or sample of supplies comprised of supplies used by Staples to price check against Office Depot. The number of SKUs in the sample was not provided to the Court, and it appears that the components of the baskets may have changed over time. Therefore, the Court would not give much weight to this evidence standing alone. However, since additional evidence supports the same conclusion, the Court credits this evidence as confirmation of the general pricing trend.

The FTC also pointed to internal Staples documents which present price comparisons between Staples' prices and Office Depot's prices and Staples' prices and OfficeMax's prices within different price zones. [FN9] The comparisons between Staples and Office Depot were made in August 1994, January 1995, August 1995, and May 1996. Staples' prices were compared with OfficeMax's prices in August 1994, July 1995, and January 1996. For each comparison, Staples calculations were based on a fairly large "basket" or sample of goods, approximately 2000 SKUs containing both price sensitive and non-price sensitive items. Using Staples' data, but organizing it differently to show which of those zones were one, two, or three firm markets, the FTC showed once again that Staples charges significantly higher prices, more than 5% higher, where it has no office superstore competition than where it competes with the two other superstores.

FN9. It was established at the hearing that Staples and Office Depot do not maintain nationally uniform prices in their stores. Instead, both companies currently organize their stores into price zones which are simply groups of one or more stores that have common prices.

The FTC offered similar price comparison evidence for Office Depot, comparing Office Depot's prices across Staples' zones. The comparisons were made in August 1994, January 1995, August 1995, and May 1996. Again, a large sample, approximately 2000 SKUs, was considered. The results of this analysis are slightly less favorable to the FTC's position. Price differentials are significantly smaller and there are even a few instances where Office Depot's prices appear to be higher in one of its three firm markets than prices in its two firm markets and

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at least one point where prices in one of the Depot-only zones were lower than prices in one of the three firm markets. On average, however, this evidence shows that Office Depot's prices are highest in its one firm markets, and lowest in its three firm markets.

This evidence all suggests that office superstore prices are affected primarily by other office superstores and not by non-superstore competitors such as mass merchandisers like Wal-Mart, Kmart, or Target, wholesale clubs such as BJ's, Sam's, and Price Costco, computer or electronic stores such as Computer City and Best Buy, independent retail office supply stores, mail orders firms like Quill and Viking, and contract stationers. Though the FTC did not present the Court with evidence regarding the precise amount of non- superstore competition in each of Staples' and Office Depot's one, two, and three firm markets, it is clear to the Court that these competitors, albeit in different combinations and concentrations, are present in every one of these markets. For example, it is a certainty that the mail order competitors compete in all of the geographic markets at issue in this case. Office products are available through the mail in all 50 states, and have been for approximately 30 years. Despite this mail order competition, however, Staples and Office Depot are still able to charge higher prices in their one firm markets than they do in the two firm markets and the three firm markets without losing a significant number of customers to the mail order firms. The same appears to be true with respect to Wal-Mart. Bill Long, Vice President for Merchandising at Wal-Mart Stores, testifying through declaration, explained that price-checking by Wal-Mart of Staples' prices in areas where both Staples and Wal-Mart exist showed that, on average, Staples' prices were higher where there was a Staples and a Wal-Mart but no other superstore than where there was a Staples, a Wal-Mart, and another superstore. [FN10] [omitted]

The evidence with respect to the wholesale club stores is consistent. Mike Atkinson, Vice President, Division Merchandise Manager of BJ's Wholesale Club, testified at the hearing regarding BJ's price checking of Staples and Office Depot in areas where BJ's competes with one or both of those superstores. Though his sample was small--he testified that less than 10% of BJ's 80 stores are located in the same area as a Staples and/or Office Depot-- BJ's price checking found that, in general, office supply superstore prices were lowest where there was both a Staples and an Office Depot. In addition, Staples' own pricing information shows that warehouse clubs have very little effect on Staples' prices. For example, Staples' maintains a "warehouse club only" price zone, which indicates a zone where Staples exists with a warehouse club but without another office superstore. The data presented by the Commission on Staples' pricing shows only a slight variation in prices (1%-2%) between "warehouse club only" zones and one superstore markets without a warehouse club. Additionally, in May 1996, two price comparison studies done by Staples, first using 2,084 SKUs including both price sensitive and non-price sensitive items and then using only 244 SKUs of price sensitive items, showed that prices in the "club only" zones, on average, were over 10% higher than in zones where Staples competes with Office Depot and/or OfficeMax.

There is also consistent evidence with respect to computer and/or consumer electronics stores such as Best Buy. For example, Office Depot maintains a separate price zone, which it calls "zone 30," for areas with Best Buy locations but no other office supply superstores. However, the FTC introduced evidence, based on a January 1997 market basket of "top 500 items by velocity," that prices in Office Depot's "zone 30" price zone are almost as high as in its "non-competitive" price zone, the zone where it does not compete with another office superstore.

There is similar evidence with respect to the defendants' behavior when faced with entry of another competitor. The evidence shows that the defendants change their price zones when faced with entry of another superstore, but do not do so for other retailers. For example, Staples changed its price zone for Cincinnati to a lower priced zone when Office Depot and OfficeMax entered that area. New entry by Staples and OfficeMax caused a decline in prices at Office Depot's Greensboro stores. In July 1996, after OfficeMax entered Jackson, Michigan, Staples moved its Jackson store to a new zone, cutting prices by 6%. There are numerous additional examples of zones being changed and prices falling as a result of superstore entry. There is no evidence that zones change and prices fall when another non-superstore retailer enters a geographic market.

Though individually the FTC's evidence can be criticized for looking at only brief snapshots in time or for considering only a limited number of SKUs, taken together, however, the Court finds this evidence a compelling showing that a small but significant increase in Staples' prices will not cause a significant number of consumers to turn to non-superstore alternatives for purchasing their

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consumable office supplies. Despite the high degree of functional interchangeability between consumable office supplies sold by the office superstores and other retailers of office supplies, the evidence presented by the Commission shows that even where Staples and Office Depot charge higher prices, certain consumers do not go elsewhere for their supplies. This further demonstrates that the sale of office supplies by non- superstore retailers are not responsive to the higher prices charged by Staples and Office Depot in the one firm markets. This indicates a low cross- elasticity of demand between the consumable office supplies sold by the superstores and those sold by other sellers.

Turning back to the other *Brown Shoe* "practical indicia" of submarkets that the Commission offered in this case, the Commission presented and the Court heard a great deal of testimony at the hearing and through declarations about the uniqueness of office superstores and the differences between the office superstores and other sellers of office supplies such as mass merchandisers, wholesale clubs, and mail order firms as well as the special characteristics of office superstore customers. In addition, the Court was asked to go and view many of the different types of retail formats. That evidence shows that office superstores are, in fact, very different in appearance, physical size, format, the number and variety of SKU's offered, and the type of customers targeted and served than other sellers of office supplies.

The Court has observed that office supply superstores look far different from other sellers of office supplies. Office supply superstores are high volume, discount office supply chain stores averaging in excess of 20,000 square feet, with over 11,000 of those square feet devoted to traditional office supplies, and carrying over 5,000 SKUs of consumable office supplies in addition to computers, office furniture, and other non-consumables. In contrast, stores such as Kmart devote approximately 210 square feet to the sale of approximately 250 SKUs of consumable office supplies. Kinko's devotes approximately 50 square feet to the sale of 150 SKUs. Target sells only 400 SKUs. Both Sam's Club and Computer City each sell approximately 200 SKUs. Even if these SKU totals are low estimates as the defendants have argued, there is still a huge difference between the superstores and the rest of the office supply sellers.

In addition to the differences in SKU numbers and variety, the superstores are different from many other sellers of office supplies due to the type of customer they target and attract. The superstores' customer base overwhelmingly consists of small businesses with fewer than 20 employees and consumers with home offices. In contrast, mail order customers are typically mid-sized companies with more than 20 employees. Another example is contract stationers who focus on serving customers with more than 100 employees. While the Court accepts that some small businesses with fewer than 20 employees as well as home office customers do choose other sellers of office supplies, the superstores' customers are different from those of many of the purported competitors.

It is difficult to fully articulate and explain all of the ways in which superstores are unique. As the plaintiff and defendant requested, the Court viewed some of the various sellers of office supplies located in the Rockville, Maryland area, including Staples, Office Depot, CompUSA, Best Buy, CVS, Kmart, Giant Food, and Wal-Mart. Based on the Court's observations, the Court finds that the unique combination of size, selection, depth and breadth of inventory offered by the superstores distinguishes them from other retailers. Other retailers devote only a fraction of their square footage to office supplies as opposed to Staples or Office Depot. The evidence shows that the typical club, mass merchant, or computer store offers only 210 to 2000 square feet of office supplies, compared to over 11,182 square feet at a typical Staples. This was evident to the Court when visiting the various stores. Superstores are simply different in scale and appearance from the other retailers. No one entering a Wal-Mart would mistake it for an office superstore. No one entering Staples or Office Depot would mistakenly think he or she was in Best Buy or CompUSA. You certainly know an office superstore when you see one. *Cf. Bon-Ton Stores, Inc. v. May Department Stores,* 881 F.Supp. 860, 870 (W.D.N.Y.1994) ("Customers know a department store when they see it.")

Another of the "practical indicia" for determining the presence of a submarket suggested by *Brown Shoe* is "industry or public recognition of the submarket as a separate economic entity." *See also Rothery Storage & Van Co. v. Atlas Van Lines,* 792 F.2d 210, 219 (D.C.Cir.1986) (Bork, J.) ("The industry or public recognition of the submarket as a separate economic unit matters because we assume that economic actors usually have accurate perceptions of economic realities."), *cert. denied,* 479 U.S. 1033, 107 S.Ct. 880, 93 L.Ed.2d 834 (1987). *FTC v. Coca-Cola Co.,* 641 F.Supp. 1128, 1132 (D.D.C.1986) ("Analysis of the market is a matter of business reality--a matter of

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how the market is perceived by those who strive for profit in it"), *vacated as moot,* 829 F.2d 191 (D.C.Cir.1987). The Commission offered abundant evidence on this factor from Staples' and Office Depot's documents which shows that both Staples and Office Depot focus primarily on competition from other superstores. The documents reviewed by the Court show that the merging parties evaluate their "competition" as the other office superstore firms, without reference to other retailers, mail order firms, or independent stationers. In document after document, the parties refer to, discuss, and make business decisions based upon the assumption that "competition" refers to other office superstores only. For example, Staples uses the phrase "office superstore industry" in strategic planning documents. PX 15 at3186. Staples' 1996 Strategy Update refers to the "Big Three" and "improved relative competitive position" since 1993 and states that Staples is "increasingly recognized as [the] industry leader." PX 15 at 3153. A document analyzing a possible acquisition of OfficeMax referenced the "[b]enefits from pricing in [newly] noncompetitive markets," and also the fact that there was "a potential margin lift overall as the industry moves to 2 players." PX 33 at 8393, 8399.

When assessing key trends and making long range plans, Staples and Office Depot focus on the plans of other superstores. In addition, when determining whether to enter a new metropolitan area, both Staples and Office Depot evaluate the extent of office superstore competition in the market and the number of office superstores the market can support. When selecting sites and markets for new store openings, defendants repeatedly refer to markets without office superstores as "non-competitive," even when the new store is adjacent to or near a warehouse club, consumer electronics store, or a mass merchandiser such as Wal-Mart. In a monthly report entitled "Competitor Store Opening/Closing Report" which Office Depot circulates to its Executive Committee, Office Depot notes all competitor store closings and openings, but the only competitors referred to for its United States stores are Staples and OfficeMax. PX 75 at 1309.

While it is clear to the Court that Staples and Office Depot do not ignore sellers such as warehouse clubs, Best Buy, or Wal-Mart, the evidence clearly shows that Staples and Office Depot each consider the other superstores as the primary competition. For example, Office Depot has a Best Buy zone and Staples has a warehouse club zone. However, each still refers to its one firm markets with no other office superstore as "non-competitive" zones or markets. In addition, it is clear from the evidence that Staples and Office Depot price check the other office superstores much more frequently and extensively than they price check other retailers such as BJ's or Best Buy, and that Staples and Office Depot are more concerned with keeping their prices in parity with the other office superstores in their geographic areas than in undercutting Best Buy or a warehouse club.

For the reasons set forth in the above analysis, the Court finds that the sale of consumable office supplies through office supply superstores is the appropriate relevant product market for purposes of considering the possible anti-competitive effects of the proposed merger between Staples and Office Depot. The pricing evidence indicates a low cross-elasticity of demand between consumable office products sold by Staples or Office Depot and those same products sold by other sellers of office supplies. This same evidence indicates that non-superstore sellers of office supplies are not able to effectively constrain the superstores prices, because a significant number of superstore customers do not turn to a non-superstore alternative when faced with higher prices in the one firm markets. In addition, the factors or "practical indicia" of *Brown Shoe* support a finding of a "submarket" under the facts of this case, and "submarkets," as *Brown Shoe* established, may themselves be appropriate product markets for antitrust purposes. 370 U.S. at 325, 82 S.Ct. at 1523-24. [FN11]

FN11. As other courts have noted, use of the term "submarket" may be confusing. *See Allen-Myland v. IBM Corp.,* 33 F.3d 194, 208 n. 16 (3rd Cir.1994) (finding it less confusing tospeak in terms of the relevant product market rather than the submarket), cert. denied, 513 U.S. 1066, 115 S.Ct. 684, 130 L.Ed.2d 615 (1994). *Olin Corp. v. FTC,* 986 F.2d 1295, 1299 (9th Cir.1993) ("[E]very market that encompasses less than all products is, in a sense, a submarket"), cert. denied, 510 U.S. 1110, 114 S.Ct. 1051, 127 L.Ed.2d 373 (1994). Whatever term is used--market, submarket, relevant product market--the analysis is the same.

This Court is not the first to find a narrower submarket or relevant product market within a larger market. Judge Larimer found one in *Bon-Ton*

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*Stores, Inc. v. May Department Stores Co.,* 881 F.Supp. 860 (W.D.N.Y.1994) , when he defined the relevant product market in that case as "traditional department stores including J.C. Penney's." Defendants had argued that the "traditional department stores" definition was underinclusive because it overlooked numerous businesses that compete with department stores. *Id.* at 865. Under the defendants' view, the relevant product market should have included all stores selling general merchandise, apparel, and furniture. *Id.* The court acknowledged that, in a broad sense, traditional department stores do compete in a vast marketplace encompassing retailers in general. *Id.* at 868. However, applying the *Brown Shoe* "practical idicia," the court found that there were qualitative differences between traditional department stores and other retailers, including the physical appearance and layout of the stores, distinctive customers, the wide range of brand-name merchandise, and service. *Id.* at 869-72. Additionally, the court found that testimony at the hearing as well as internal company documents indicated that the department stores themselves recognize each other as competitors different from other retailers. *Id.* at 873. The court found that this evidence established that "traditional department stores including J.C. Penney's" constituted a proper submarket under the *Brown Shoe* criteria. *Id.* at 874. The court enjoined the merger. *Id.* at 878.

A similar, though not as detailed, analysis was undertaken in *State of California v. American Stores Co.,* 697 F.Supp. 1125 (C.D.Ca.1988), *aff'd in part and rev'd in part on other grounds,* 872 F.2d 837 (9th Cir.1989), *rev'd on other grounds,* 495 U.S. 271, 110 S.Ct. 1853, 109 L.Ed.2d 240 (1990). In that case, the State of California brought an action to enjoin the merger of two supermarket chains. *Id.* at 1127. The State defined the relevant product market as "supermarkets--full line grocery stores with more than 10,000 square feet." *Id.* at 1129. In contrast, defendants contended that the relevant product marketincluded retail grocery purchases from "mom and pop" retail grocery stores, convenience stores, and non-grocery stores such as department stores, gasoline service stations, eating and drinking places, drug stores, and liquor stores. *Id.* The court credited evidence which showed that shoppers as well as the supermarkets themselves did not consider these other retailers as competition. *Id.* Thereafter, the court defined the relevant product market as the State had defined it. *Id.*

The Court is aware that litigants have not always been successful in proving submarkets similar to the one found by the Court in this case. *See Thurman Industries, Inc. v. Pay 'N Pak Stores, Inc.,* 875 F.2d 1369 (9th Cir.1989) (concluding that plaintiff failed to show that home centers were submarkets for purposes of its restraint of trade and monopolization claims). In addition, when the supermarket case went up on appeal, the Ninth Circuit did not set aside the relevant product market definition, but did express some reservations about it. *See State of California v. American Stores,* 872 F.2d 837, 841 (9th Cir.1989) ("Were we to evaluate independently the evidence of the relevant product market, we might reach a different conclusion"). However, each of those cases is distinguishable on its facts. None, including *Bon-Ton,* possessed the compelling pricing evidence submitted to the Court in this case.

**IV. Probable Effect on Competition**

After accepting the Commission's definition of the relevant product market, the Court next must consider the probable effect of a merger between Staples and Office Depot in the geographic markets previously identified. One way to do this is to examine the concentration statistics and HHIs within the geographic markets. [FN12] If the relevant product market is defined as the sale of consumable office supplies through office supply superstores, the HHIs in many of the geographic markets are at problematic levels even before the merger. Currently, the least concentrated market is that of Grand Rapids- Muskegon-Holland, Michigan, with an HHI of 3,597, while the most concentrated is Washington, D.C. with an HHI of 6,944. In contrast, after a merger of Staples and Office Depot, the least concentrated area would be Kalamazoo-Battle Creek Michigan, with an HHI of 5,003, and many areas would have HHIs of 10,000. The average increase in HHI caused by the merger would be 2,715 points. The concentration statistics show that a merged Staples-Office Depot would have a dominant market share in 42 geographic markets across the country. The combined shares of Staples and Office Depot in the office superstore market would be 100% in 15 metropolitan areas. It is in these markets the post-merger HHI would be 10,000. In 27 other metropolitan areas, where the number of office superstore competitors would drop from three to two, the post-merger market shares would range from 45% to 94%, with post-merger HHIs ranging from 5,003 to 9,049. Even the lowest of these HHIs indicates a "highly concentrated" market.

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FN12. Market power or the lack of it is often determined by the Herfindahl-Hirschmann Index ("HHI"). The HHI is calculated by squaring the individual market shares of all the firms in the market and adding up the squares. The HHI takes into account the relative size and distribution of the firms in a market, increasing both as the number of firms in the market decreases and as the disparity in size among those firms increases.

According to the Department of Justice Merger Guidelines, a market with an HHI of less than 1000 in "unconcentrated." An HHI between 1000 and 1800 indicates a "moderately concentrated" market, and any market with an HHI over 1800 qualifies as "highly concentrated." *See FTC v. PPG Indus., Inc.*, 798 F.2d 1500, 1503 (D.C.Cir.1986) (citing the U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines) (hereinafter "Merger Guidelines"). Further, according to the *Merger Guidelines,* unless mitigated by other factors which lead to the conclusion that the merger is not likely to lessen competition, an increase in the HHI is excess of 50 points in a post- merger highly concentrated market may raise significant competitive concerns. In cases where the post-merger HHI is less than 1,800, but greater than 1,000, the *Merger Guidelines* presume that a 100 point increase in the HHI is evidence that the merger will create or enhance market power. The *Merger Guidelines,* of course, are not binding on the Court, but, as this Circuit has stated, they do provide "a useful illustration of the application of the HHI," *Id.* at 1503 n. 4, and the Court will use that guidance here. In addition, though the Supreme Court has established that there is no fixed threshold at which an increase in market concentration triggers the antitrust laws, *see, e.g., United States v. Philadelphia National Bank,* 374 U.S. 321, 363-65, 83 S.Ct. 1715, 1741-43, 10 L.Ed.2d 915 (1963), this is clearly not a borderline case. The pre-merger markets are already in the "highly concentrated" range, and the post-merger HHIs show an average increase of 2,715 points. Therefore, the Court finds that the plaintiff's have shown a likelihood of success on the merits. With HHIs of this level, the Commission certainly has shown a "reasonable probability" that the proposed merger would have an anti- competitive effect. [FN13] [omitted]

The HHI calculations and market concentration evidence, however, are not the only indications that a merger between Staples and Office Depot may substantially lessen competition. Much of the evidence already discussed with respect to defining the relevant product market also indicates that the merger would likely have an anti-competitive effect. The evidence of the defendants' own current pricing practices, for example, shows that an office superstore chain facing no competition from other superstores has the ability to profitably raise prices for consumable office supplies above competitive levels. The fact that Staples and Office Depot both charge higher prices where they face no superstore competition demonstrates that an office superstore can raise prices above competitive levels. The evidence also shows that defendants also change their price zones when faced with entry of another office superstore, but do not do so for other retailers. Since prices are significantly lower in markets where Staples and Office Depot compete, eliminating this competition with one another would free the parties to charge higher prices in those markets, especially those in which the combined entity would be the sole office superstore. In addition, allowing the defendants to merge would eliminate significant future competition. Absent the merger, the firms are likely, and in fact have planned, to enter more of each other's markets, leading to a deconcentration of the market and, therefore, increased competition between the superstores.

In addition, direct evidence shows that by eliminating Staples' most significant, and in many markets only, rival, this merger would allow Staples to increase prices or otherwise maintain prices at an anti-competitive level. [FN14] The merger would eliminate significant head-to-head competition between the two lowest cost and lowest priced firms in the superstore market. Thus, the merger would result in the elimination of a particularly aggressive competitor in a highly concentrated market, a factor which is certainly an important consideration when analyzing possible anti- competitive effects. *See, e.g., FTC v. Food Town Stores, Inc.*, 539 F.2d 1339, 1345 (4th Cir.1976) (enjoining merger when merging firms had been "aggressive competitors in the past," by opening stores in each other's markets and increasing sales by greater than the industry's sales average). It is based on all of this evidence as well that the Court finds that the Commission has shown a likelihood of success on the merits and a "reasonable probability" that the proposed transaction will have an anti-competitive effect.

FN14. There has been tremendous

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> argument regarding whether the FTC actually contends that prices will go up after the merger. The Court understands that is not precisely the Commission's contention. Rather, the Commission argues that the merger will have an anti-competitive effect such that the combined firm's prices will be higher after the merger than they would be absent the merger. This does not necessarily mean that prices would rise from the levels they are now. Instead, according to the Commission, prices would simply not decrease as much as they would have on their own absent the merger.. . . .

By showing that the proposed transaction between Staples and Office Depot will lead to undue concentration in the market for consumable office supplies sold by office superstores in the geographic markets agreed upon by the parties, the Commission establishes a presumption that the transaction will substantially lessen competition. *See United States v. Citizens & Southern Nat'l Bank,* 422 U.S. 86, 95 S.Ct. 2099, 45 L.Ed.2d 41 (1975). *United States v. Philadelphia Nat'l Bank,* 374 U.S. 321, 83 S.Ct. 1715, 10 L.Ed.2d 915 (1963). Once such a presumption has been established, the burden of producing evidence to rebut the presumption shifts to the defendants. *See, e.g., United States v. Marine Bancorporation,* 418 U.S. 602, 631, 94 S.Ct. 2856, 2874-75, 41 L.Ed.2d 978 (1974); *United States v. General Dynamics Corp.,* 415 U.S. 486, 496-504, 94 S.Ct. 1186, 1193-97, 39 L.Ed.2d 530 (1974). To meet this burden, the defendants must show that the market-share statistics give an inaccurate prediction of the proposed acquisition's probable effect on competition. *See United States v. Baker Hughes, Inc.,* 908 F.2d 981, 991 (D.C.Cir.1990) (rejecting argument that a defendant should be required to "clearly" disprove future anti-competitive effects, because that would impermissibly shift the ultimate burden of persuasion). *See also Marine Bancorporation,* 418 U.S. at 631, 94 S.Ct. at 2874-75 (finding presumption may be overcome by a showing that the statistics do not accurately reflect the probable effect of the proposed merger on competition). In order to rebut the FTC's showing with respect to the likely anti-competitive effects of a merger, defendants challenged the FTC's market-share statistics in this case in various ways, such as criticizing the Commission's definition of the relevant product market and introducing evidence to counter the FTC's pricing information. Defendants' also made allegations of "cherry-picking" on the part of the Commission, pointing to data which tend to show the opposite from the Commission's contentions. Finally, the defendants argued that the price differentials between one, two, and three firm markets shown by the Commission do not accurately reflect market power because the Commission failed to take into account factors such as the differences in marketing costs between stores.

In their criticism of the Commission's pricing evidence, the defendants accused the FTC of "cherry-picking" its data and pointed to specific examples which contradict the Commission's conclusions. For example, the defendants focused on the FTC's comparison prices on manila folders in two Ohio towns, Columbus which has two superstores and Cincinnati which has all three superstore chains. For 1995-96, the prices of those manila folders were shown to be, on average, 51% higher in the two firm market than in the three firm market. [FN15] [omitted] The defendants argued that in contrast to the Ohio example, a comparison of two Indiana towns, Kokomo with two firms and Elkhart/South Bend with all three firms, shows the opposite. In fact, the defendants' comparison of the average prices of manila folders for 1996 in Kokomo and Elkhart/South Bend shows that the prices in Kokomo, the two firm market, were 30% lower than in the three firm market.

The Court acknowledges that there is some evidence of this type in the record, and the Court has considered all of it. However, the fact that there may be some examples with respect to individual items in individual cities which contradict the FTC's evidence does not overly concern the Court. A few examples of isolated products simply cannot refute the power of the FTC's evidence with respect to the overall trend over time, which is that Staples' and Office Depot's prices are lowest in three firm markets and highest where they do not compete with another office superstore. Neither does the fact that some two superstore areas have lower prices than some three firm markets. In addition, a closer examination of the price comparison study done by the defendants for Kokomo and Elkhart/South Bend shows that for four of the six products compared, the prices were actually higher in Kokomo. [FN16] [omitted] Moreover, when Staples' total of price sensitive and non-price sensitive items are examined, Kokomo's prices are between 3 and 5% higher than Elkhart, which reconfirms the Commission's result rather than refuting it.

Defendants also argued that the regional price

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differences set forth in the FTC's pricing evidence do not reflect market power, because the reason for those differentials is not solely the presence or absence of other superstore competition. Instead, argued the defendants, these differentials are the result of a host of factors other than superstore competition. As examples of other factors which cause differences in pricing between geographic markets, the defendants offered sales volume, product mix, marketing or advertizing costs, and distribution costs. Defendants also argued that there are differences in wages and rent which cause the differences in pricing between certain stores. The Court, however, cannot find that the evidence submitted by the defendants with respect to other reasons for the differences in pricing between one, two, and three firm markets is sufficient to rebut the Commission's evidence.

The Court generally accepts that per-store advertizing costs, such as those incurred for a newspaper insert, will likely be lower in markets where Staples or Office Depot has a larger number of stores as those costs may be spread over a larger number of stores, and the defendants have provided some concrete evidence that the price differentials shown by the FTC may be somewhat affected by marketing costs. Donna Rosenberg, Vice President of Marketing Strategy at Staples, testified by declaration that Staples has the lowest average marketing costs per store in Staples/Office Depot areas and the highest marketing costs per store in Staples only areas. Exhibit H to her declaration shows, more specifically, that in 1996 Staples stores in three firm areas had an average marketing expense of 202,112. In Staples/Office Depot areas, Staples' stores had an average marketing expense of 185,905. Staples stores in Staples/OfficeMax areas paid an average of 218,500, and the stores in Staples only markets had an average marketing expense of 243,763. These numbers do suggest a correlation between the prices charged by Staples and marketing costs as average marketing costs are higher in the one firm markets than the three firm markets. However, the marketing cost evidence also shows that marketing costs are lower in Staples/Depot areas than in Staples/OfficeMax areas and, in fact, that costs are higher in Staples/OfficeMax areas than in the three firm markets, which does not correspond with the pricing trend. Staples generally charges lower prices where it competes with Office Depot than where it competes with OfficeMax and generally charges lower prices in three firm markets than in Staples/OfficeMax areas. In addition, the differences in marketing costs are not so large that they alone could account for the significant price differentials shown by the FTC.

As the Court has already noted, the defendants, of course, point to other factors besides marketing costs. However, unlike the comparison of average marketing costs between one, two, and three firm markets, the defendants produced no concrete evidence in support of these other factors. For example, the Court believes that it is probably true that distribution costs are higher for stores which are the farthest from either company's distribution centers. Yet, the defendants introduced no evidence to show that the one firm markets are, in fact, the farthest from distribution centers or that in the three firm markets, the stores are the closest to the distribution centers. Nor did the defendants introduce any evidence showing the actual differences in distribution costs based on a store's distance from a distribution center. The only evidence that the Court heard on this point was the testimony of Thomas Stemberg, Chairman and CEO of Staples, who testified at the hearing that "typically the smaller markets are further away from the distribution hubs. It costs you a lot more to haul freight up to Bangor, Maine, than it does from Hagerstown to Washington." The Court cannot find that the FTC's pricing evidence is seriously undermined by such a general statement.

The defendants' evidence is similar with respect to sales volume, rent and wages. For example, Steven Mandel, Senior Managing Director of Tiger Management Corporation, testified at the hearing that single store markets are typically smaller markets. He continued by explaining that even though the costs of rent and labor may be lower in a smaller market, they would be higher as a percentage of sales because the volume of sales are also typically lower in these smaller markets. Therefore, in order to come out with a decent return on investment, it will be necessary to have a modestly higher gross margin in those markets. While this seems logical to the Court, again, the only evidence presented on the point is very general and the Court cannot give it much weight. For example, Mr. Mandel testified that "typically" one firm areas are in smaller markets but offered no concrete evidence relating specifically to Staples' or Office Depot's one firm market stores. Also, the Court has heard evidence that Bangor, Maine, a one firm store in a smaller market, actually has an extremely high volume of sales which directly contradicts Mr. Mandel's testimony. Mr. Mandel is not employed by either Staples or Office Depot, and while he may be generally knowledgeable about the

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broader office supply industry, the Court questions his level of knowledge with respect to individual Staples and Office Depot stores. Finally, Mr. Mandel's testimony regarding the fact that he would generally expect higher gross margins in smaller one firm markets is contradicted by other evidence submitted by the defendants in their DX 1968 which states that in 1996, Staples' lowest gross margins were in the one superstore areas. For these reasons, the Court cannot find that the defendants' evidence regarding the different costs attributed to sales volume, rent, and wages shows that the Commission's evidence gives an inaccurate prediction of the proposed acquisition's probable effect on competition.

The defendants also argued that the variations in product mix between different stores account for some of the differences in prices between one, two, and three firm markets. For example, defendants argued that Staples' mix of general office supplies is highest in three superstore towns (37.29% of retail sales), lower in Staples/Office Depot areas (36.14%), lower yet in Staples/OfficeMax areas, and lowest in Staples-only areas (26.68%). On the other hand, defendants argue, computer mix is highest in Staples-only areas (30.36%), and lowest in three superstore areas (13.62%). Computer sales make up 40% of store sales in Bangor, Maine, for example, but only 10% in Los Angeles. Pointing to evidence showing that Staples' sale of computers in 1996 generated a net loss of 10.6%, defendants argued that stores with higher computer sales must have higher margins on their other products to generate sufficient total returns. Therefore, defendants explained that the higher prices of consumable office supplies in these areas are a result of economic costs and do not imply that Staples has more market power in Staples-only markets. The Court cannot agree. While the higher percentage of computer sales in a one firm market such as Bangor, Maine, may be one of the reasons that Staples chooses to charge higher prices for consumable office supplies in that location, it does not change the fact that Staples is able to charge those higher prices. The primary reason that computer sales generate a very small or even negative return is the competition among sellers of computers. Individual competitors are effectively constrained from raising prices on computers. The fact that Staples can raise its prices for consumable office supplies in order to offset the low or negative returns on the sale of computers shows the opposite--that Staples is not constrained by non-superstore competitors from raising prices on consumable office supplies.

The above discussion covers some of the ways in which the defendants have challenged the FTC's market-share statistics in this case, including the highly debated issue of the relevant product market definition as well as the defendants' allegations of "cherry-picking" on the part of the Commission, and the defendants' argument that regional price differentials do not reflect market power because of the other factors such as marketing costs involved. However, in addition to attempting to discredit the Commission's evidence with respect to the combined company's market share and ability to raise prices, the defendants focused specifically on two other areas in an attempt to rebut the presumption that the proposed transaction will substantially lessen competition--entry into the market and efficiencies.

**V. Entry Into the Market**

"The existence and significance of barriers to entry are frequently, of course, crucial considerations in a rebuttal analysis [because] [i]n the absence of significant barriers, a company probably cannot maintain supra- competitive pricing for any length of time." *Baker Hughes, Inc.*, 908 F.2d at 987. Thus, the Court must consider whether, in this case, "entry into the market would likely avert anticompetitive effects from [Staples'] acquisition of [Office Depot]." *Id.* at 989. If the defendants' evidence regarding entry showed that the Commission's market-share statistics give an incorrect prediction of the proposed acquisition's probable effect on competition because entry into the market would likely avert any anti-competitive effect by acting as a constraint on Staples-Office Depot's prices, the Court would deny the FTC's motion. The Court, however, cannot make such a finding in this case.

The defendants argued during the hearing and in their briefs that the rapid growth in overall office supply sales has encouraged and will continue to encourage expansion and entry. One reason for this, according to Dr. Hausman's declaration, is that entry is more attractive when an industry is growing, because new entrants can establish themselves without having to take all of their sales away from existing competitors. In addition, the defendants' impressive retailing expert, Professor Maurice Segall, testified at the hearing that there are "no barriers to entry in retailing," and defendants pointed to the fact that all office superstore entrants have entered within the last 11 years.

In addition to this general testimony regarding entry,

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defendants emphasized specific examples of recent or planned entry. For example, defendants offered testimony from John Ledecky, Chairman and CEO of U.S. Office Products, regarding U.S. Office Products' acquisition of Mailboxes, Etc., an acquisition that was coincidentally announced the night before Mr. Ledecky's testimony in this case. Through this acquisition, U.S. Office Products, an organization or co-op of approximately 165 contract stationers located throughout the country, will acquire the 3300-unit Mailboxes, Etc. franchise operation. Defendants also offered testimony regarding Wal-Mart's plans to revamp and expand the office supply section in its stores. According to the deposition testimony of William Long, Vice President for Merchandizing at Wal-Mart, and David Glass, President and CEO of Wal-Mart, Wal-Mart will modify its office supplies department, called "Department 3," beginning in May 1997 and continuing through the summer. Though Mr. Long was not certain of the exact number of SKUs of office supplies Wal-Mart's new Department 3 will offer, he estimated the range to be 2,600 to 3,000 SKUs. [FN17] [redacted by court] Finally, defendants offered testimony regarding the general ability of mass merchandisers, computer superstores, and warehouse clubs to change store configurations and shift shelf space to accommodate new demands or popular products.

There are problems with the defendants' evidence, however, that prevent the Court from finding in this case that entry into the market by new competitors or expansion into the market by existing firms would likely avert the anti-competitive effects from Staples' acquisition of Office Depot. For example, while it is true that all office superstore entrants have entered within the last 11 years, the recent trend for office superstores has actually been toward exiting the market rather than entering. Over the past few years, the number of office superstore chains has dramatically dropped from twenty- three to three. All but Staples, Office Depot, and OfficeMax have either closed or been acquired. The failed office superstore entrants include very large, well-known retail establishments such as Kmart, Montgomery Ward, Ames, and Zayres. A new office superstore would need to open a large number of stores nationally in order to achieve the purchasing and distribution economies of scale enjoyed by the three existing firms. Sunk costs would be extremely high. Economies of scale at the local level, such as in the costs of advertizing and distribution, would also be difficult for a new superstore entrant to achieve since the three existing firms have saturated many important local markets. For example, according to the defendants' own saturation analyses, Staples estimates that there is room for less than two additional superstores in the Washington, D.C. area and Office Depot estimates that there is room for only two more superstores in Tampa, Florida.

The Commission offered Office 1 as a specific example of the difficulty of entering the office superstore arena. Office 1 opened its first two stores in 1991. By the end of 1994, Office 1 had 17 stores, and grew to 35 stores operating in 11 Midwestern states as of October 11, 1996. As of that date, Office 1 was the fourth largest office supply superstore chain in the United States. Unfortunately, also as of that date, Office 1 filed for Chapter 11 bankruptcy protection. Brad Zenner, President of Office 1, testified through declaration, that Office 1 failed because it was severely undercapitalized in comparison with the industry leaders, Staples, Office Depot, and OfficeMax. In addition, Mr. Zenner testified that when the three leaders ultimately expanded into the smaller markets where Office 1 stores were located, they seriously undercut Office 1's retail prices and profit margins. Because Office 1 lacked the capitalization of the three leaders and lacked the economies of scale enjoyed by those competitors, Office 1 could not remain profitable.

For the reasons discussed above, the Court finds it extremely unlikely that a new office superstore will enter the market and thereby avert the anti-competitive effects from Staples' acquisition of Office Depot. The defendants, of course, focused their entry argument on more than just the entry of additional superstores, pointing also to the expansion of existing companies such as U.S. Office Products and Wal-Mart. The Court also finds it unlikely that the expansions by U.S. Office Products and Wal-Mart would avert the anti- competitive effects which would result from the merger.

The problems with the defendants' evidence regarding U.S. Office Products are numerous. In contrast to Staples and Office Depot, U.S. Office Products is a company which is focused on a contract stationers business servicing primarily the medium corporate segment. The Mailboxes stores recently acquired by U.S. Office Products carry only 50-200 SKUs of office supplies in stores of approximately 1,000-4,000 square feet with no more than half of that area devoted to consumable office supplies. In addition to their small size and limited number of SKUs, the Mailboxes stores would not actually be new entrants. U.S. Office Products is acquiring

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existing stores, and, besides Mr. Ledecky's plans to put a U.S. Office Products catalogue in every Mailboxes store, there was no testimony regarding plans to expand the number of SKUs available in the retail stores themselves or to increase the size of the average Mailboxes store. Finally, though Mr. Ledecky testified that if Staples and Office Depot were to raise prices after the merger he would look on that as an opportunity to take business away from the combined entity, he later clarified that statement by explaining that he meant in the contract stationer field.

The defendants' evidence regarding Wal-Mart's expansion of Department 3 has similar weaknesses. While the total number of SKUs expected to be carried by the new Department 3 is impressive, Mr. Glass estimated it to be between 2,600 to 3,000 SKUs, the evidence shows that this is only an increase of approximately 400 SKUs. The Court has already found that Wal-Mart's sales of office supplies are outside the relevant product market in this case primarily because the pricing evidence shows that Wal-Mart does not presently effectively constrain the superstores' prices. The Court cannot conclude that an addition of 400 SKUs and reconfigured shelf space will significantly change Wal-Mart's ability to constrain Staples' and Office Depot's prices. The superstores will continue to offer significantly more SKUs of consumable office supplies. For these reasons, the Court cannot find that Wal-Mart's expansion through Department 3 is likely to avert anti-competitive effects resulting from Staples' acquisition of Office Depot. [FN18] [redacted]

The defendants' final argument with respect to entry was that existing retailers such as Sam's Club, Kmart, and Best Buy have the capability to reallocate their shelf space to include additional SKUs of office supplies. While stores such as these certainly do have the power to reallocate shelf space, there is no evidence that they will in fact do this if a combined Staples-Office Depot were to raise prices by 5% following a merger. In fact, the evidence indicates that it is more likely that they would not. For example, even in the superstores' anti-competitive zones where either Staples or Office Depot does not compete with other superstores, no retailer has successfully expanded its consumable office supplies to the extent that it constrains superstore pricing. Best Buy attempted such an expansion by creating an office supplies department in 1994, offering 2000 SKUs of office supplies, but found the expansion less profitable than hoped for and gave up after two years. For these reasons, the Court also cannot find that the ability of many sellers of office supplies to reconfigure shelf space and add SKUs of office supplies is likely to avert anti-competitive effects from Staples' acquisition of Office Depot. The Court will next consider the defendants' efficiencies defense.

**VI. Efficiencies**

Whether an efficiencies defense showing that the intended merger would create significant efficiencies in the relevant market, thereby offsetting any anti-competitive effects, may be used by a defendant to rebut the government's prima facie case is not entirely clear. The newly revised efficiencies section of the *Merger Guidelines* recognizes that, "mergers have the potential to generate significant efficiencies by permitting a better utilization of existing assets, enabling the combined firm to achieve lower costs in producing a given quality and quantity than either firm could have achieved without the proposed transaction." *See Merger Guidelines* § 4. This coincides with the view of some courts that "whether an acquisition would yield significant efficiencies in the relevant market is an important consideration in predicting whether the acquisition would substantially lessen competition.... [T]herefore, ... an efficiency defense to the government's prima facie case in section 7 challenges is appropriate in certain circumstances." *FTC v. University Health,* 938 F.2d 1206, 1222 (11th Cir.1991) . The Supreme Court, however, in *FTC v. Procter & Gamble Co.,* 386 U.S. 568, 579, 87 S.Ct. 1224, 1230, 18 L.Ed.2d 303 (1967), stated that "[p]ossible economics cannot be used as a defense to illegality in section 7 merger cases." There has been great disagreement regarding the meaning of this precedent and whether an efficiencies defense is permitted. . . . . Neither the Commission or the defendants could point to a case in which this Circuit has spoken on the issue. . . . . Assuming that it is a viable defense, however, the Court cannot find in this case that the defendants' efficiencies evidence rebuts the presumption that the merger may substantially lessen competition or shows that the Commission's evidence gives an inaccurate prediction of the proposed acquisition's probable effect.

The Court agrees with the defendants that where, as here, the merger has not yet been consummated, it is impossible to quantify precisely the efficiencies that it will generate. In addition, the Court recognizes a difference between efficiencies which are merely speculative and those which are based on a prediction backed by sound business judgment. Nor does the

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Court believe that the defendants must prove their efficiencies by "clear and convincing evidence" in order for those efficiencies to be considered by the Court. That would saddle Section 7 defendants with the nearly impossible task of rebutting a possibility with a certainty, a burden which was rejected in *United States v. Baker Hughes, Inc.*, 908 F.2d 981, 992 (D.C.Cir.1990). Instead, like all rebuttal evidence in Section 7 cases, the defendants must simply rebut the presumption that the merger will substantially lessen competition by showing that the Commission's evidence gives an inaccurate prediction of the proposed acquisition's probable effect. *See id.* at 991. Defendants, however, must do this with credible evidence, and the Court with respect to this issue did not find the defendants' evidence to be credible.

Defendants' submitted an "Efficiencies Analysis" which predicated that the combined company would achieve savings of between $4.9 and $6.5 billion over the next five years. In addition, the defendants argued that the merger would also generate dynamic efficiencies. For example, defendants argued that as suppliers become more efficient due to their increased sales volume to the combined Staples-Office Depot, they would be able to lower prices to their other retailers. Moreover, defendants argued that two-thirds of the savings realized by the combined company would be passed along to consumers.

Evaluating credibility, as the Court must do, the Court credits the testimony and Report of the Commission's expert, David Painter, over the testimony and Efficiencies Study of the defendants' efficiencies witness, Shira Goodman, Senior Vice President of Integration at Staples. Mr. Painter's testimony was compelling, and the Court finds, based primarily on Mr. Painter's testimony, that the defendants' cost savings estimates are unreliable. First, the Court notes that the cost savings estimate of $4.947 billion over five years which was submitted to the Court exceeds by almost 500% the figures presented to the two Boards of Directors in September 1996, when the Boards approved the transaction. The cost savings claims submitted to the Court are also substantially greater than those represented in the defendants' Joint Proxy Statement/Prospectus "reflecting the best currently available estimate of management," and filed with the Securities and Exchange Commission on January 23, 1997, or referenced in the "fairness opinions" rendered by the defendants' investment bankers which are contained in the Proxy Statement.

The Court also finds that the defendants' projected "Base Case" savings of $5 billion are in large part unverified, or at least the defendants failed to produce the necessary documentation for verification. One example of this is the estimated cost savings from the Goods and Services category which projects cost savings of $553 million, about 10% of the total cost savings attributed to the merger by the defendants. Ms. Goodman admitted that the entire backup, source, and the calculations of the Goods and Services' cost savings were not included in the Efficiencies Analysis. In addition, Ms. Goodman was unable to explain the methods used to calculate many of the cost savings. Similarly, the projected distribution cost savings, $883 million or 17% of the projected total cost savings, are problematic. Defendants' consultant A.T. Kearney estimated the savings, and Ms. Goodman admitted the Efficiency Analysis did not show that Kearney had deducted the projected Staples stand-alone savings from the new Hagerstown and Los Angeles full line distribution centers.

As with the failure to deduct the Staples stand-alone savings from the new Hagerstown and Los Angeles full line distribution centers from the projected distribution cost savings, the evidence shows that the defendants did not accurately calculate which projected cost savings were merger specific and which were, in fact, not related to the merger. For example, defendants' largest cost savings, over $2 billion or 40% of the total estimate, are projected as a result of their expectation of obtaining better prices from vendors. However, this figure was determined in relation to the cost savings enjoyed by Staples at the end of 1996 without considering the additional cost savings that Staples would have received in the future as a stand-alone company. Since Staples has continuously sought and achieved cost savings on its own, clearly the comparison that should have been made was between the projected future cost savings of Staples as a stand-alone company, not its past rate of savings, and the projected future cost savings of the combined company. Thus, the calculation in the Efficiencies Analysis included product cost savings that Staples and Office Depot would likely have realized without the merger. In fact, Mr. Painter testified that, by his calculation, 43% of the estimated savings are savings that Staples and Office Depot would likely have achieved as stand-alone entities.

There are additional examples of projected savings, such as the projected savings on employee health insurance, which are not merger specific, but the

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Court need not discuss every example here. However, in addition to the non-merger specific projected savings, Mr. Painter also revealed problems with the defendants' methodology in making some of the projections. For example, in calculating the projected cost savings from vendors, Staples estimated cost savings for a selected group of vendors, and then extrapolated these estimated savings to all other vendors. Mr. Painter testified that, although Hewlett Packard is Staples' single largest vendor, it was not one of the vendors used for the savings estimate. In addition, the evidence shows that Staples was not confident that it could improve its buying from Hewlett Packard. Yet, Staples' purchases and sales of Hewlett Packard products were included in the "all other" vendor group, and defendants, thereby, attributed cost savings in the amount of $207 million to Hewlett Packard even though Staples' personnel did not believe that they could, in fact, achieve cost savings from Hewlett Packard.

In addition to the problems that the Court has with the efficiencies estimates themselves, the Court also finds that the defendants' projected pass through rate--the amount of the projected savings that the combined company expects to pass on to customers in the form of lower prices--is unrealistic. The Court has no doubt that a portion of any efficiencies achieved through a merger of the defendants would be passed on to customers. Staples and Office Depot have a proven track record of achieving cost savings through efficiencies, and then passing those savings to customers in the form of lower prices. However, in this case the defendants have projected a pass through rate of two-thirds of the savings while the evidence shows that, historically, Staples has passed through only 15-17%. Based on the aboveevidence, the Court cannot find that the defendants have rebutted the presumption that the merger will substantially lessen competition by showing that, because of the efficiencies which will result from the merger, the Commission's evidence gives an inaccurate prediction of the proposed acquisition's probable effect. Therefore, the only remaining issue for the Court is the balancing of the equities.

**VII. The Equities**

Where, as in this case, the Court finds that the Commission has established a likelihood of success on the merits, a presumption in favor of a preliminary injunction arises. *FTC v. PPG Indus., Inc.*, 798 F.2d 1500, 1507 (D.C.Cir.1986); *FTC v. Alliant Techsystems, Inc.*, 808 F.Supp. 9, 22-23 (D.D.C.1992). Despite this presumption, however, once the Court has determined the FTC's likelihood of success on the merits, it must still turn to and consider the equities. The D.C. Circuit has held that in cases such as the one now before the Court, a judge is obligated "to exercise independent judgment on the propriety of issuance of a temporary restraining order or preliminary injunction." *FTC v. Weyerhaeuser Co.*, 665 F.2d 1072, 1082 (D.C.Cir.1981) (quoting H.R.Rep. No. 624 at 31). "Independent judgment is not exercised when a court responds automatically to the agency's threshold showings. To exercise such judgment, the court must take genuine amount of 'the equities.' " *Id.*

There are two types of equities which the Court must consider in all Section 13(b) cases, private equities and public equities. In this case, the private equities include the interests of the shareholders and employees of Staples and Office Depot. The public equities are the interests of the public, either in having the merger go through or in preventing the merger. An analysis of the equities properly includes the potential benefits, both public and private, that may be lost by a merger blocking preliminary injunction. *Id.* at 1083. In addition, the Court notes that in balancing the equities, it is important to keep in mind that while private equities are important, "[w]hen the Commission demonstrates a likelihood of ultimate success, a counter showing of private equities alone would not suffice to justify denial of a preliminary injunction barring the merger." *Id.* at 1083. After examining the evidence in this case, the Court finds that in light of the public equities advanced by the plaintiff, the equities, both public and private, set forth by the defendants are insufficient to overcome the presumption in favor of granting a preliminary injunction.

The strong public interest in effective enforcement of the antitrust laws weighs heavily in favor of an injunction in this case, as does the need to preserve meaningful relief following a full administrative trial on the merits. "Unscrambling the eggs" after the fact is not a realistic option in this case. Both the plaintiff as well as the defendants introduced evidence regarding the combined company's post-merger plans, including the consolidation of warehouse and supply facilities in order to integrate the two distribution systems, the closing of 40 to 70 Office Depot and Staples stores, changing the name of the Office Depot stores, negotiating new contracts with manufacturers and suppliers, and, lastly, the consolidation of management which is likely to lead to the loss of employment for many of Office Depot's

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key personnel. As a result, the Court finds that it is extremely unlikely, if the Court denied the plaintiff's motion and the merger were to go through, that the merger could be effectively undone and the companies divided if the agency later found that the merger violated the antitrust laws. It would not simply be a matter of putting the old Office Depot signs back on the stores. Office Depot would have lost its name, many of its stores, its distribution centers, and key personnel. It would also be behind in future plans to open new stores and expand on its own.

More importantly, in addition to the practical difficulties in undoing the merger, consumers would be at risk of serious anti-competitive harm in the interim. Without an injunction, consumers in the 42 geographic markets where superstore competition would be eliminated or significantly reduced face the prospect of higher prices than they would have absent the merger. These higher charges could never be recouped even if the administrative proceeding resulted in a finding that the merger violated the antitrust laws. Failure to grant a preliminary injunction also would deny consumers the benefit of any new competition that would have occurred, absent the merger, between Staples and Office Depot as those stores continued to enter and compete in each other's markets. Both parties had aggressive expansion plans before the merger, many of which have been put on hold pending the outcome of this case.

The public equities raised by the defendants simply do not outweigh those offered by the FTC. In addition, given some of the Court's earlier findings, several of the public equities submitted by the defendants are without factual support. For example, the defendants argued that the public equities favor the merger because prices will fall for all products, in all markets, following the merger. Since the Court has already found that the Commission has shown a likelihood of success on the merits with respect to proving that the proposed merger will have anti-competitive effects, the Court cannot give any weight to this particular public equity advanced by the defendants. In addition, as the Court has previously explained, the fact that prices might be lower than current prices after the merger does not mean that the merger will not have an anti-competitive effect. Consumers would still be hurt if prices after the merger did not fall as far as they would have absent the merger. Similarly, the Court has already determined the defendants' efficiencies evidence to be unconvincing. On the public equities issue as it relates to efficiencies, Dr. Hausman testified that the merger will result in huge efficiencies to the U.S. economy, and that the cost savings realized as a result of those efficiencies will result in the creation of additional jobs. While the Court believes that there would be some efficiencies realized by the merger, though not at the level argued by the defendants, the Court cannot find that those efficiencies would result in the creation of so many additional jobs that the public equity would outweigh those argued by the plaintiff.

Finally, according to the defendants, the public equities also include the benefits consumers will derive from even greater product selection and the benefits the U.S. economy will derive from increased international trade as the combined company through its increased efficiencies and improved distribution system will be poised for a dramatic expansion into foreign markets. Defendants, however, have provided no specific evidence regarding the probable increase in product selection or the likelihood that a combined Staples-Office Depot will expand overseas. In addition, the Court is not convinced that this is an appropriate equity which the Court may consider in this case. The Court, therefore, cannot find that the public equities regarding increased product selection for consumers and expansion into foreign markets overcome the public equities set forth by the FTC.

Turning finally to the private equities, the defendants have argued that the principal private equity at stake in this case is the loss to Office Depot shareholders who will likely lose a substantial portion of their investments if the merger is enjoined. The Court certainly agrees that Office Depot shareholders may be harmed, at least in the short term, if the Court granted the plaintiff's motion and enjoined the merger. This private equity alone, however, does not suffice to justify denial of a preliminary injunction.

The defendants have also argued that Office Depot itself has suffered a decline since the incipiency of this action. It is clear that Office Depot has lost key personnel, especially in its real estate department. This has hurt this year's projected store openings. The defendants argue, therefore, that Office Depot, as a separate company, will have difficulty competing if the merger is enjoined. While the Court recognizes that Office Depot has indeed been hurt or weakened as an independent stand-alone company, the damage is not irreparable. The evidence shows that Office Depot, which of the three superstores has been the low-priced aggressive maverick of the group, would

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continue generating sales volume and turning a substantial profit. In reaching this conclusion, the Court credits one of the defendants' own expert witnesses, Steven Mandel, who testified that, in his opinion, Office Depot would be fine even if the merger did not go through. He described Office Depot as a very strong and well-run company, and said that it would certainly have a little bit of a hole to dig out of if the merger were enjoined. However, his ultimate conclusion was that the company would recover. Certainly Office Depot is in a better position to recover and move forward now if the Court grants the plaintiff's motion than it would be if the merger was allowed to go forward and then later the two companies were ordered to separate.

### *CONCLUSION*

Thomas Stemberg pioneered the office supply superstore concept in 1985. He created a deep discount chain selling a broad array of office supplies primarily to small businesses which theretofore were undeniably "paying through the nose" for office supplies. Staples was to be a high volume chain operating at low gross margins, with higher volume leading to still lower costs for consumers. Staples' pricing as well as the pricing of other office supply superstores which soon followed Staples' lead, revolutionized the office products industry, impacting all channels of office products retailing. By selling office products at 30 to 60% off list price, Staples and the other superstores worked as a catalyst that forced everyone else in the industry to focus on cutting their prices. In a relatively short period of time, the office supply superstores caused a general decrease in the price of office products across the board. That decrease continued as the superstores have increased their buying power, forcing manufacturers and suppliers to implement efficiencies in their own businesses in order to compete in the sale of their products.

In light of the undeniable benefits that Staples and Office Depot have brought to consumers, it is with regret that the Court reaches the decision that it must in this case. This decision will most likely kill the merger. The Court feels, to some extent, that the defendants are being punished for their own successes and for the benefits that they have brought to consumers. In effect, they have been hoisted with their own petards. *See* William Shakespeare, *Hamlet,* act 3, sc 4. In addition, the Court is concerned with the broader ramifications of this case. The superstore or "category killer" like office supply superstores are a fairly recent phenomenon and certainly not restricted to office supplies. There are a host of superstores or "category killers" in the United States today, covering such areas as pet supplies, home and garden products, bed, bath, and kitchen products, toys, music, books, and electronics. Indeed, such "category killer" stores may be the way of retailing for the future. It remains to be seen if this case is *sui generis* or is the beginning of a new wave of FTC activism. For these reasons, the Court must emphasize that the ruling in this case is based strictly on the facts of this particular case, and should not be construed as this Court's recognition of general superstore relevant product markets.

Despite the Court's sympathy toward the plight of the defendants in this case, the Court finds that the Commission has shown a "reasonable probability" that the proposed merger between Staples and Office Depot may substantially impair competition and likewise has "raised questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instances and ultimately by the Court of Appeals." Therefore, the Court finds that the Commission has shown a likelihood that it will succeed in proving, after a full administrative trial on the merits, that the effect of the proposed merger between Staples and Office Depot "may be substantially to lessen competition" in violation of Section 7 of the Clayton Act. In addition, the Court has weighed the equities and finds that they tip in favor of granting a preliminary injunction. A preliminary injunction is, therefore, found to be in the public interest. The FTC's motion for a preliminary injunction shall be granted.

The Court once again commends counsel on both sides for their excellent performances in this matter and the tremendous efforts made on both sides. Though this was an extremely complex matter, the issues were clearly presented to the Court by counsel possessing superior advocacy skills. Counsel also exhibited a high degree of professionalism in their ability to resolve peripheral matters so that the Court could focus on the important issues presented by this action.

An appropriate order accompanies this Memorandum Opinion.

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United States Court of Appeals,
District of Columbia Circuit.

FEDERAL TRADE COMMISSION, Appellant,
v.
H.J. HEINZ CO. and Milnot Holding Corporation, Appellees.

**No. 00-5362.**

Argued Feb. 12, 2001.
Decided April 27, 2001.

Before: HENDERSON, RANDOLPH and GARLAND, Circuit Judges.

Opinion for the court filed by Circuit Judge HENDERSON.

KAREN LeCRAFT HENDERSON, Circuit Judge.

On February 28, 2000 H.J. Heinz Company (Heinz) and Milnot Holding Corporation (Beech-Nut) entered into a merger agreement. The Federal Trade Commission (Commission or FTC) sought a preliminary injunction pursuant to section 13(b) of the Federal Trade Commission Act (FTCA), 15 U.S.C. § 53(b), to enjoin the consummation of the merger. The injunction was sought in aid of an FTC administrative proceeding which was subsequently instituted by complaint to challenge the merger as violative of, *inter alia,* section 7 of the Clayton Act, 15 U.S.C. § 18. The district court denied the preliminary injunction and the FTC appealed to this court. For the reasons set forth below, we reverse the district court and remand for entry of a preliminary injunction against Heinz and Beech-Nut.

**I. Background**

Four million infants in the United States consume 80 million cases of jarred baby food annually, representing a domestic market of $865 million to $1 billion. [FN1] [omitted] *FTC v. H.J. Heinz, Co.,* 116 F.Supp.2d 190, 192 (D.D.C.2000) . The baby food market is dominated by three firms, Gerber Products Company (Gerber), Heinz and Beech-Nut. Gerber, the industry leader, enjoys a 65 per cent market share while Heinz and Beech-Nut come in second and third, with a 17.4 per cent and a 15.4 per cent share respectively. *Id.* The district court found that Gerber enjoys unparalleled brand recognition with a brand loyalty greater than any other product sold in the United States. *Id.* at 193. Gerber's products are found in over 90 per cent of all American supermarkets. [FN2]

FN2. Product volume in retail stores throughout the country is measured by the product's All Commodity Volume (ACV). Gerber's near 100 per cent ACV is impressive because virtually all supermarkets stock at most two brands of baby food. In at least one area of the country as many as 80 per cent of supermarket retailers stock only Gerber.

By contrast, Heinz is sold in approximately 40 per cent of all supermarkets. Its sales are nationwide but concentrated in northern New England, the Southeast and Deep South and the Midwest. *Id.* at 194. Despite its second-place domestic market share, Heinz is the largest producer of baby food in the world with $1 billion in sales worldwide. Its domestic baby food products with annual net sales of $103 million are manufactured at its Pittsburgh, Pennsylvania plant, which was updated in 1991 at a cost of $120 million. *Id.* at 192-93. The plant operates at 40 per cent of its production capacity and produces 12 million cases of baby food annually. Its baby food line includes about 130 SKUs (stock keeping units), that is, product varieties (*e.g.,* strained carrots, apple sauce, etc.). Heinz lacks Gerber's brand recognition; it markets itself as a "value brand" with a shelf price several cents below Gerber's. *Id.* at 193.

Beech-Nut has a market share (15.4%) comparable to that of Heinz (17.4%), with $138.7 million in annual sales of baby food, of which 72 per cent is jarred baby food. Its jarred baby food line consists of 128 SKUs. Beech-Nut manufactures all of its baby food in Canajoharie, New York at a manufacturing plant that was built in 1907 and began manufacturing baby food in 1931. Beech- Nut maintains price parity with Gerber, selling at about one penny less. It markets its product as a premium brand. *Id.* Consumers generally view its product as comparable in quality to Gerber's. *Id.* Beech-Nut is carried in approximately 45 per cent of all grocery stores. Although its sales are nationwide, they are concentrated in New York, New Jersey, California and Florida. [FN3] *Id.* at 194.

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FN3. Although Heinz and Beech-Nut introduced evidence showing that in areas that account for 80% of Beech-Nut sales, Heinz has a market share of about 2% and in areas that account for about 72% of Heinz sales, Beech- Nut's share is about 4%, the FTC introduced evidence that Heinz and Beech- Nut are locked in an intense battle at the wholesale level to gain (and maintain) position as the second brand on retail shelves.

At the wholesale level Heinz and Beech-Nut both make lump-sum payments called "fixed trade spending" (also known as "slotting fees" or "pay-to-stay" arrangements) to grocery stores to obtain shelf placement. *Id.* at 197. Gerber, with its strong name recognition and brand loyalty, does not make such pay-to-stay payments. The other type of wholesale trade spending is "variable trade spending," which typically consists of manufacturers' discounts and allowances to supermarkets to create retail price differentials that entice the consumer to purchase their product instead of a competitor's. *Id.*

Under the terms of their merger agreement, Heinz would acquire 100 per cent of Beech-Nut's voting securities for $185 million. Accordingly, they filed a Premerger Notification and Report Form with the FTC and the United States Department of Justice pursuant to the Hart-Scott-Rodino Antitrust Improvement Act of 1976, 15 U.S.C. § 18a. [FN4] [omitted] On July 7, 2000 the FTC authorized this action for a preliminary injunction under section 13(b) of the FTCA and, on July 14, 2000, it filed a complaint and motion for preliminary injunction. The district court conducted a five-day hearing in late August and early September and heard final arguments on September 21, 2000. The record before the district court consisted of 1,267 exhibits, including 150 demonstrative exhibits, 32 depositions and 41 affidavits. In addition, eleven witnesses testified. On October 18, 2000 the district court denied preliminary injunctive relief. The court concluded that it was "more probable than not that consummation of the Heinz/Beech-Nut merger will actually increase competition in jarred baby food in the United States." *H.J. Heinz,* 116 F.Supp.2d at 200. The FTC appealed and sought injunctive relief pending appeal, which this court granted on November 8, 2000. On November 22, 2000 the FTC filed an administrative complaint against Heinz and Beech-Nut, charging that the proposed merger violates section 5 of the FTCA and, if consummated, would violate section 7 of the Clayton Act. *In the Matter of H. J. Heinz,* Docket No. 9295 (filed Nov. 22, 2000).

## II. Analysis

### A. *Standard of Review*

We review a district court order denying preliminary injunctive relief for abuse of discretion, *National Wildlife Fed'n v. Burford,* 835 F.2d 305, 319 (D.C.Cir.1987) , and will set aside the court's factual findings only if they are "clearly erroneous." Fed.R.Civ.P. 52(a); *United States v. Marine Bancorporation, Inc.,* 418 U.S. 602, 615 n. 13, 94 S.Ct. 2856, 41 L.Ed.2d 978 (1974). If our review of the district court order "reveals that it rests on an erroneous premise as to the pertinent law, however, we must examine the decision in light of the legal principles we believe proper and sound." *Ambach v. Bell,* 686 F.2d 974, 979 (D.C.Cir.1982). We apply *de novo* review to the district court's conclusions of law. *See FTC v. National Tea Co.,* 603 F.2d 694, 696-98 (8th Cir.1979) (reviewing *de novo* proper standard of proof under section 13(b) of FTCA); *cf. FTC v. Warner Communications Inc.,* 742 F.2d 1156, 1160 (9th Cir.1984) (per curiam) (finding as matter of law district court applied incorrect standard for section 7 violation). In deciding whether to grant preliminary injunctive relief under section 13(b), the court evaluates whether it is in the public interest to enjoin the proposed merger. *See* 15 U.S.C. § 53(b).

### B. *Section 7 of the Clayton Act*

Section 7 of the Clayton Act prohibits acquisitions, including mergers, "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." 15 U.S.C. § 18; *see United States v. Philadelphia Nat'l Bank,* 374 U.S. 321, 355, 83 S.Ct. 1715, 10 L.Ed.2d 915 (1963) ("The statutory test is whether the effect of the merger 'may be substantially to lessen competition' 'in any line of commerce in any section of the country.' "). The "Congress used the words '*may* be substantially to lessen competition' (emphasis supplied), to indicate that its concern was with probabilities, not certainties." *Brown Shoe Co. v. United States,* 370 U.S. 294, 323, 82 S.Ct. 1502, 8 L.Ed.2d 510 (1962) (emphasis original); *see* S.Rep. No. 1775, at 6 (1950), U.S.Code Cong. & Admin. News at 4293,

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4298 ("The use of these words ["may be"] means that the bill, if enacted, would not apply to the mere possibility but only to the reasonable probability of the pr[o]scribed effect...."). "Merger enforcement, like other areas of antitrust, is directed at market power. It shares with the law of monopolization a degree of schizophrenia: an aversion to potent power that heightens risk of abuse; and tolerance of that degree of power required to attain economic benefits." Lawrence A. Sullivan & Warren S. Grimes, *The Law of Antitrust* § 9.1, at 511 (2000). The Congress has empowered the FTC, *inter alia,* to weed out those mergers whose effect "may be substantially to lessen competition" from those that enhance competition. *See* H.R.Rep. No. 1142, at 18-19 (1914). In section 13(b) of the FTCA, the Congress provided a mechanism whereby the FTC may seek preliminary injunctive relief preventing the merging parties from consummating the merger until the Commission has had an opportunity to investigate and, if necessary, adjudicate the matter.

C. *Section 13(b) of the Federal Trade Commission Act*

"Whenever the Commission has reason to believe that a corporation is violating, or is about to violate, Section 7 of the Clayton Act, the FTC may seek a preliminary injunction to prevent a merger pending the Commission's administrative adjudication of the merger's legality." *FTC v. Staples, Inc.*, 970 F.Supp. 1066, 1070 (D.D.C.1997); *see* 15 U.S.C. § 53(b). Section 13(b) provides for the grant of a preliminary injunction where such action would be in the public interest--as determined by a weighing of the equities and a consideration of the Commission's likelihood of success on the merits. 15 U.S.C. § 53(b). [FN5] [omitted] The Congress intended this standard to depart from what it regarded as the then-traditional equity standard, which it characterized as requiring the plaintiff to show: (1) irreparable damage, (2) probability of success on the merits and (3) a balance of equities favoring the plaintiff. H.R.Rep. No. 93-624, at 31 (1971). The Congress determined that the traditional standard was not "appropriate for the implementation of a Federal statute by an independent regulatory agency where the standards of the public interest measure the propriety and the need for injunctive relief." *Id.* "The courts had evolved an approach to cases in which government agencies, acting to enforce a federal statute, sought interim relief. The agency, in such cases, was not held to the high thresholds applicable where private parties seek interim restraining orders." *FTC v. Weyerhaeuser Co.*, 665 F.2d 1072, 1082 (D.C.Cir.1981); *see FTC v. Exxon Corp.*, 636 F.2d 1336, 1343 (D.C.Cir.1980) ("In enacting [ Section 13(b) ], Congress further demonstrated its concern that injunctive relief be broadly available to the FTC by incorporating a unique 'public interest' standard in 15 U.S.C. § 53(b), rather than the more stringent, traditional 'equity' standard for injunctive relief."). The FTC is not required to *establish* that the proposed merger would in fact violate section 7 of the Clayton Act. *Staples,* 970 F.Supp. at 1071; *see FTC v. Food Town Stores, Inc.*, 539 F.2d 1339, 1342 (4th Cir.1976) ("The district court is not authorized to determine whether the antitrust laws have been or are about to be violated. That adjudicatory function is vested in the FTC in the first instance."). We now consider the FTC's likelihood of success and weigh the equities. *Accord FTC v. Freeman Hosp.*, 69 F.3d 260, 267 (8th Cir.1995); *FTC v. University Health, Inc.*, 938 F.2d 1206, 1217 (11th Cir.1991); *Warner Communications,* 742 F.2d at 1160.

1. Likelihood of Success

To determine likelihood of success on the merits we measure the probability that, after an administrative hearing on the merits, the Commission will succeed in proving that the effect of the Heinz/Beech-Nut merger "may be substantially to lessen competition, or to tend to create a monopoly" in violation of section 7 of the Clayton Act. 15 U.S.C. § 18. This court and others have suggested that the standard for likelihood of success on the merits is met if the FTC "has raised questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instance and ultimately by the Court of Appeals." *FTC v. Beatrice Foods Co.*, 587 F.2d 1225, 1229 (D.C.Cir.1978) (Appendix to Statement of MacKinnon & Robb, JJ.) [FN6] [omitted]; *Staples,* 970 F.Supp. at 1071; *Warner Communications,* 742 F.2d at 1162 (quoting *National Tea,* 603 F.2d at 698); *see University Health,* 938 F.2d at 1218. This specific standard was articulated by the court below, *see H.J. Heinz,* 116 F.Supp.2d at 194, and it is a standard to which the appellees have not objected.

In *United States v. Baker Hughes Inc.*, 908 F.2d 981, 982-83 (D.C.Cir.1990) , we explained the analytical approach by which the government establishes a section 7 violation. First the government must show that the merger would produce "a firm controlling an undue percentage share of the relevant market, and [would] result[ ] in

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a significant increase in the concentration of firms in that market." *Philadelphia Nat'l Bank,* 374 U.S. at 363, 83 S.Ct. 1715. Such a showing establishes a "presumption" that the merger will substantially lessen competition. *See Baker Hughes,* 908 F.2d at 982. To rebut the presumption, the defendants must produce evidence that "show [s] that the market-share statistics [give] an inaccurate account of the [merger's] probable effects on competition" in the relevant market. *United States v. Citizens & S. Nat'l Bank,* 422 U.S. 86, 120, 95 S.Ct. 2099, 45 L.Ed.2d 41 (1975). [FN7] "If the defendant successfully rebuts the presumption [of illegality], the burden of producing additional evidence of anticompetitive effect shifts to the government, and merges with the ultimate burden of persuasion, which remains with the government at all times." *Baker Hughes Inc.,* 908 F.2d at 983; *see also Kaiser Aluminum,* 652 F.2d at 1340 & n. 12. Although *Baker Hughes* was decided at the merits stage as opposed to the preliminary injunctive relief stage, we can nonetheless use its analytical approach in evaluating the Commission's showing of likelihood of success. Accordingly, we look at the FTC's prima facie case and the defendants' rebuttal evidence.

FN7. To rebut the defendants may rely on "[n]onstatistical evidence which casts doubt on the persuasive quality of the statistics to predict future anticompetitive consequences" such as "ease of entry into the market, the trend of the market either toward or away from concentration, and the continuation of active price competition." *Kaiser Aluminum & Chem. Corp. v. FTC,* 652 F.2d 1324, 1341 (7th Cir.1981) . In addition, the defendants may demonstrate unique economic circumstances that undermine the predictive value of the government's statistics. *See United States v. General Dynamics Corp.,* 415 U.S. 486, 506-10, 94 S.Ct. 1186, 39 L.Ed.2d 530 (1974) (fundamental changes in structure of coal market made market concentration statistics inaccurate predictors of anticompetitive effect); *see also University Health,* 938 F.2d at 1218.

a. Prima Facie Case

[6] Merger law "rests upon the theory that, where rivals are few, firms will be able to coordinate their behavior, either by overt collusion or implicit understanding, in order to restrict output and achieve profits above competitive levels." *FTC v. PPG Indus.,* 798 F.2d 1500, 1503 (D.C.Cir.1986). [FN8] [omitted] Increases in concentration above certain levels are thought to "raise[ ] a likelihood of 'interdependent anticompetitive conduct.' " *Id.* (quoting *General Dynamics,* 415 U.S. at 497, 94 S.Ct. 1186); *see FTC v. Elders Grain,* 868 F.2d 901, 905 (7th Cir.1989) . Market concentration, or the lack thereof, is often measured by the Herfindahl-Hirschmann Index (HHI). *See Staples,* 970 F.Supp. at 1081 n. 12. [FN9]

FN9. "The FTC and the Department of Justice, as well as most economists, consider the measure superior to such cruder measures as the four-or eight-firm concentration ratios which merely sum up the market shares of the largest four or eight firms." *PPG,* 798 F.2d at 1503. The Department of Justice and the FTC rely on the HHI in evaluating proposed horizontal mergers. *See* United States Dep't of Justice & Federal Trade Comm'n, *Horizontal Merger Guidelines* § § 1.5, 1.51 (1992), as revised (1997). The HHI is calculated by totaling the squares of the market shares of every firm in the relevant market. For example, a market with ten firms having market shares of 20%, 17%, 13%, 12%, 10%, 10%, 8%, 5%, 3% and 2% has an HHI of 1304 (202 + 172 + 132 + 122 + 102 + 102 + 82 + 52 +32 +22). If the firms with 13% and 5% market shares were to merge, the HHI would increase by 130 points, expressed by the formula 2ab, which is derived from (a+b)2 or a2 + 2ab + b2. Under the Merger Guidelines a market with a postmerger HHI above 1800 is considered "highly concentrated" and mergers that increase the HHI in such a market by over 50 points "potentially raise significant competitive concerns." *Id.* at § 1.51. Mergers "producing an increase in the HHI of more than 100 points [in such markets] are [presumed] likely to create or enhance market power or facilitate its exercise." *Id* . Although the Merger Guidelines are not binding on the court, they provide "a useful illustration of the application of the HHI." *PPG,* 798 F.2d at 1503 n. 4.

Sufficiently large HHI figures establish the FTC's

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prima facie case that a merger is anti-competitive. *See Baker Hughes,* 908 F.2d at 982-83 & n. 3; *PPG,* 798 F.2d at 1503. The district court found that the pre-merger HHI "score for the baby food industry is 4775"--indicative of a highly concentrated industry. [FN10] *H.J. Heinz,* 116 F.Supp.2d at 196; *see PPG,* 798 F.2d at 1503; Horizontal Merger Guidelines, *supra,* § 1.51. The merger of Heinz and Beech-Nut will increase the HHI by 510 points. This creates, by a wide margin, a presumption that the merger will lessen competition in the domestic jarred baby food market. *See* Horizontal Merger Guidelines, *supra,* § 1.51 (stating that HHI increase of more than 100 points, where post-merger HHI exceeds 1800, is "presumed ... likely to create or enhance market power or facilitate its exercise"); *see also Baker Hughes,* 908 F.2d at 982-83 & n. 3; *PPG,* 798 F.2d at 1503. [FN11] Here, the FTC's market concentration statistics [FN12] [omitted] are bolstered by the indisputable fact that the merger will eliminate competition between the two merging parties at the wholesale level, where they are currently the only competitors for what the district court described as the " second position on the supermarket shelves." *H.J. Heinz,* 116 F.Supp.2d at 196. Heinz's own documents recognize the wholesale competition and anticipate that the merger will end it. JA 2680; *see also* JA 2185. Indeed, those documents disclose that Heinz considered three options to end the vigorous wholesale competition with Beech-Nut: two involved innovative measures while the third entailed the acquisition of Beech-Nut. JA 2184. Heinz chose the third, and least pro-competitive, of the options.

FN10. To determine the HHI score the district court first had to define the relevant market. The court defined the product market as jarred baby food and the geographic market as the United States. *H.J. Heinz,* 116 F.Supp.2d at 195. The parties do not challenge the court's definition.

FN11. The FTC argues that this finding alone--that it is certain to establish a prima facie case--entitles it to preliminary injunctive relief under *PPG.* We disagree with the Commission's reading of *PPG.* In *PPG,* the Commission appealed the district court's denial of its request for a preliminary injunction to prevent PPG Industries, the world's largest producer of glass aircraft transparencies, from acquiring Swedlow, Inc., the world's largest manufacturer of acrylic aircraft transparencies. 798 F.2d at 1502. After defining the relevant market and determining market share, the district court found that the merger would significantly increase the concentration in an already highly concentrated market. It also "found high market-entry barriers that would prolong high market concentration." *Id.* at 1503. On appeal, this court stated: "There is no doubt that the pre-and post-acquisition HHI's and market shares found in this case entitle the Commission to some preliminary relief." *Id.* This statement came, however, in the context of a case in which the appellants offered no rebuttal (other than the observation of rapid and continuing technological changes in the industry) to the presumption generated by the market concentration data on which the FTC based its prima facie showing. *Id.* at 1506. The court then noted the rule established in *Weyerhaeuser* that the FTC is entitled to a "presumption in favor of a preliminary injunction when [it] establishes a strong likelihood of success on the merits." *Id.* at 1507.

Finally, the anticompetitive effect of the merger is further enhanced by high barriers to market entry. [FN13] The district court found that there had been no significant entries in the baby food market in decades and that new entry was "difficult and improbable." *H.J. Heinz,* 116 F.Supp.2d at 196. This finding largely eliminates the possibility that the reduced competition caused by the merger will be ameliorated by new competition from outsiders and further strengthens the FTC's case. *See University Health,* 938 F.2d at 1219 & n. 26.

FN13. Barriers to entry are important in evaluating whether market concentration statistics accurately reflect the pre- and likely postmerger competitive picture. *Cf. Baker Hughes,* 908 F.2d at 987. If entry barriers are low, the threat of outside entry can significantly alter the anticompetitive effects of the merger by deterring the remaining entities from colluding or exercising market power. *See United States v. Falstaff Brewing Corp.,* 410 U.S. 526, 532-33, 93 S.Ct. 1096, 35 L.Ed.2d 475 (1973); *Baker Hughes,* 908 F.2d at 987 ("In

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the absence of significant barriers, a company probably cannot maintain supracompetitive pricing for any length of time."); Horizontal Merger Guidelines, *supra,* § 3.0 ("A merger is not likely to create or enhance market power or to facilitate its exercise, if entry into the market is so easy that market participants, after the merger, either collectively or unilaterally could not profitably maintain a price increase above premerger levels."). Low barriers to entry enable a potential competitor to deter anticompetitive behavior by firms within the market simply by its ability to enter the market. *FTC v. Procter & Gamble Co.,* 386 U.S. 568, 581, 87 S.Ct. 1224, 18 L.Ed.2d 303 (1967) ("It is clear that the existence of Procter at the edge of the industry exerted considerable influence on the market."). Existing firms know that if they collude or exercise market power to charge supracompetitive prices, entry by firms currently not competing in the market becomes likely, thereby increasing the pressure on them to act competitively. *See Baker Hughes,* 908 F.2d at 988; *Byars v. Bluff City News Co.,* 609 F.2d 843, 851 n. 19 (6th Cir.1979).

As far as we can determine, no court has ever approved a merger to duopoly under similar circumstances.

b. Rebuttal Arguments

In response to the FTC's prima facie showing, the appellees make three rebuttal arguments, which the district court accepted in reaching its conclusion that the merger was not likely to lessen competition substantially. For the reasons discussed below, these arguments fail and thus were not a proper basis for denying the FTC injunctive relief.

1. Extent of Pre-Merger Competition

The appellees first contend, and the district court agreed, that Heinz and Beech-Nut do not really compete against each other at the retail level. Consumers do not regard the products of the two companies as substitutes, the appellees claim, and generally only one of the two brands is available on any given store's shelves. Hence, they argue, there is little competitive loss from the merger.

This argument has a number of flaws which render clearly erroneous the court's finding that Heinz and Beech-Nut have not engaged in significant pre-merger competition. First, in accepting the appellees' argument that Heinz and Beech- Nut do not compete, the district court failed to address the record evidence that the two do in fact price against each other, *see, e.g.,* 8/31/2000 Tr. 247- 48, and that, where both are present in the same areas, [FN14] they depress each other's prices as well as those of Gerber even though they are virtually never all found in the same store. *See, e.g.,* 8/30/2000 Tr. 147-48, 172; PX 531 at ¶ 8; PX 481 at ¶ 12; PX 479 at ¶ ¶ 6-7; PX 478 at ¶ 6; DX 14 at RP- 110. This evidence undermines the district court's factual finding.

FN14. There are at least ten metropolitan areas in which Heinz and Beech-Nut both have more than a 10 per cent market share and their combined share exceeds 35 per cent. PX 781 at Ex. 1B.

Second, the district court's finding is inconsistent with its conclusion that there is a single, national market for jarred baby food in the United States. The Supreme Court has explained that "[t]he outer boundaries of a product market are determined by the reasonable interchangeability of use [by consumers] or the cross-elasticity of demand between the product itself and substitutes for it." *Brown Shoe,* 370 U.S. at 325, 82 S.Ct. 1502; *see also United States v. E.I. du Pont de Nemours & Co.,* 351 U.S. 377, 395, 76 S.Ct. 994, 100 L.Ed. 1264 (1956). [FN15] The definition of product market thus "focuses solely on demand substitution factors," *i.e.,* that consumers regard the products as substitutes. Horizontal Merger Guidelines, *supra,* § 1.0; Sullivan & Grimes, *supra,* § 11.2b1, at 579. By defining the relevant product market generically as jarred baby food, the district court concluded that in areas where Heinz's and Beech-Nut's products are both sold, consumers will switch between them in response to a "small but significant and nontransitory increase in price (SSNIP)." Horizontal Merger Guidelines, *supra,* § 1.11; *H.J. Heinz,* 116 F.Supp.2d at 195. The district court never explained this inherent inconsistency in its logic nor could counsel for the appellees explain it at oral argument.

FN15. Interchangeability of use and cross-elasticity of demand look to the availability

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of products that are similar in nature or use and the degree to which buyers are willing to substitute those similar products for one another. *See E.I. du Pont de Nemours,* 351 U.S. at 393, 76 S.Ct. 994.

Third, and perhaps most important, the court's conclusion concerning pre- merger competition does not take into account the indisputable fact that the merger will eliminate competition at the wholesale level between the only two competitors for the "second shelf" position. Competition between Heinz and Beech-Nut to gain accounts at the wholesale level is fierce with each contest concluding in a winner-take-all result. JA 2680. The district court regarded this loss of competition as irrelevant because the FTC did not establish to its satisfaction that wholesale competition ultimately benefitted consumers through lower retail prices. The district court concluded that fixed trade spending did not affect consumer prices and that "the FTC's assertion that the proposed merger will affect variable trade spending levels and consumer prices is ... at best, inconclusive." [FN16] *H.J. Heinz,* 116 F.Supp.2d at 197. Although the court noted the FTC's examples of consumer benefit through couponing initiatives, the court held that it was "impossible to conclude with any certainty that the consumer benefit from such couponing initiatives would be lost in the merger." *Id.*

FN16. Fixed trade spending consists of "slotting fees," "pay-to-stay" arrangements, new store allowances and other payments to retailers in exchange for shelf space and desired product display. *H.J. Heinz,* 116 F.Supp.2d at 197. Variable trade spending includes payments to retailers tied to sales volume and intended to insure a specific sales volume and lower shelf price. *Id.*

In rejecting the FTC's argument regarding the loss of wholesale competition, the court committed two legal errors. First, as the appellees conceded at oral argument, no court has ever held that a reduction in competition for wholesale purchasers is not relevant unless the plaintiff can prove impact at the consumer level. Oral Arg. Tr. at 22, 28; *see Hospital Corp. of Am. v. FTC,* 807 F.2d 1381, 1389 (7th Cir.1986) ("Section 7 does not require proof that a merger or other acquisition has caused higher prices in the affected market. All that is necessary is that the merger create an appreciable danger of [collusive practices] in the future. A predictive judgment, necessarily probabilistic and judgmental rather than demonstrable, is called for.") (citation omitted). Second, it is, in any event, not the FTC's burden to prove such an impact with "certainty." To the contrary, the antitrust laws assume that a retailer faced with an increase in the cost of one of its inventory items "will try so far as competition allows to pass that cost on to its customers in the form of a higher price for its product." *In re Brand Name Prescription Drugs Antitrust Litig.,* 123 F.3d 599, 605 (7th Cir.1997), *reh'g and suggestion for reh'g en banc denied* (Oct. 8, 1997). Section 7 is, after all, concerned with *probabilities,* not certainties. *United States v. El Paso Natural Gas Co.,* 376 U.S. 651, 658, 84 S.Ct. 1044, 12 L.Ed.2d 12 (1964); *Brown Shoe,* 370 U.S. at 323, 82 S.Ct. 1502; *Baker Hughes,* 908 F.2d at 984. [FN17] [omitted]

2. Post-Merger Efficiencies

The appellees' second attempt to rebut the FTC's prima facie showing is their contention that the anticompetitive effects of the merger will be offset by efficiencies resulting from the union of the two companies, efficiencies which they assert will be used to compete more effectively against Gerber. It is true that a merger's primary benefit to the economy is its potential to generate efficiencies. *See generally* 4A Phillip E. Areeda, Herbert Hovenkamp & John L. Solow, *Antitrust Law* ¶ 970 at 22-25 (1998). As the Merger Guidelines now recognize, efficiencies "can enhance the merged firm's ability and incentive to compete, which may result in lower prices, improved quality, or new products." Horizontal Merger Guidelines, *supra,* § 4.

Although the Supreme Court has not sanctioned the use of the efficiencies defense in a section 7 case, *see Procter & Gamble Co.,* 386 U.S. at 580, 87 S.Ct. 1224, [FN18] [omitted] the trend among lower courts is to recognize the defense. *See, e.g., FTC v. Tenet Health Care Corp.,* 186 F.3d 1045, 1054 (8th Cir.1999), *reh'g and reh'g en banc denied* (Oct. 6.1999); *University Health,* 938 F.2d at 1222; *FTC v. Cardinal Health, Inc.,* 12 F.Supp.2d 34, 61 (D.D.C.1998); *Staples,* 970 F.Supp. at 1088-89; *see also* ABA Antitrust Section, *Mergers and Acquisitions: Understanding the Antitrust Issues* 152 (2000) ("The majority of courts have considered efficiencies as a means to rebut the government's prima facie case that a merger will lead to restricted output or increased prices. These courts, however,

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generally have found inadequate proof of efficiencies to sustain a rebuttal of the government's case."). In 1997 the Department of Justice and the FTC revised their Horizontal Merger Guidelines to recognize that "mergers have the potential to generate significant efficiencies by permitting a better utilization of existing assets, enabling the combined firm to achieve lower costs in producing a given quantity and quality than either firm could have achieved without the proposed transaction." Horizontal Merger Guidelines, *supra,* § 4.

Nevertheless, the high market concentration levels present in this case require, in rebuttal, proof of extraordinary efficiencies, which the appellees failed to supply. *See University Health,* 938 F.2d at 1223 ("[A] defendant who seeks to overcome a presumption that a proposed acquisition would substantially lessen competition must demonstrate that the intended acquisition would result in significant economies and that these economies ultimately would benefit competition and, hence, consumers."); Horizontal Merger Guidelines, *supra,* § 4 (stating that "[e]fficiencies almost never justify a merger to monopoly or near-monopoly"); 4A Areeda, *et al., Antitrust Law* ¶ 971f, at 44 (requiring "extraordinary" efficiencies where the "HHI is well above 1800 and the HHI increase is well above 100"). Moreover, given the high concentration levels, the court must undertake a rigorous analysis of the kinds of efficiencies being urged by the parties in order to ensure that those "efficiencies" represent more than mere speculation and promises about post-merger behavior. The district court did not undertake that analysis here.

In support of its conclusion that post-merger efficiencies will outweigh the merger's anticompetitive effects, the district court found that the consolidation of baby food production in Heinz's under-utilized Pittsburgh plant "will achieve substantial cost savings in salaries and operating costs." *H.J. Heinz,* 116 F.Supp.2d at 199. The court also credited the appellees' promise of improved product quality as a result of recipe consolidation. [FN19] The only cost reduction the court quantified as a percentage of pre-merger costs, however, was the so called "variable conversion cost": the cost of processing the volume of baby food now processed by Beech- Nut. The court accepted the appellees' claim that this cost would be reduced by 43% if the Beech-Nut production were shifted to Heinz's plant, *see* JA 4619, a reduction the appellees' expert characterized as "extraordinary."

FN19. In addition, the district court described Heinz's distribution network as much more efficient than Beech-Nut's. *H.J. Heinz,* 116 F.Supp.2d at 199. It failed to find, however, a significant diseconomy of scale in distribution from which either Heinz or Beech-Nut suffers. 4A Areeda, *et al., supra,* ¶ 975e1, at 73. In other words, although Beech- Nut has an inefficient distribution system, it can make that system more efficient without merger. Heinz's own efficient distribution network illustrates that a firm the size of Beech-Nut does not need to merge in order to attain an efficient distribution system.

The district court's analysis falls short of the findings necessary for a successful efficiencies defense in the circumstances of this case. We mention only three of the most important deficiencies here. First, "variable conversion cost" is only a percentage of the total variable manufacturing cost. A large percentage reduction in only a small portion of the company's overall variable manufacturing cost does not necessarily translate into a significant cost advantage to the merger. Thus, for cost reduction to be relevant, we must at least consider the percentage of Beech-Nut's total variable manufacturing cost that would be reduced as a consequence of the merger. At oral argument, the appellees' counsel agreed. Oral Arg. Tr. at 43. This correction immediately cuts the asserted efficiency gain in half since, according to the appellees' evidence, using total variable manufacturing cost as the measure cuts the cost savings from 43% to 22.3%. *See* JA 4620.

Second, the percentage reduction in *Beech-Nut's* cost is still not the relevant figure. After the merger, the two entities will be combined, and to determine whether the merged entity will be a significantly more efficient competitor, cost reductions must be measured across the new entity's combined production--not just across the pre-merger output of Beech-Nut. *See* 4A Areeda, *et al., supra,* ¶ 976d at 93-94. The district court, however, did not consider the cost reduction over the merged firm's combined output. At oral argument the appellees' counsel was unable to suggest a formula that could be used for determining that cost reduction. *See* Oral Arg. Tr. at 45-47.

Finally, and as the district court recognized, the asserted efficiencies must be "merger-specific" to be

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cognizable as a defense. [FN20] [omitted] *H.J. Heinz,* 116 F.Supp.2d at 198-99; *see* Horizontal Merger Guidelines, *supra,* § 4; 4A Areeda, *et al., supra,* ¶ 973, at 49-62. That is, they must be efficiencies that cannot be achieved by either company alone because, if they can, the merger's asserted benefits can be achieved without the concomitant loss of a competitor. *See generally* 4A Areeda, *et al., supra,* ¶ 973. Yet the district court never explained why Heinz could not achieve the kind of efficiencies urged without merger. As noted, the principal merger benefit asserted for Heinz is the acquisition of Beech-Nut's better recipes, which will allegedly make its product more attractive and permit expanded sales at prices lower than those charged by Beech-Nut, which produces at an inefficient plant. Yet, neither the district court nor the appellees addressed the question whether Heinz could obtain the benefit of better recipes by investing more money in product development and promotion-- say, by an amount less than the amount Heinz would spend to acquire Beech-Nut. At oral argument, Heinz's counsel agreed that the taste of Heinz's products was not so bad that no amount of money could improve the brand's consumer appeal. Oral Arg. Tr. at 54. That being the case, the question is how much Heinz would have to spend to make its product equivalent to the Beech-Nut product and hence whether Heinz could achieve the efficiencies of merger without eliminating Beech-Nut as a competitor. The district court, however, undertook no inquiry in this regard. In short, the district court failed to make the kind of factual determinations necessary to render the appellees' efficiency defense sufficiently concrete to offset the FTC's prima facie showing.

3. Innovation

The appellees claim next that the merger is required to enable Heinz to innovate, and thus to improve its competitive position against Gerber. Heinz and Beech-Nut asserted, and the district court found, that without the merger the two firms are unable to launch new products to compete with Gerber because they lack a sufficient shelf presence or ACV. *See H.J. Heinz,* 116 F.Supp.2d at 199-200. This kind of defense is often a speculative proposition. *See* 4A Areeda, *et al., supra,* ¶ 975g (noting "truly formidable" proof problems in determining innovation economies). In this case, given the old-economy nature of the industry as well as Heinz's position as the world's largest baby food manufacturer, it is a particularly difficult defense to prove. The court below accepted the appellees' argument principally on the basis of their expert's testimony that new product launches are cost-effective only when a firm's ACV is 70% or greater (Heinz's is presently 40%; Beech-Nut's is 45%). ***723 **379** That testimony, in turn, was based on a graph that plotted revenue against ACV. According to the expert, the graph showed that only four out of 27 new products launched in 1995 had been successful--all for companies with an ACV of 70% or greater.

The chart, however, does not establish this proposition and the court's consequent finding that the merger is necessary for innovation is thus unsupported and clearly erroneous. All the chart plotted was revenue against ACV and hence all it showed was the unsurprising fact that the greater a company's ACV, the greater the revenue it received. Because the graph did not plot the profitability (or any measure of "cost-effectiveness"), there is no way to know whether the expert's claim--that a 70% ACV is required for a launch to be "successful" in an economic sense--is true. [FN21] Moreover, the number of data points on the chart were few; they were limited to launches in a single year; and they involved launches of all new grocery products rather than of baby food alone. Assessing such data's statistical significance in establishing the proposition at issue, *i.e.,* the necessity of 70% ACV penetration, is thus highly speculative. The district court did not even address the question of the data's statistical significance and the appellees' counsel could offer no help at oral argument. *See* Oral Arg. Tr. at 39 ("I'm not aware of the statistical significance of the underlying study."). [FN22] In the absence of reliable and significant evidence that the merger will permit innovation that otherwise could not be accomplished, the district court had no basis to conclude that the FTC's showing was rebutted by an innovation defense.

FN21. For example, a 5 cent piece of bubble gum introduced with a 90% ACV could appear as a failure on the graph because of low revenue but nonetheless be profitable. On the other hand, a high priced grocery product introduced with the same ACV could generate a lot of revenue (and thus appear as a "success" on the graph) yet be unprofitable.

FN22. The graph evidence is also not useful unless we know the "sunk" costs in bringing the product to market and the manufacturer's

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fixed and variable costs in producing the product. Sunk costs are costs that have already been incurred such as research and development and promotional expenses, including brand name development. *See* Henry N. Butler, *Economic Analysis for Lawyers* 935 (1998). Fixed costs refer to those expenses that do not vary with output and will be incurred as long as the firm continues in business. Variable costs are those that change with the rate of output such as wages paid to workers and payments for raw materials. *See id.* at 920, 936; E. Thomas Sullivan & Jeffrey L. Harrison, *Understanding Antitrust and its Economic Implications* 19-21 (3d ed.1998).

Moreover, Heinz's insistence on a 70-plus ACV before it brings a new product to market may be largely to persuade the court to recognize promotional economies as a defense. Heinz argues that to profitably launch a new product, it must have nationwide market penetration to recoup the money spent on advertising and promotion. It wants to spread advertising costs out among as many product units as possible, thereby lowering the advertising cost per unit. It does not want to "waste" promotional expenditures in markets where its products are not on the shelf or where they are on only a few shelves. For example, in a metropolitan area in which Heinz has a 75 per cent ACV, every dollar spent on advertising is two or three times more "effective" than in a market in which it has only a 25 per cent ACV. As one authority notes, however, "[t]he case for recognizing a defense based on promotional economies is relatively weak." 4A Areeda, *et al., supra,* ¶ 975f, at 77. The district court accepted Heinz's claim that it could not introduce new products without at least a 70 per cent ACV because it would be unable to adequately diffuse its advertising and promotional expenditures. But the court failed to determine whether substantial promotional scale economies exist now and, if they do, whether Heinz and Beech-Nut "for that reason operate at a substantial competitive disadvantage in the market or markets in which they sell" or whether there are effective alternatives to merger by which the disadvantage can be overcome. *Id.* at ¶ 975f2, at 78.

4. Structural Barriers to Collusion

In a footnote the district court dismissed the likelihood of collusion derived from the FTC's market concentration data. "[S]tructural market barriers to collusion" in the retail market for jarred baby food, the court said, rebut the normal presumption that increases in concentration will increase the likelihood of tacit collusion. *H.J. Heinz,* 116 F.Supp.2d at 198 n. 7. The court's sole citation, however, was to testimony by the appellees' expert, Jonathan B. Baker, a former Director of the Bureau of Economics at the FTC, who testified that in order to coordinate successfully, firms must solve "cartel problems" such as reaching a consensus on price and market share and deterring each other from deviating from that consensus by either lowering price or increasing production. He opined that after the merger the merged entity would want to expand its market share at Gerber's expense, thereby decreasing the likelihood of consensus on price and market share. 9/8/2000 Tr. 1010-1013. In his report, Baker elaborated on his theory, explaining that the efficiencies created by the merger will give the merged firm the ability and incentive to take on Gerber in price and product improvements. DX 617. He also predicted that policing and monitoring of any agreement would be more difficult than it is now, due in part to a time lag in the ability of one firm to detect price cuts by another. But the district court made no finding that any of these "cartel problems" are so much greater in the baby food industry than in other industries that they rebut the normal presumption. In fact, Baker's testimony about "time lag" is refuted by the record which reflects that supermarket prices are available from industry-wide scanner data within 4-8 weeks. *See* DX 617 at ¶ 86 (report of appellees' expert Jonathan Baker); *see also* Oral Arg. Tr. at 30 (statement by appellees' counsel that nothing in record reflects time lag is greater in baby food industry than in other industries). His testimony is further undermined by the record evidence of past price leadership in the baby food industry. [FN23]

FN23. In an oligopolistic market characterized by few producers, price leadership occurs when firms engage in interdependent pricing, setting their prices at a profit-maximizing, supracompetitive level by recognizing their shared economic interests with respect to price and output decisions. *See Brooke Group Ltd. v. Brown & Williamson Tobacco Corp .,* 509 U.S. 209, 227, 113 S.Ct. 2578, 125 L.Ed.2d 168 (1993); . . . In a duopoly, a market with only two competitors, supracompetitive pricing at monopolistic levels is a danger. . . .

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The combination of a concentrated market and barriers to entry is a recipe for price coordination. *See University Health,* 938 F.2d at 1218 n. 24 ("Significant market concentration makes it 'easier for firms in the market to collude, expressly or tacitly, and thereby force price above or farther above the competitive level.' " (citation omitted)). "[W]here rivals are few, firms will be able to coordinate their behavior, either by overt collusion or implicit understanding, in order to restrict output and achieve profits above competitive levels." *PPG,* 798 F.2d at 1503. The creation of a durable duopoly affords both the opportunity and incentive for both firms to coordinate to increase prices. The district court recognized this when it questioned Baker on whether the merged entity will, up to a point, expand its market share but "then [with Gerber will] find a nice equilibrium and they'll all get along together." 9/8/2000 Tr. 1014. Tacit coordination

> is feared by antitrust policy even more than express collusion, for tacit coordination, even when observed, cannot easily be controlled directly by the antitrust laws. It is a central object of merger policy to obstruct the creation or reinforcement by merger of such oligopolistic market structures in which tacit coordination can occur.

4 Phillip E. Areeda, Herbert Hovenkamp & John L. Solow, *Antitrust Law* ¶ 901b2, at 9 (rev. ed.1998). Because the district court failed to specify any "structural market barriers to collusion" that are unique to the baby food industry, its conclusion that the ordinary presumption of collusion in a merger to duopoly was rebutted is clearly erroneous. [FN24]

FN24. Contrary to the appellees' claims, nothing in *Baker Hughes* suggests otherwise. In that case, the sophisticated nature of the purchasers of the industry's product and the "volatile and shifting" nature of each firm's market share rendered the HHI figures an unreliable measure of concentration. *See* 908 F.2d at 986-87. No such circumstances exist in this case.

* * * * * *

Although we recognize that, post-hearing, the FTC may accept the rebuttal arguments proffered by the appellees, including their efficiencies defense, and permit the merger to proceed, we conclude that the FTC succeeded in "rais[ing] questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC." *Warner Communications,* 742 F.2d at 1162. The FTC demonstrated that the merger to duopoly will increase the concentration in an already highly concentrated market; that entry barriers in the market make it unlikely that any anticompetitive effects will be avoided; that pre-merger competition is vigorous at the wholesale level nationwide and present at the retail level in some metropolitan areas; and that post-merger competition may be lessened substantially. These substantial questions have not been sufficiently answered by the appellees. As we said in *Baker Hughes,* "[t]he more compelling the prima facie case, the more evidence the defendant must present to rebut it successfully." 908 F.2d at 991. In concluding that the FTC failed to make the requisite showing, the district court erred in a number of respects. Regarding the contention of lack of pre-merger competition, it made a clearly erroneous factual finding and misunderstood the law with respect to the import of competition at the wholesale level. Regarding the proffered efficiencies defense, the court failed to make the kind of factual findings required to render that defense sufficiently concrete to rebut the government's prima facie showing. Finally, as to the contention that the merger is necessary for innovation, the court clearly erred in relying on evidence that does not support its conclusion. Because the district court incorrectly assessed the merits of the appellees' rebuttal arguments, it improperly discounted the FTC's showing of likelihood of success.

2. Weighing of the Equities

Although the FTC's showing of likelihood of success creates a presumption in favor of preliminary injunctive relief, we must still weigh the equities in order to decide whether enjoining the merger would be in the public interest. 15 U.S.C. § 53(b); *see PPG,* 798 F.2d at 1507; *Weyerhaeuser,* 665 F.2d at 1081-83. The principal public equity weighing in favor of issuance of preliminary injunctive relief is the public interest in effective enforcement of the antitrust laws. *University Health,* 938 F.2d at 1225. The Congress specifically had this public equity consideration in mind when it enacted section 13(b). *See Food Town Stores,* 539 F.2d at 1346 (Congress enacted section 13(b) to preserve status quo until FTC can perform its function). The district court found, and there is no dispute, that if the merger were allowed to proceed, subsequent administrative and judicial proceedings on the merits "will not matter" because Beech-Nut's manufacturing facility "will be closed, the Beech-Nut distribution channels will be

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closed, the new label and recipes will be in place, and it will be impossible as a practical matter to undo the transaction." *H.J. Heinz*, 116 F.Supp.2d at 201. Hence, if the merger were ultimately found to violate the Clayton Act, it would be impossible to recreate pre-merger competition. *See* *Warner Communications*, 742 F.2d at 1165 ("A denial of a preliminary injunction would preclude effective relief if the Commission ultimately prevails and divestiture is ordered."). Section 13(b) itself embodies congressional recognition of the fact that divestiture is an inadequate and unsatisfactory remedy in a merger case, 119 Cong. Rec. 36612 (1973), a point that has been emphasized by the United States Supreme Court. *See, e.g.,* *FTC v. Dean Foods Co.*, 384 U.S. 597, 606 n. 5, 86 S.Ct. 1738, 16 L.Ed.2d 802 (1966) ("Administrative experience shows that the Commission's inability to unscramble merged assets frequently prevents entry of an effective order of divestiture.").

On the other side of the ledger, the appellees claim that the injunction would deny consumers the procompetitive advantages of the merger. *See* *FTC v. Pharmtech Research, Inc.*, 576 F.Supp. 294, 299 (D.D.C.1983) (explaining that public equities include "beneficial economic effects and procompetitive advantages for consumers"). The district court found that if the merger were preliminarily enjoined, the injury to competition would also be irreversible, that is, the merger would be abandoned and could not be consummated if ultimately found lawful. By contrast to its first finding, however, for the latter conclusion the court relied not on the facts of this case but on our statement in *Exxon* that--as a general matter--temporarily blocking a tender offer is likely to end an attempted acquisition, "as a result of the short life-span of most tender offers." *Id.* (quoting *Exxon*, 636 F.2d at 1343). In their brief in this court, the appellees offer nothing more to support the finding that the merger would never be consummated were an injunction to issue. Indeed, they devote only a single sentence, without any citation, to the point. The district court's finding that an injunction would "kill this merger" is thus not a factual finding supported by record evidence. This case does not involve a short-lived tender offer as did the case cited by the court for its "kill the merger" conclusion. The appellees acknowledge that there is no alternative buyer for Beech-Nut and the court found that it is not a failing company but rather a "profitable and ongoing enterprise." *H.J. Heinz*, 116 F.Supp.2d at 201 n. 9. If the merger makes economic sense now, the appellees have offered no reason why it would not do so later. Moreover, Beech-Nut's principal assets of value to Heinz are, assertedly, its recipes and brand ***727 **383** name. Nothing in the record leads us to believe that both will not still exist when the FTC completes its work. It may be that Beech-Nut will have to sell its recipes to Heinz at a lower price than the price of today's merger. But that is at best a "private" equity which does not affect our analysis of the impact on the market of the two options now before us and which has not in any event been urged by the appellees. [FN25] *See* *id.*

FN25. The district court noted that "[t]he parties have not stressed private equities" but the court nonetheless considered them. It concluded that while "the corporate interests of Heinz and Milnot and especially the interests of Dearborn Capital Partners LP, which presumably acquired Milnot through a leveraged buyout with the purpose and intent of selling its interest at a profit" were important to the private parties, they should not affect the outcome of the proceeding. *H.J. Heinz*, 116 F.Supp.2d at 200 n. 9. We agree. "While it is proper to consider private equities in deciding whether to enjoin a particular transaction, we must afford such concerns little weight, lest we undermine section 13(b)'s purpose of protecting the 'public-at-large, rather than the individual private competitors.' " *University Health*, 938 F.2d at 1225 (citation omitted); *cf.* *Weyerhaeuser*, 665 F.2d at 1083 ("Private equities do not outweigh effective enforcement of the antitrust laws. When the Commission demonstrates a likelihood of ultimate success, a countershowing of private equities alone would not suffice to justify denial of a preliminary injunction barring the merger.").

In sum, weighing of the equities favors the FTC. If the merger is ultimately found to violate section 7 of the Clayton Act, it will be too late to preserve competition if no preliminary injunction has issued. On the other hand, if the merger is found not to lessen competition substantially, the efficiencies that the appellees urge can be reclaimed by a renewed transaction. Our conclusion with respect to the equities necessarily lightens the burden on the FTC to show likelihood of success on the merits, a burden which the FTC has met here.

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**III. Conclusion**

It is important to emphasize the posture of this case. We do not decide whether the FTC will ultimately prove its case or whether the defendants' claimed efficiencies will carry the day. [FN26] Our task is to review the district court's order to determine whether, under section 13(b), preliminary injunctive relief would be in the public interest. We have considered the FTC's likelihood of success on the merits. We have weighed the equities. We conclude that the FTC has raised serious and substantial questions. We also conclude that the public equities weigh in favor of preliminary injunctive relief and therefore that a preliminary injunction would be in the public interest. Accordingly, we reverse the district court's denial of preliminary injunctive relief and remand the case for entry of a preliminary injunction pursuant to section 13(b) of the Federal Trade Commission Act.

FN26. "The most difficult mergers to assess may be those that combine both negative and positive effects: creating market power that increases the risk of oligopolistic pricing while at the same time creating efficiencies that reduce production or marketing costs." Sullivan & Grimes, *supra,* § 9.1, at 511.

*So ordered.*

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Revision to the Horizontal Merger Guidelines Issued by the
U.S. Department of Justice and the Federal Trade Commission

Federal Trade Commission

1997 FTC LEXIS 283

April 8, 1997

Section 4. Efficiencies

Competition usually spurs firms to achieve efficiencies internally. Nevertheless, mergers have the potential to generate significant efficiencies by permitting a better utilization of existing assets, enabling the combined firm to achieve lower costs in producing a given quantity and quality than either firm could have achieved without the proposed transaction. Indeed, the primary benefit of mergers to the economy is their potential to generate such efficiencies.

Efficiencies generated through merger can enhance the merged firm's ability and incentive to compete, which may result in lower prices, improved quality, enhanced service, or new products. For example, merger-generated efficiencies may enhance competition by permitting two ineffective (e.g., high cost) competitors to become one effective (e.g., lower cost) competitor. In a coordinated interaction context (see Section 2.1), marginal cost reductions may make coordination less likely or effective by enhancing the incentive of a maverick to lower price or by creating a new maverick firm. In a unilateral effects context (see Section 2.2), marginal cost reductions may reduce the merged firm's incentive to elevate price. Efficiencies also may result in benefits in the form of new or improved products, and efficiencies may result in benefits even when price is not immediately and directly affected. Even when efficiencies generated through merger enhance a firm's ability to compete, however, a merger may have other effects that may lessen competition and ultimately may make the merger anticompetitive.

The Agency will consider only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. These are termed merger-specific efficiencies.[1] Only alternatives that are practical in the business situation faced by the merging firms will be considered in making this determination; the Agency will not insist upon a less restrictive alternative that is merely theoretical.

Efficiencies are difficult to verify and quantify, in part because much of the information

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[1] The Agency will not deem efficiencies to be merger-specific if they could be preserved by practical alternatives that mitigate competitive concerns, such as divestiture or licensing. If a merger affects not whether but only when an efficiency would be achieved, only the timing advantage is a merger-specific efficiency.

relating to efficiencies is uniquely in the possession of the merging firms. Moreover, efficiencies projected reasonably and in good faith by the merging firms may not be realized. Therefore, the merging firms must substantiate efficiency claims so that the Agency can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific. Efficiency claims will not be considered if they are vague or speculative or otherwise cannot be verified by reasonable means.

Cognizable efficiencies are merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service. Cognizable efficiencies are assessed net of costs produced by the merger or incurred in achieving those efficiencies.

The Agency will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market.[2] To make the requisite determination, the Agency considers whether cognizable efficiencies likely would be sufficient to reverse the merger's potential to harm consumers in the relevant market, e.g., by preventing price increases in that market. In conducting this analysis,[3] the Agency will not simply compare the magnitude of the cognizable efficiencies with the magnitude of the likely harm to competition absent the efficiencies. The greater the potential adverse competitive effect of a merger--as indicated by the increase in the HHI and post-merger HHI from Section 1, the analysis of potential adverse competitive effects from Section 2, and the timeliness, likelihood, and sufficiency of entry from Section 3--the greater must be cognizable efficiencies in order for the Agency to conclude that the merger will not have an anticompetitive effect in the relevant market. When the potential adverse competitive effect of a merger is likely to be particularly large, extraordinarily great cognizable efficiencies would be necessary to prevent the merger from being anticompetitive.

In the Agency's experience, efficiencies are most likely to make a difference in merger

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[2] Section 7 of the Clayton Act prohibits mergers that may substantially lessen competition "in any line of commerce...in any section of the country." Accordingly, the Agency normally assesses competition in each relevant market affected by a merger independently and normally will challenge the merger if it is likely to be anticompetitive in any relevant market. In some cases,however, the Agency in its prosecutorial discretion will consider efficiencies not strictly in the relevant market, but so inextricably linked with it that a partial divestiture or other remedy could not feasibly eliminate the anticompetitive effect in the relevant market without sacrificing the efficiencies in the other market(s). Inextricably linked efficiencies rarely are a significant factor in the Agency's determination not to challenge a merger. They are most likely to make a difference when they are great and the likely anticompetitive effect in the relevant market(s) is small.

[3] The result of this analysis over the short term will determine the Agency's enforcement decision in most cases. The Agency also will consider the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market. Delayed benefits from efficiencies (due to delay in the achievement of, or the realization of consumer benefits from the efficiencies) will be given less weight because they are less proximate and more difficult to predict.

analysis when the likely adverse competitive effects, absent the efficiencies, are not great. Efficiencies almost never justify a merger to monopoly or near-monopoly.

The Agency has found that certain types of efficiencies are more likely to be cognizable and substantial than others. For example, efficiencies resulting from shifting production among facilities formerly owned separately, which enable the merging firms to reduce the marginal cost of production, are more likely to be susceptible to verification, merger-specific, and substantial, and are less likely to result from anticompetitive reductions in output. Other efficiencies, such as those relating to research and development, are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions. Yet others, such as those relating to procurement, management, or capital cost are less likely to be merger-specific or substantial, or may not be cognizable for other reasons.

435 U.S. 679, *; 98 S. Ct. 1355, **;
55 L. Ed. 2d 637, ***; 1978 U.S. LEXIS 47



**NATIONAL SOCIETY OF PROFESSIONAL ENGINEERS v. UNITED STATES**

**No. 76-1767**

**SUPREME COURT OF THE UNITED STATES**

***435 U.S. 679; 98 S. Ct. 1355; 55 L. Ed. 2d 637; 1978 U.S. LEXIS 47; 1978-1 Trade Cas. (CCH) P61,990***

**January 18, 1978, Argued**

**April 25, 1978, Decided**

MR. JUSTICE STEVENS delivered the opinion of the Court.

This is a civil antitrust case brought by the United States to nullify an association's canon of ethics prohibiting competitive bidding by its members. The question is whether the canon may be justified under the Sherman Act, 26 Stat. 209, as amended, *15 U. S. C. § 1 et seq.* (1976 ed.), because it was adopted by members of a learned profession for the purpose of minimizing the risk that competition would produce inferior engineering work endangering the public safety. The District Court rejected this justification without making any findings on the likelihood that competition would produce the dire consequences foreseen by the association. n1 The Court of Appeals affirmed. n2 We granted certiorari to decide whether the District Court should have considered the factual basis for the proffered justification before rejecting it. *434 U.S. 815.* Because we are satisfied that the asserted defense rests on a fundamental misunderstanding of the Rule of Reason frequently applied in antitrust litigation, we affirm.

n1 *389 F.Supp. 1193 (DC 1974).*

n2 *181 U. S. App. D. C. 41, 555 F.2d 978 (1977).* When the District Court's original judgment was entered, petitioner was entitled to appeal directly to this Court. We vacated the District Court's judgment for reconsideration in the light of our then recent decision in *Goldfarb v. Virginia State Bar, 421 U.S. 773. 422 U.S. 1031.* After reconsideration, the District Court re-entered its original judgment, *404 F.Supp. 457 (DC 1975),* and petitioner then appealed to the Court of Appeals.

I

Engineering is an important and learned profession. There are over 750,000 graduate engineers in the United States, of whom about 325,000 are registered as professional engineers. Registration requirements vary from State to State, but usually require the applicant to be a graduate engineer with at least four years of practical experience and to pass a written examination. About half of those who are registered engage in consulting engineering on a fee basis. They perform services in connection with the study, design, and construction of all types of improvements to real property -- bridges, office buildings, airports, and factories are examples. Engineering fees, amounting to well over $ 2 billion each year, constitute about 5% of total construction costs. In any given facility, approximately 50% to 80% of the cost of construction is the direct result of work performed by an engineer concerning the systems and equipment to be incorporated in the structure.

The National Society of Professional Engineers (Society) was organized in 1935 to deal with the nontechnical aspects of engineering practice, including the promotion of the professional, social, and economic interests of its members. Its present membership of 69,000 resides throughout the United States and in some foreign countries. Approximately 12,000 members are consulting engineers who offer their services to governmental, industrial, and

private clients. Some Society members are principals or chief executive officers of some of the largest engineering firms in the country.

The charges of a consulting engineer may be computed in different ways. He may charge the client a percentage of the cost of the project, may set his fee at his actual cost plus overhead plus a reasonable profit, may charge fixed rates per hour for different types of work, may perform an assignment for a specific sum, or he may combine one or more of these approaches. Suggested fee schedules for particular types of services in certain areas have been promulgated from time to time by various local societies. This case does not, however, involve any claim that the National Society has tried to fix specific fees, or even a specific method of calculating fees. It involves a charge that the members of the Society have unlawfully agreed to refuse to negotiate or even to discuss the question of fees until after a prospective client has selected the engineer for a particular project. Evidence of this agreement is found in § 11 (c) of the Society's Code of Ethics, adopted in July 1964. n3

n3 That section, which remained in effect at the time of trial, provided:

"Section 11 -- The Engineer will not compete unfairly with another engineer by attempting to obtain employment or advancement or professional engagements by competitive bidding ....

"c. He shall not solicit or submit engineering proposals on the basis of competitive bidding. Competitive bidding for professional engineering services is defined as the formal or informal submission, or receipt, of verbal or written estimates of cost or proposals in terms of dollars, man days of work required, percentage of construction cost, or any other measure of compensation whereby the prospective client may compare engineering services on a price basis prior to the time that one engineer, or one engineering organization, has been selected for negotiations. The disclosure of recommended fee schedules prepared by various engineering societies is not considered to constitute competitive bidding. An Engineer requested to submit a fee proposal or bid prior to the selection of an engineer or firm subject to the negotiation of a satisfactory contract, shall attempt to have the procedure changed to conform to ethical practices, but if not successful he shall withdraw from consideration for the proposed work. These principles shall be applied by the Engineer in obtaining the services of other professions." App. 9951.

The District Court found that the Society's Board of Ethical Review has uniformly interpreted the "ethical rules against competitive bidding for engineering services as prohibiting the submission of any form of price information to a prospective customer which would enable that customer to make a price comparison on engineering services." n4 If the client requires that such information be provided, then § 11 (c) imposes an obligation upon the engineering firm to withdraw from consideration for that job. The Society's Code of Ethics thus "prohibits engineers from both soliciting and submitting such price information," *389 F.Supp. 1193, 1206 (DC 1974),* n5 and seeks to preserve the profession's "traditional" method of selecting professional engineers. Under the traditional method, the client initially selects an engineer on the basis of background and reputation, not price. n6

n4 *389 F.Supp., at 1206.* In addition to § 11 (c) of the Society's Code of Ethics, see n. 3, *supra*, the Society's Board of Directors has adopted various "Professional Policy" statements. Policy statement 10-F was issued to "make it clear beyond all doubt" that the Society opposed competitive bidding for all engineering projects. *389 F.Supp., at 1206.* This policy statement was replaced in 1972 by Policy 10-G which permits price quotations for certain types of engineering work -- in particular, research and development projects.

n5 Although the Society argues that it has never "enforced" its ban on competitive bidding, Reply Brief for Petitioner 15-18, the District Court specifically found that the record "[supports] a finding that NSPE and its members actively pursue a course of policing adherence to the competitive bid ban through direct and indirect communication with members and prospective clients." *389 F.Supp., at 1200.* This finding has not been challenged as clearly erroneous.

n6 Having been selected, the engineer may then, in accordance with the Society's canons of ethics, negotiate a satisfactory fee arrangement with the client. If the negotiations are unsuccessful, then the client may withdraw his selection and approach a new engineer. *Id., at 1215.*

In 1972 the Government filed its complaint against the Society alleging that members had agreed to abide by canons of ethics prohibiting the submission of competitive bids for engineering services and that, in consequence, price competition among the members had been suppressed and customers had been deprived of the benefits of free and open competition. The complaint prayed for an injunction terminating the unlawful agreement.

In its answer the Society admitted the essential facts alleged by the Government and pleaded a series of affirmative defenses, only one of which remains in issue. In that defense, the Society averred that the standard set out in the Code of Ethics was reasonable because competition among professional engineers was contrary to the public interest. It was averred that it would be cheaper and easier for an engineer "to design and specify inefficient and unnecessarily expensive structures and methods of construction." n7 Accordingly, competitive pressure to offer engineering services at the lowest possible price would adversely affect the quality of engineering. Moreover, the practice of awarding engineering contracts to the lowest bidder, regardless of quality, would be dangerous to the public health, safety, and welfare. For these reasons, the Society claimed that its Code of Ethics was not an "unreasonable restraint of interstate trade or commerce."

n7 The entire defense pleaded in the answer reads as follows:

"18. (a) The principles and standards contained in the NSPE Code of Ethics, particularly those contained in that part of the NSPE Code of Ethics set out above, are reasonable, necessary to the public health, safety and welfare insofar as they are affected by the work of professional engineers, and serve the the public interest.

"(b) Experience has demonstrated that competitive bidding for professional engineering services is inconsistent with securing for the recipients of such services the most economical projects or structures. Testing, calculating and designing the most economical and efficient structures and methods of construction is complex, difficult and expensive. It is cheaper and easier to design and specify inefficient and unnecessarily expensive structures and methods of construction. Consequently, if professional engineers are required by competitive pressures to submit bids in order to obtain employment of their services, the inevitable tendency will be to offer professional engineering services at the lowest possible price. Although this may result in some lowering of the cost of professional engineering services it will inevitably result in increasing the overall cost and decreasing the efficiency of those structures and projects which require professional engineering design and specification work.

"(c) Experience has also demonstrated that competitive bidding in most instances and situations results in an award of the work to be performed to the lowest bidder, regardless of other factors such as ability, experience, expertise, skill, capability, learning and the like, and that such awards in the case of professional engineers endanger the public health, welfare and safety.

"(d) For the aforesaid reasons, the provisions of the NSPE Code of Ethics set out above are not, in any event, in unreasonable restraint of interstate trade or commerce." App. 21-22.

The parties compiled a voluminous discovery and trial record. The District Court made detailed findings about the engineering profession, the Society, its members' participation in interstate commerce, the history of the ban on competitive bidding, and certain incidents in which the ban appears to have been violated or enforced. The District Court did not, however, make any finding on the question whether, or to what extent, competition had led to inferior engineering work which, in turn, had adversely affected the public health, safety, or welfare. That inquiry was considered unnecessary because the court was convinced that the ethical prohibition against competitive bidding was "on its face a tampering with the price structure of engineering fees in violation of § 1 of the Sherman Act." *389 F.Supp., at 1200.*

Although it modified the injunction entered by the District Court, n8 the Court of Appeals affirmed its conclusion that the agreement was unlawful on its face and therefore "illegal without regard to claimed or possible benefits." *181 U. S. App. D. C. 41, 47, 555 F.2d 978, 984.*

n8 The Court of Appeals struck down the portion of the District Court's decree that ordered the Society to state that it did not consider competitive bidding to be unethical. *181 U. S. App. D. C., at 47, 555 F.2d, at 984.* The court reasoned that this provision was "more intrusive than necessary to achieve fulfillment of the governmental interest." *Ibid.* The Government has not petitioned for review of that decision.

II

In *Goldfarb v. Virginia State Bar, 421 U.S. 773,* the Court held that a bar association's rule prescribing minimum fees for legal services violated § 1 of the Sherman Act. In that opinion the Court noted that certain practices by members of a learned profession might survive scrutiny under the Rule of Reason even though they would be viewed as a violation of the Sherman Act in another context. The Court said:

"The fact that a restraint operates upon a profession as distinguished from a business is, of course, relevant in determining whether that particular restraint violates the Sherman Act. It would be unrealistic to view the practice of professions as interchangeable with other business activities, and automatically to apply to the professions antitrust concepts which originated in other areas. The public service aspect, and other features of the professions may require that a particular practice, which could properly be viewed as a violation of the Sherman Act in another context, be treated differently. We intimate no view on any other situation than the one with which we are confronted today." *421 U.S., at 788-789, n. 17.*

Relying heavily on this footnote, and on some of the major cases applying a Rule of Reason -- principally *Mitchel v. Reynolds, 1 P. Wms. 181, 24 Eng. Rep. 347 (1711); Standard Oil Co.* v. *United States, 221 U.S. 1; Chicago Board of Trade v. United States, 246 U.S. 231;* and *Continental T. V., Inc.* v. *GTE Sylvania Inc., 433 U.S. 36* -- petitioner argues that its attempt to preserve the profession's traditional method of setting fees for engineering services is a reasonable method of forestalling the public harm which might be produced by unrestrained competitive bidding. To evaluate this argument it is necessary to identify the contours of the Rule of Reason and to discuss its application to the kind of justification asserted by petitioner.

*A. The Rule of Reason.*

One problem presented by the language of § 1 of the Sherman Act is that it cannot mean what it says. The statute says that "every" contract that restrains trade is unlawful. n9 But, as Mr. Justice Brandeis perceptively noted, restraint is the very essence of every contract; n10 read literally, § 1 would outlaw the entire body of private contract law. Yet it is that body of law that establishes the enforceability of commercial agreements and enables competitive markets -- indeed, a competitive economy -- to function effectively.

n9 Section 1 of the Sherman Act, as set forth in *15 U. S. C. § 1* (1976 ed.), provides:

"Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. ..."

n10

"But the legality of an agreement or regulation cannot be determined by so simple a test, as whether it restrains competition. Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence." *Chicago Board of Trade v. United States, 246 U.S. 231, 238.*

See also *United States v. Topco Associates, 405 U.S. 596, 606:*

"Were § 1 to be read in the narrowest possible way, any commercial contract could be deemed to violate it."

Congress, however, did not intend the text of the Sherman Act to delineate the full meaning of the statute or its application in concrete situations. The legislative history makes it perfectly clear that it expected the courts to give shape to the statute's broad mandate by drawing on common-law tradition. n11 The Rule of Reason, with its origins in common-law precedents long antedating the Sherman Act, has served that purpose. It has been used to give the Act both flexibility and definition, and its central principle of antitrust analysis has remained constant. Contrary to its name, the Rule does not open the field of antitrust inquiry to any argument in favor of a challenged restraint that may fall within the realm of reason. Instead, it focuses directly on the challenged restraint's impact on competitive conditions.

n11 See 21 Cong. Rec. 2456 (1890) (comments of Sen. Sherman); see generally H. Thorelli, Federal Antitrust Policy 228-229 (1955).

This principle is apparent in even the earliest of cases applying the Rule of Reason, *Mitchel v. Reynolds, supra. Mitchel* involved the enforceability of a promise by the seller of a bakery that he would not compete with the purchaser of his business. The covenant was for a limited time and applied only to the area in which the bakery had operated. It was therefore upheld as reasonable, even though it deprived the public of the benefit of potential competition. The long-run benefit of enhancing the marketability of the business itself -- and thereby providing incentives to develop such an enterprise -- outweighed the temporary and limited loss of competition. n12

n12 "4thly, The fourth reason is in favour of these contracts, and is, that there may happen instances wherein they may be useful and beneficial, as ... in case of an old man, who finding himself under such circumstances either of body or mind, as that he is likely to be a loser by continuing his trade, in this case it will be better for him to part with it for a consideration, that by selling his custom, he may procure to himself a livelihood, which he might probably have lost, by trading longer." *1 P. Wms., at 191, 24 Eng. Rep., at 350.*

The Rule of Reason suggested by *Mitchel* v. *Reynolds* has been regarded as a standard for testing the enforceability of covenants in restraint of trade which are ancillary to a legitimate transaction, such as an employment contract or the sale of a going business. Judge (later Mr. Chief Justice) Taft so interpreted the Rule in his classic rejection of the argument that competitors may lawfully agree to sell their goods at the same price as long as the agreed-upon price is reasonable. *United States v. Addyston Pipe & Steel Co., 85 F. 271, 282-283 (CA6 1898),* aff'd, *175 U.S. 211.* That case, and subsequent decisions by this Court, unequivocally foreclose an interpretation of the Rule as permitting an inquiry into the reasonableness of the prices set by private agreement. n13

n13 *85 F., at 293.* See also *United States v. Trans-Missouri Freight Assn., 166 U.S. 290, 340-342.*

The early cases also foreclose the argument that because of the special characteristics of a particular industry, monopolistic arrangements will better promote trade and commerce than competition. *United States v. Trans-Missouri Freight Assn., 166 U.S. 290; United States v. Joint Traffic Assn., 171 U.S. 505, 573-577.* That kind of argument is properly addressed to Congress and may justify an exemption from the statute for specific industries, n14 but it is not permitted by the Rule of Reason. As the Court observed in *Standard Oil Co.* v. *United States, 221 U.S., at 65,* "restraints of trade within the purview of the statute ... [cannot] be taken out of that category by indulging in general reasoning as to the expediency or nonexpediency of having made the contracts or the wisdom or want of wisdom of the statute which prohibited their being made. "

n14 Congress has exempted certain industries from the full reach of the Sherman Act. See, *e. g., 7 U. S. C. § § 291*-292 (1976 ed.) (Capper-Volstead Act, agricultural cooperatives); *15 U. S. C. § § 1011*-1013 (1976 ed.) (McCarran-Ferguson Act, insurance); *49 U. S. C. § 5b* (Reed-Bulwinkle Act, rail and motor carrier rate-fixing bureaus); *15 U. S. C. § 1801* (1976 ed.) (newspaper joint operating agreements).

The test prescribed in *Standard Oil* is whether the challenged contracts or acts "were unreasonably restrictive of competitive conditions." Unreasonableness under that test could be based either (1) on the nature or character of the contracts, or (2) on surrounding circumstances giving rise to the inference or presumption that they were intended to restrain trade and enhance prices. n15 Under either branch of the test, the inquiry is confined to a consideration of impact on competitive conditions. n16

n15 "Without going into detail and but very briefly surveying the whole field, it may be with accuracy said that the dread of enhancement of prices and of other wrongs which it was thought would flow from the undue limitation on competitive conditions caused by contracts or other acts of individuals or corporations, led, as a matter of public policy, to the prohibition or treating as illegal all contracts or acts which were unreasonably restrictive of competitive conditions, either from the nature or character of the contract or act or where the surrounding circumstances were such as to justify the conclusion that they had not been entered into or performed with the legitimate purpose of reasonably forwarding personal interest and developing trade, but on the contrary were of such a character as to give rise to the inference or presumption that they had been entered into or done with the intent to do wrong to the general public and to limit the right of individuals, thus restraining the free flow of commerce and tending to bring about the evils, such as enhancement of prices, which were considered to be against public policy." *221 U.S., at 58.*

n16 Throughout the Court's opinion the emphasis is on economic conceptions. For instance, the Court's description of the common-law treatment of engrossing and forestalling statutes noted that contracts which had been illegal on their face were later recognized as reasonable because they tended to promote competition. *Id., at 55.* As was pointed out in the Report of the Attorney General's National Committee To Study the Antitrust Laws 11 (1955):

"While *Standard Oil* gave the courts discretion in interpreting the word 'every' in Section 1, such discretion is confined to consideration of whether in each case the conduct being reviewed under the Act constitutes an undue restraint of competitive conditions, or a monopolization, or an attempt to monopolize. This standard permits the courts to decide whether conduct is significantly and unreasonably anticompetitive in character or effect; it makes obsolete once prevalent arguments, such as, whether monopoly arrangements would be socially preferable to competition in a particular industry, because, for example, of high fixed costs or the risks of 'cut-throat' competition or other similar unusual conditions."

In this respect the Rule of Reason has remained faithful to its origins. From Mr. Justice Brandeis' opinion for the Court in *Chicago Board of Trade* to the Court opinion written by MR. JUSTICE POWELL in *Continental T. V., Inc.*, the Court has adhered to the position that the inquiry mandated by the Rule of Reason is whether the challenged agreement is one that promotes competition or one that suppresses competition. "The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition." *246 U.S., at 238,* quoted in *433 U.S., at 49 n. 15.* n17

n17 In *Continental T. V., Inc.*, the Court explained the Rule of Reason standard as follows:

"Under this rule, the factfinder weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition." *433 U.S., at 49.*

The Court then analyzed the "market impact" of vertical restraints, noting their complexity because of the potential for a simultaneous reduction of intrabrand competition and stimulation of interbrand competition. *Id., at 50-51.* "Competitive impact" and "economic analysis" were emphasized throughout the opinion.

There are, thus, two complementary categories of antitrust analysis. In the first category are agreements whose nature and necessary effect are so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality -- they are "illegal *per se*." In the second category are agreements whose competitive effect can only be evaluated by analyzing the facts peculiar to the business, the history of the restraint, and the reasons why it was imposed. In either event, the purpose of the analysis is to form a judgment about the competitive significance of the restraint; it is not to decide whether a policy favoring competition is in the public interest, or in the interest of the members of an industry. Subject to exceptions defined by statute, that policy decision has been made by the Congress. n18

n18 See generally Attorney General's Report, *supra* n. 16, at 10-11; Bork, The Rule of Reason and the Per Se Concept: Price Fixing and Market Division, *74 Yale L. J. 775 (1965);* L. Sullivan, Law of Antitrust 165-197 (1977).

B. The Ban on Competitive Bidding.

Price is the "central nervous system of the economy," *United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 226 n. 59,* and an agreement that "[interferes] with the setting of price by free market forces" is illegal on its face. *United States v. Container Corp., 393 U.S. 333, 337.* In this case we are presented with an agreement among competitors to refuse to discuss prices with potential customers until after negotiations have resulted in the initial selection of an engineer. While this is not price fixing as such, no elaborate industry analysis is required to demonstrate the anticompetitive character of such an agreement. It operates as an absolute ban on competitive bidding, applying with equal force to both complicated and simple projects and to both inexperienced and sophisticated customers. As the District Court found, the ban "impedes the ordinary give and take of the market place," and substantially deprives the customer of "the ability to utilize and compare prices in selecting engineering services." *404 F.Supp. 457, 460.* On its face, this agreement restrains trade within the meaning of § 1 of the Sherman Act.

The Society's affirmative defense confirms rather than refutes the anticompetitive purpose and effect of its agreement. The Society argues that the restraint is justified because bidding on engineering services is inherently imprecise, would lead to deceptively low bids, and would thereby tempt individual engineers to do inferior work with consequent risk to public safety and health. n19 The logic of this argument rests on the assumption that the agreement will tend to maintain the price level; if it had no such effect, it would not serve its intended purpose. The Society nonetheless invokes the Rule of Reason, arguing that its restraint on price competition ultimately inures to the public benefit by preventing the production of inferior work and by insuring ethical behavior. As the preceding discussion of the Rule of Reason reveals, this Court has never accepted such an argument.

n19 The Society also points out that competition, in the form of bargaining between the engineer and customer, is allowed under its canon of ethics once an engineer has been initially selected. See n. 6, *supra.* It then contends that its prohibition of competitive bidding regulates only the *timing* of competition, thus making this case analogous to *Chicago Board of Trade*, where the Court upheld an exchange rule which forbade exchange members from making purchases after the close of the day's session at any price other than the closing bid price. Indeed, petitioner has reprinted the Government's brief in that case to demonstrate that the Solicitor General regarded the exchange's rule as a form of price fixing. Reply Brief for Petitioner A1-A28. We find this reliance on *Chicago Board of Trade* misplaced for two reasons. First, petitioner's claim mistakenly treats negotiation between a single seller and a single buyer as the equivalent of competition between two or more potential sellers. Second, even if we were to accept the Society's equation of bargaining with price competition, our concern with *Chicago Board of Trade* is in its formulation of the proper test to be used in judging the legality of an agreement; that formulation unquestionably stresses impact on competition. Whatever one's view

of the application of the Rule of Reason in that case, see Sullivan, *supra* n. 18, at 175-182, the Court considered the exchange's regulation of price information as having a positive effect on competition. *246 U.S., at 240-241.* The District Court's findings preclude a similar conclusion concerning the effect of the Society's "regulation."

It may be, as petitioner argues, that competition tends to force prices down and that an inexpensive item may be inferior to one that is more costly. There is some risk, therefore, that competition will cause some suppliers to market a defective product. Similarly, competitive bidding for engineering projects may be inherently imprecise and incapable of taking into account all the variables which will be involved in the actual performance of the project. n20 Based on these considerations, a purchaser might conclude that his interest in quality -- which may embrace the safety of the end product -- outweighs the advantages of achieving cost savings by pitting one competitor against another. Or an individual vendor might independently refrain from price negotiation until he has satisfied himself that he fully understands the scope of his customers' needs. These decisions might be reasonable; indeed, petitioner has provided ample documentation for that thesis. But these are not reasons that satisfy the Rule; nor are such individual decisions subject to antitrust attack.

n20 We, of course, express no view on the truth of this assertion, although it might be noted that the Society has allowed competitive bidding for some types of engineering projects in this country, see n. 4, *supra*, and, at one time, allowed competitive bidding for all engineering work in foreign countries "as required by the laws, regulations or practices of the foreign country." App. 6487. This rule, called the "When-in-Rome" clause, was abolished in 1968. *Id.*, at 6344.

The Sherman Act does not require competitive bidding; n21 it prohibits unreasonable restraints on competition. Petitioner's ban on competitive bidding prevents all customers from making price comparisons in the initial selection of an engineer, and imposes the Society's views of the costs and benefits of competition on the entire marketplace. It is this restraint that must be justified under the Rule of Reason, and petitioner's attempt to do so on the basis of the potential threat that competition poses to the public safety and the ethics of its profession is nothing less than a frontal assault on the basic policy of the Sherman Act.

n21 Indeed, Congress has decided not to require competitive bidding for Government purchases of engineering services. The Brooks Act, *40 U. S. C. § § 541*-544 (1970 ed., Supp. V), requires the Government to use a method of selecting engineers similar to the Society's "traditional method." See n. 6, *supra*. The Society relies heavily on the Brooks Act as evidence that its ban on competitive bidding is reasonable. The argument is without merit. The Brooks Act does not even purport to exempt engineering services from the antitrust laws, and the reasonableness of an individual purchaser's decision not to seek lower prices through competition does not authorize the vendors to conspire to impose that same decision on all other purchasers.

The Sherman Act reflects a legislative judgment that ultimately competition will produce not only lower prices, but also better goods and services. "The heart of our national economic policy long has been faith in the value of competition." *Standard Oil Co.* v. *FTC, 340 U.S. 231, 248.* The assumption that competition is the best method of allocating resources in a free market recognizes that all elements of a bargain -- quality, service, safety, and durability -- and not just the immediate cost, are favorably affected by the free opportunity to select among alternative offers. Even assuming occasional exceptions to the presumed consequences of competition, the statutory policy precludes inquiry into the question whether competition is good or bad.

The fact that engineers are often involved in large-scale projects significantly affecting the public safety does not alter our analysis. Exceptions to the Sherman Act for potentially dangerous goods and services would be tantamount to a repeal of the statute. In our complex economy the number of items that may cause serious harm is almost endless -- automobiles, drugs, foods, aircraft components, heavy equipment, and countless others, cause serious harm to

individuals or to the public at large if defectively made. The judiciary cannot indirectly protect the public against this harm by conferring monopoly privileges on the manufacturers.

By the same token, the cautionary footnote in *Goldfarb, 421 U.S., at 788-789, n. 17,* quoted *supra*, cannot be read as fashioning a broad exemption under the Rule of Reason for learned professions. We adhere to the view expressed in *Goldfarb* that, by their nature, professional services may differ significantly from other business services, and, accordingly, the nature of the competition in such services may vary. Ethical norms may serve to regulate and promote this competition, and thus fall within the Rule of Reason. n22 But the Society's argument in this case is a far cry from such a position. We are faced with a contention that a total ban on competitive bidding is necessary because otherwise engineers will be tempted to submit deceptively low bids. Certainly, the problem of professional deception is a proper subject of an ethical canon. But, once again, the equation of competition with deception, like the similar equation with safety hazards, is simply too broad; we may assume that competition is not entirely conducive to ethical behavior, but that is not a reason, cognizable under the Sherman Act, for doing away with competition.

n22 Courts have, for instance, upheld marketing restraints related to the safety of a product, provided that they have no anticompetitive effect and that they are reasonably ancillary to the seller's main purpose of protecting the public from harm or itself from product liability. See, *e. g., Tripoli Co.* v. *Wella Corp., 425 F.2d 932 (CA3 1970)* (en banc); cf. *Continental T. V., 433 U.S., at 55 n. 23.*

In sum, the Rule of Reason does not support a defense based on the assumption that competition itself is unreasonable. Such a view of the Rule would create the "sea of doubt" on which Judge Taft refused to embark in *Addyston, 85 F., at 284,* and which this Court has firmly avoided ever since.

III

The judgment entered by the District Court, as modified by the Court of Appeals, n23 prohibits the Society from adopting any official opinion, policy statement, or guideline stating or implying that competitive bidding is unethical. n24 Petitioner argues that this judgment abridges its First Amendment rights. n25 We find no merit in this contention.

n23 See n. 8, *supra.*

n24 See App. 9974-9980.

n25

Petitioner contends the judgment is both an unconstitutional prior restraint on speech and an unconstitutional prohibition against free association.

Having found the Society guilty of a violation of the Sherman Act, the District Court was empowered to fashion appropriate restraints on the Society's future activities both to avoid a recurrence of the violation and to eliminate its consequences. See, *e. g., International Salt Co.* v. *United States, 332 U.S. 392, 400-401; United States v. Glaxo Group, Ltd., 410 U.S. 52, 64.* While the resulting order may curtail the exercise of liberties that the Society might otherwise enjoy, that is a necessary and, in cases such as this, unavoidable consequence of the violation. Just as an injunction against price fixing abridges the freedom of businessmen to talk to one another about prices, so too the injunction in this case must restrict the Society's range of expression on the ethics of competitive bidding. n26 The First Amendment does not "make it ... impossible ever to enforce laws against agreements in restraint of trade ...." *Giboney v. Empire Storage & Ice Co., 336 U.S. 490, 502.* In fashioning a remedy, the District Court may, of course, consider the fact that its injunction may impinge upon rights that would otherwise be constitutionally protected, but those protections do not prevent it from remedying the antitrust violations.

n26 Thus, in *Goldfarb*, although the bar association believed that its fee schedule accurately reflected ethical price levels, it was nonetheless enjoined "from adopting, publishing, or distributing any future schedules

of minimum or suggested fees." *Goldfarb v. Virginia State Bar, 355 F.Supp. 491, 495-496 (ED Va. 1973).* See also *United States v. National Assn. of Real Estate Boards, 339 U.S. 485.*

The standard against which the order must be judged is whether the relief represents a reasonable method of eliminating the consequences of the illegal conduct. We agree with the Court of Appeals that the injunction, as modified, meets this standard. While it goes beyond a simple proscription against the precise conduct previously pursued, that is entirely appropriate.

"The District Court is not obliged to assume, contrary to common experience, that a violator of the antitrust laws will relinquish the fruits of his violation more completely than the court requires him to do. And advantages already in hand may be held by methods more subtle and informed, and more difficult to prove, than those which, in the first place, win a market. When the purpose to restrain trade appears from a clear violation of law, it is not necessary that all of the untraveled roads to that end be left open and that only the worn one be closed." *International Salt Co., supra*, at 400.

The Society apparently fears that the District Court's injunction, if broadly read, will block legitimate paths of expression on all ethical matters relating to bidding. n27 But the answer to these fears is, as the Court held in *International Salt*, that the burden is upon the proved transgressor "to bring any proper claims for relief to the court's attention." *Ibid.* In this case, the Court of Appeals specifically stated that "[if] the Society wishes to adopt some other ethical guideline more closely confined to the legitimate objective of preventing deceptively low bids, it may move the district court for modification of the decree." *181 U. S. App. D. C., at 46, 555 F.2d, at 983.* This is, we believe, a proper approach, adequately protecting the Society's interests. We therefore reject petitioner's attack on the District Court's order.

n27 For instance, the Society argues that the injunction can be read as prohibiting it from opposing repeal of statutes such as the Brooks Act, see n. 21, *supra*, and that such a prohibition would violate the principles of the *Noerr-Pennington* doctrine. See *Eastern Railroad Presidents Conf.* v. *Noerr Motor Freight, Inc., 365 U.S. 127; Mine Workers v. Pennington, 381 U.S. 657.* By its terms the injunction contains no such prohibition, and indeed the Government contends that "[nothing] in the judgment prevents NSPE and its members from attempting to influence governmental action ...." Brief for United States 60.

The judgment of the Court of Appeals is

*Affirmed.*

MR. JUSTICE BRENNAN took no part in the consideration or decision of this case.

# The Evolving Approach to Merger Remedies

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Probably no single issue currently is receiving as much attention as the topic of relief in merger cases. The question of whether there is a remedy to an anticompetitive merger and what that remedy should be is perhaps the single most intriguing and complex issue faced by the Bureau of Competition of the Federal Trade Commission.

In this article, we seek to provide an overview of how the Bureau of Competition approaches the issue of merger enforcement and remedy. We begin by outlining the important responsibilities of an enforcement agency in fashioning relief. We then discuss how the FTC's approach toward merger remedies has evolved over the past two decades. After that, we describe several cases in which the Bureau of Competition chose not to accept various remedies proposed by parties to a merger. These examples illustrate why certain forms of relief, both structural and non-structural, may be inadequate to resolve certain types of competitive problems. We close with a series of difficult and important questions regarding merger remedies.

## the merger wave: new challenges

The merger wave continues at a rapid and breathtaking pace. Each week there are announcements of new mergers, many of which appear to restructure industries or create firms of a size that was unimagined a few years ago. A recent article characterized the merger wave as "a frenzy of merger madness, capping a dramatic wave of global corporate consolidation that has been gaining momentum through much of the decade."[1] In terms of simple numbers, reported Hart-Scott-Rodino transactions have tripled since 1991, from 1,529 to 4,642 in fiscal year 1999. More important, the total value of these mergers has increased eleven-fold during this period, from $169 billion to over $1.9 trillion. The pace in the first six months of fiscal year 2000 promises another record year, with transactions averaging over 20 percent more than last year.

Of course, the vast majority of mergers are procompetitive or competitively neutral. Some mergers bring together firms in complementary relationships, or involve markets that appear to be converging. That is why at both the FTC and the Justice Department only a small handful, less that 3 percent a year receive some type of in-depth investigation. At the FTC, the vast majority (over 60 percent) of these investigations result in enforcement actions. In fiscal year 1999 there were thirty merger enforcement actions. So far in fiscal year 2000 there have been ten enforcement actions.

T e are several aspects to the ever-intensifying merger wave that directly impact the issue of merger remedies. The problem of designing and securing effective relief is an increasingly complex and challenging problem. Why is that? The primary reason is that mergers are increasingly strategic in nature. Many of the investigated mergers are motivated by strategic concerns, such as the desire to become dominant in a market. Unlike the mergers of the 1980s, which were frequently motivated primarily by financial concerns, today's mergers are based on a desire to strengthen competitive position. Thus, they are more likely to involve substantial horizontal overlaps, some of which are much larger than those the FTC dealt with in the past. Replacing a competitor with 30 percent of the market is far more daunting than replacing one with a 5 percent market share. Moreover, as each merger occurs the number of remaining firms diminishes and, in turn, so does the pool of potential acquirers of divested assets. Often, when presented with problems of substantial relief and few remaining competitors, the parties propose putting the FTC in a regulatory position, monitoring remedies short of a clean divestiture.

There are other factors that increase the challenge of remedy. The sheer size of the mergers and the number of markets involved is far greater than the past. Since technology and information are assuming primacy as driving forces in the economy, relief often must include these assets. But crafting relief for intangible assets can create tough challenges. Some transactions are in regulated or newly deregulated industries where the antitrust agencies must determine whether to rely on regulation to protect competition.



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Finally, as described below, the Bureau of Competition recently completed an important study of the divestiture process. The Bureau has learned from the success and failure of remedies in the past, and approaches merger remedies with a renewed sense of humility and caution. Unlike other agencies which possess expertise in a specific industry, the FTC has general jurisdiction. We are not experts in any particular industry. Therefore, we have increasingly recognized the need for more thorough examination and care before any particular remedy is adopted.[2]

**the range of remedial options -- how do we choose?**

There are a variety of approaches to curing anticompetitive mergers. First and foremost, the agencies may simply decide that no remedy, short of blocking the transaction, will fully resolve the competitive concerns. Second, the agencies may decide that the resolution of competitive concerns will require the divestiture of an entire ongoing business and related assets. Third, they might conclude that some form of partial divestiture incorporating various aspects of a business would be acceptable, because it could facilitate the entry or expansion of a replacement competitor. Fourth, a merger might be resolved through contractual arrangements, such as the licensing of intellectual property or perhaps a supply agreement. Fifth, the agencies may decide to use some form of behavioral relief such as a non-discrimination provision. Some mergers can be resolved with a combination of these forms of relief.

The Commission has broad discretion in deciding whether any one of these possible remedies is acceptable in a particular case, so long as the remedy will cure the competitive problem.[3] So how does it decide which approach is most suitable a given case?

The foremost obligation of antitrust enforcers is to make sure that a merger does not reduce competition to any significant extent. As Justice Brennan recognized over forty years ago in *DuPont:* "The key to the whole question of an antitrust remedy is of course the discovery of measures effective to preserve competition."[4] Consumers should benefit from the same degree of competition after a merger as before a merger. Thus, our first objective is to determine which remedies will effectively and fully preserve competition.

A second objective is to select a remedy that will preserve competition with as much certainty as possible. The risk of inadequate relief, or the burden of untimely relief, should not be borne by consumers.

The third objective is to preserve the efficiency-enhancing potential of a merger, to the extent that is possible without compromising our obligation to preserve competition. If there are two remedial options, both equally effective (based on experience) and both equally likely to achieve their objective, but with different implications for preserving cognizable merger efficiencies, we should choose the one that is more likely to preserve efficiencies. They must be effective *based on experience*--theory alone may not be enough for the risk of a failed remedy to be shifted to consumers.

Our approach to remedies evolves, as does our approach to merger enforcement generally. We learn from each case what works and what doesn't work. Our past actions provide guidance, but there are no absolute rules. We evaluate remedies based on the facts in each individual case. We also go back and evaluate our remedy process, as described below, to see if expectations are borne out and the remedies are effective.

We should also keep in mind what our objectives do not include. The FTC is not a market regulator. Apart from enforcing the prohibitions that are contained in the antitrust laws, our job is not to regulate or prescribe the market behavior of firms. That is a function of the competitive process. Nor are we industrial planners. Our obligation is straightforward and simple--make sure that the post-merger world is every bit as competitive as the one that existed before the merger. Of course, nothing in the real world is ever that simple. Tradeoffs and judgment calls need to be made.

**is there a preferred merger remedy?**

One way to assess the FTC's approach to merger remedies is to determine whether there is some benchmark or preferred remedy it should be trying to achieve. Generally, there is. In most cases divestiture is the preferred remedy. As Justice Brennan stated in *DuPont*: "Divestiture has been called the most important of antitrust remedies. It is simple, relatively easy to administer, and sure. It should be in the forefront of a court's mind when a violation of § 7 has been found."[5] Many courts have followed that guidance for the past several decades, as have the enforcement agencies.

The facts in *DuPont* illustrate why divestiture is preferable. The parties had proposed various forms of behavioral relief (e. g., barring DuPont from influencing the selection of GM officers or directors and prohibiting preferential trade relationships) in favor of divestiture. The Court found that enforcing such a decree likely would be cumbersome and time-consuming, that framing an injunction to address all forms of anticompetitive conduct would be impossible, and that policing the order "would probably involve the courts and the Government in regulation of private business affairs more deeply than administration of a simple order of divestiture."[6]

Of course, saying that divestiture is the preferred remedy somewhat begs the question: Divestiture of what? The entire acquired entity? A complete, ongoing business? A partial divestiture of assets that might provide the basis for starting a business? In markets where technology is a key to success, is a divestiture of "soft" assets such as intellectual property sufficient, or is a broader asset package, even an ongoing business, needed to ensure successful entry? The Supreme Court's characterization of divestiture in *DuPont* as "simple, relatively easy to administer, and sure" applies most clearly to a clean separation of two ongoing businesses--essentially, undoing the merger or acquisition. That is what was ordered in *DuPont*, where the Court stated that "complete divestiture is peculiarly appropriate in cases of stock acquisitions which violate § 7."[7] *DuPont* was a post-acquisition case, of course. Today, thanks to Hart-Scott-Rodino, we more typically look at the remedy issue in the premerger context, and the lesson of *DuPont* would be to prevent the two businesses from combining in the first place.

One issue that arises where the divested facility produces several products is whether divestiture of the entire facility is necessary. Occasionally, parties argue that they should be able to retain those portions of a facility that produce products which do not raise competitive concerns. This argument will not carry the day where those other portions of the facility are necessary to ensure the viability of the divested entity. For example, in *Olin Corporation*, which involved a chemical plant that manufactured certain swimming pool sanitizers, the respondents sought to exclude from the Commission's order part of the plant that manufactured cyanuric acid. The Commission rejected that request because there was no evidence that the part of the plant that manufactured the swimming pool sanitizers could operate independently. Thus, the Commission concluded that divestiture of the entire facility was necessary "to give its acquirer a real chance at competitive success."[8]

The teaching of *DuPont* and *Olin* is that it is clearly within the Commission's power to require divestiture of a greater set of assets than those which participate in the overlap markets in order to effectively replace competition. Often the buyers of the divested assets will need other ancillary assets in order to effectively restore competition. Sometimes without these ancillary assets the buyer will not be able to replicate the economies of scale or scope of the firm that has been acquired. In other cases, these additional assets will be necessary to give the buyer both the incentive and ability to fully restore competition.

This principle was applied in both of the recent oil mega-mergers, Exxon/Mobil and BP/ARCO. In Exxon/Mobil, there was a direct overlap in California between the two firms in oil refining, but a far less significant overlap downstream (in gas stations). The FTC required divestiture not only of Exxon's refinery, but also of all of Exxon's downstream assets. The Commission required a "clean sweep" of all assets in order to assure the buyer had the same level of economies of scale and scope that Exxon possessed prior to the merger. A vertically integrated refinery would be a far more significant competitive force.

Similarly, in BP/ARCO, there were significant competitive overlaps in the production, sale, and delivery of Alaska North Slope crude oil. The parties entered into a separate agreement with the State of Alaska which would have combined various assets of BP and ARCO. This mix-and-match approach at best only partially cured the direct overlaps, but failed to create a

firm with the efficiencies possessed by ARCO. The Commission rejected the proposed consent and sought to enjoin the merger. Ultimately, after extensive negotiations the parties agreed to the divestiture of all of ARCO's complete, free-standing Alaska businesses, including oil and gas interests, tankers, pipeline interests, exploration data, and selected long-term supply agreements. Again, a clean sweep approach was necessary to provide the acquirer of the assets (Phillips) with ability to fully restore competition.

When we depart from the kind of divestiture remedy the Court spoke about in *DuPont*, it is not always clear that divestiture is "simple, relatively easy to administer, and sure"--at least not retrospectively. That is the lesson of the Bureau's divestiture study. But first let us explain how our policy to merger remedies has evolved.

**the government's approach to merger remedies over the years**

The government's position towards remedy has evolved over the past several decades. Prior to enactment of Hart-Scott-Rodino, the government typically was faced with seeking to remedy a merger several years after it had been consummated. That was a daunting, almost always hopeless, task because the assets had been intermingled and the acquired firm typically dissolved. Usually there was relatively little left to divest, at least little that resembled the acquired entity. Sometimes the agencies would require the merged firm to scrabble together various plants and other assets into something that vaguely resembled the acquired entity before the merger. Most often these divestitures were nothing more than "pyrrhic victories."[9] *DuPont* was an easier case, since it involved a partial stock acquisition and it was not difficult (apart from tax considerations) to spin off the acquired stock.

With the enactment of the Hart-Scott-Rodino Act and its mandatory waiting period before merger consummation, the agencies became able to enjoin a merger before the assets were scrambled. That placed the agencies and the merging firms on equal footing in terms of finding the appropriate resolution to a problematic merger.

The agencies' initial response to Hart-Scott-Rodino was to almost always seek a preliminary injunction. Sometimes the agencies would seek to enjoin the entire merger even when the amount of overlap was relatively small. That policy began to change in the early 1980s, when the agencies were more willing to allow firms to restructure transactions to avoid competitive problems ("fix-it-first"), or to engage in partial divestitures. In some cases, such as the Alcan/Arco joint venture, or the GM/Toyota joint venture, the agencies were even willing to resolve their concerns solely on certain forms of behavioral relief.[10]

During the mid 1980s, there was a shift back toward litigation and away from settlement, at least at the FTC. From 1986 to 1988, for example, of the thirty merger enforcement actions authorized by the Commission, only seven, or 23 percent, were settled prior to litigation with some form of divestiture or behavioral relief. In the vast majority of enforcement actions the Commission chose to litigate. Typically that resulted in the parties' dropping the transaction. In the cases that were litigated, the FTC often prevailed and the merger was preliminarily enjoined.

During the late 1980s and early 1990s, the FTC began to take a more flexible view of merger relief. While divestiture of a plant or facility was typically the most common remedy, the Commission increasingly considered a variety of alternative solutions to competitive problems. In a number of cases, the Commission was willing to accept licensing arrangements (which might eventually result in partial structural relief), supply agreements, and certain forms of behavioral relief, such as firewalls and nondiscrimination provisions. A number of these cases involved high-technology markets in which licensing was used to convey intellectual property rights to bring a new entrant into the market. We had come a long way from *DuPont*. Not surprisingly, this broader remedy policy resulted in a greater number of settlements and far fewer litigated cases.

When Bill Baer and George Cary arrived at the Bureau of Competition in 1995, they wanted to take a fresh look at the question of merger remedies. There had been a perception, both in the private bar and within the FTC staff, that some

merger relief orders had not worked as well as expected. As part of the Baer-Cary initiative, the Bureau of Competition and Bureau of Economics staffs were directed to study what happened as a result of a number of merger consent orders issued from 1990 through 1994.

**the ftc divestiture study**

Issued in August 1999, the study ("Divestiture Report") has both reinforced some of our approaches to remedies and caused us to rethink others.[11] The Divestiture Report provided new insight into the divestiture process, and understanding its lessons is vital for all merger lawyers. It found that in the majority of cases the acquirer of the divested assets was able to enter the market. An important detail, however, was that the likelihood of successful entry was much higher if an ongoing business was divested. A divestiture of selected assets to facilitate entry was significantly more problematic. The Divestiture Report also observed that a number of factors can complicate the divestiture process and lessen the likelihood of success, unless they are adequately dealt with. For example, respondents have incentives to offer a divestiture package that is too narrow, to propose a weak buyer, and to engage in strategic behavior to impede the success of the buyer; and even if they don't affirmatively try to impede the buyer, respondents normally don't have incentives to assist or cooperate with the buyer during the transition phase.

C particular problem identified by the Divestiture Report was continuing relationships between the seller and buyer of divested assets after divestiture, such as a supply arrangement or technical assistance requirement, which may increase the buyer's vulnerability to the seller's behavior. Of the nineteen divestitures where a seller had a continuing relationship with the buyer of the assets, in six cases the ongoing relationship was so detrimental that the buyer could not operate effectively, and in seven cases the ongoing relationship was competitively harmful. Yet those ongoing relationships may be critical to the buyer's success, particularly if less than a separate complete business is divested.

Another significant finding was that buyers sometimes--too often, in fact--have a serious informational disadvantage. They may not fully know what assets they need to succeed in the business, or whether the assets offered by respondents are up to the task. That finding came as somewhat of a surprise, since it was generally assumed that purchasers of divested assets would be informed buyers who could protect their own interests. That assumption isn't necessarily valid when much of the key information is principally held by the respondent. Unfortunately, we face the same informational disadvantage. While we try to learn as much as we can about the industries and businesses we investigate, we don't presume to know how to operate the business. The Divestiture Report also revealed that buyers may not have the same objectives as the Commission, so the remedial purposes of the order may not be met.

F lly, divestitures that include technology transfers present serious difficulties and challenges. They bring together many o ne problems already mentioned--respondent's incentive to limit the asset package, the buyer's informational disadvantage, the buyer's reliance on the respondent for technical assistance and transfer of know-how, and the respondent's incentives to engage in strategic behavior. Another difficulty, because technology transfers often involve the divestiture of less than an ongoing business, is that the buyer may be at the bottom of the learning curve and thus starts with a disadvantage.

So it became increasingly evident from a relative early stage of that study that we needed to rethink and modify our approach to merger remedies. If fact, the Bureau of Competition began to incorporate many of those lessons into its remedy approach while the study was still being completed. In 1996, the Bureau adopted several reforms based on initial findings of the Divestiture Report:

- More frequent use of up-front buyers;
- Shorter divestiture periods, to minimize the risk of interim harm and dissipation of asset value. The divestiture periods were shortened from twelve months to typically three or four months;
- Increased use of full or structural relief. The closer the divestiture package is to an ongoing business--better yet, if it is an ongoing business--the greater the likelihood that competition will in fact be restored;

- The use of interim trustees, especially where technology transfers are involved.

The value of up-front buyers and short divestiture periods is illustrated by the Schnucks supermarket case, where the consent order did not require an up-front buyer. Schnucks Markets acquired its chief competitor in St. Louis, Missouri, and the Commission required the divestiture of twenty-four stores within twelve months. But before the stores could be acquired Schnucks failed to maintain them properly, resulting in a relatively unattractive set of assets.[12] The Commission filed a civil penalty action, and Schnucks agreed to pay a $3 million civil penalty and divest two additional stores.[13] While that was a substantial penalty, we cannot rely on civil penalty actions alone to ensure that respondents do it right. Obviously, the prospect of substantial civil penalties did not deter Schnucks from engaging in strategic behavior, and it may simply have been an investment or cost of doing business to preserve market power. Moreover, by the time we can bring a civil penalty action, the damage to the market will have already been done. So we have to make sure up front that the remedy really will work.

Up-front buyers are probably the most vital tool in assuring a successful divestiture. It enables us to better determine (a) whether a proposed package of assets that is not a stand-alone business is viable in the real world, (b) whether there is a buyer for the proposed divestiture assets, and (c) the likelihood that the proposed buyer will restore the competition that otherwise would be lost through the merger. This last factor is receiving careful scrutiny. The FTC seeks to assure not only that the buyer will successfully enter, but also that it can restore competition fully.

Up-front buyers are now used in over 60 percent of the cases in which there is some form of non-behavioral relief. There might have been an impression that the up-front buyer policy is reserved for cases where assets may waste quickly, such as supermarkets. That is not the case. The Commission has used up-front buyers in pharmaceutical cases, in other health care products, industrial products such as refractories, acrylic polymers, lead smelters, industrial power sources, and consumer products. (See the appendix for a representative list of cases and markets.) In many cases where the parties have identified an up-front buyer at the beginning of the investigation, the Commission has been able to resolve its concerns and enter a proposed consent order in less than sixty days after the investigation began. The message is straightforward: parties must consider and be able to identify an up-front buyer as part of the merger planning process.

**recent application of remedy reforms**

The application of remedy reforms over the past few years, especially the greater focus on effective structural relief, has led to claims that the FTC has raised the bar for resolving merger concerns. That characterization is not entirely accurate. We have always insisted on the kind and quantum of relief necessary to protect competition. We evaluate what it takes to preserve or restore competition, based on our experience and the evidence. But as our experience with divestitures grows, so does our understanding of what it takes to successfully remedy the potential anticompetitive effects of a proposed merger. We are more willing today to consider non-litigated resolutions to merger concerns, but that is no more a lowering of the bar than the recent reconsideration of merger remedies has resulted in a raising of the bar.

In reality, the vast number of mergers raising competitive problems are resolved through consent orders that include a wide variety of approaches to relief. In most cases, structural relief involving divestiture of an ongoing business is required. In many cases, a partial divestiture is appropriate, often because it is clear that the acquiring firm has sufficient assets to replicate the efficiencies of the acquired firm and fully restore competition. In other cases, even more refined relief, such as behavioral relief or licensing arrangements, may be used. Again, cases of more limited relief will require a careful assessment of whether the relief can fully restore competition.

One illustration of the Commission's flexible approach is its evaluation of the merger between Ciba and Sandoz. Although divestiture is the "preferred remedy," that does not mean it will be invariably used, especially where it might diminish procompetitive aspects of a merger. This can be a tough issue, particularly in high-technology markets where research and development rights and scientists work together on a number of projects. In the Ciba/Sandoz merger, the Commission chose licensing over divestiture because of the problems of separating ongoing R&D projects.[14] Commissioner Azcuenaga

dissented as to the licensing aspect of this order, noting that divestiture would cure the anticompetitive problem in a "simple, complete, and easily reviewable" manner. While divestiture is certainly an easier remedy to impose and monitor, it may not always be the most effective way of restoring competition. Because licensing is more flexible and can more easily be tailored to unusual fact situations, it may be the preferred remedy in innovation cases where divestiture could interrupt potentially successful research efforts. In this case, the majority of the Commission determined that the gene therapy research efforts, which contained a number of joint efforts with third parties, would be too difficult to disentangle from the merging firms, and would thus "not only ... hamper efficiency but also could be less effective in restoring competition if it led to coordinated interaction or left the divested business at the mercy of the merged firm."[15]

Another consideration to keep in mind is that many mergers are taking place in a changing market environment. As noted earlier, many mergers we review are large and complex, they involve strategic combinations of businesses, and they may involve new forms of competition. Complex cases are difficult to resolve, and we must be careful that the remedy we accept really will do the job. Not surprisingly, parties are presenting the Commission with proposed orders that are increasingly complex and regulatory. As Chairman Pitofsky has observed, our recent experience is that parties are often presenting "proposals that are so extensive and complex that it is impossible to predict with any confidence that competition will be restored and consumer welfare protected."[16]

That said, our approach to merger remedies may affect the resolution of particular cases. Compared to the practice in the late 1980s and early 1990s, we are somewhat more careful in the use of non-structural and partial structural relief. During the mid and later 1990s, the Commission was faced with a number of cases in which the parties proposed relief short of divestiture that was simply insufficient to remedy the competitive problem. The nature of the competitive problem has a lot to do with whether there is an acceptable fix. Some of the mergers during the last few years presented new competitive issues that were not easy to fix, short of blocking the merger. Others posed particularly complex issues of relief. Here are some examples of these types of situations.

**partial divestiture of the overlapping assets**

Often the competitive problems from a merger can be resolved through the divestiture of some assets in overlapping markets. This is frequently the approach in retail markets where we require divestiture of all the stores in markets where there are overlaps and significant levels of concentration. For example, in Exxon/Mobil we required the divestiture of all gasoline stations from Virginia to Maine to ensure that there was no increase in concentration in northeastern gasoline retail markets. This "clean sweep" approach resolved the competitive concerns in those markets.

**Drug wholesalers**

Sometimes, such an approach will not be sufficient, especially where competition is not solely local. For example, in the drug wholesalers cases, *FTC v. Cardinal Health, Inc.* and *FTC v. McKesson Corp.*,[17] the FTC challenged two mergers of the four largest drug wholesalers. As anyone who followed the trial knows, the court explored every opportunity with the parties to find a settlement that could permit the proposed mergers to go forward. The parties suggested that a divestiture of several drug wholesale distribution centers in the Northwest, where there were clear overlaps, would be sufficient to restore competition. As the FTC told the court, that divestiture would have been severely inadequate because, in the FTC's view, customers demanded firms that could provide national service and divestiture of a handful of distribution centers could not compensate for the loss of two national competitors that would have resulted from the proposed transactions. The court found that regional firms did not offer the same level of competitive restraint as the national firms. Thus, the proposed settlement was appropriately rejected and the court issued a preliminary injunction.

**Rite Aid/Revco**

Rite Aid's proposed 1995 acquisition of Revco would have resulted in a single pharmacy chain of over 5,000 stores. In thirty MSAs in twelve Midwestern states, the firm would have had over a 35 percent market share, and in most of these

markets it would have been more than twice as large as its closet rival. Rite Aid proposed to divest some stores where there was an immediate geographic overlap. Had we been concerned only about those retail overlaps, we might have been able to reach a satisfactory resolution. In previous cases where the relevant market was viewed as direct retail sales to consumers, the Commission had agreed to accept divestitures in towns where the firms had immediate overlaps.

Although that remedy might have been satisfactory in the past it was not in this case because the markets had evolved. The competitive problem was not simply the elimination of competition in direct retail sales to consumers but also in a parallel market, the provision of network pharmacy services to pharmaceutical benefit managers ("PBMs") and other managed care providers. These firms use networks of pharmacies to deliver pharmaceutical benefits to consumers. From the perspective of these PBMs it was necessary to form a network of pharmacies in geographically diverse locations. Rite Aid and Revco were direct competitors in providing PBMs with a suitable network, and they often competed to be the "anchor" of the managed care network.

The nature of the competitive concern complicated the remedy issue; it was more difficult to make the divestitures necessary to replace a network than it was to eliminate some local overlaps through the divestiture of a few stores. The proposed divestitures offered by Rite Aid would have eliminated the direct local overlaps, but were simply insufficient for an acquirer of those assets to fully restore competition in this managed care market. Ultimately, the Commission refused the proposed divestiture and authorized staff to seek an injunction. Rite Aid dropped the acquisition, and Revco was acquired by CVS, which currently competes aggressively with Rite Aid in the markets where competitive concerns were raised.

**Mediq/UHS**

Mediq and UHS are the two largest firms in the country that rent durable, movable medical equipment--such as respiratory devices, infusion devices, and monitoring devices--to hospitals on an "as-needed," short-term basis. Much of the contracting for durable medical equipment is done on a national basis, and hospital chains and group purchasing arrangements require a national network for this equipment. Mediq Inc.'s proposed acquisition of Universal Hospital Services ("UHS") in 1997 would have given Mediq a near monopoly in the national market, and a near monopoly in numerous local geographic markets as well. Competitive concerns were heightened because earlier acquisitions by Mediq had led to higher prices.

In an attempt to forestall litigation, the parties presented a purported "fix-it-first" solution involving Medical Specialties, a firm in the business of renting infusion pumps to home healthcare customers. The parties proposed to sell rental equipment to Medical Specialties and provide it with an option to lease several facilities. Our assessment--and that of customers--was that Medical Specialties would not have been an adequate replacement for UHS. The new firm would have had a substantially smaller inventory than UHS, which itself was considerably smaller than Mediq. Customers--particularly national ones, like hospital buying groups--testified that Medical Specialties would not have the amount and breadth of equipment necessary to replace UHS. Moreover, much of the business that Medical Specialties claimed it needed in order to compete successfully in the hospital rental market was under long-term exclusive contracts with UHS and MEDIQ.

The Commission found the proposed relief inadequate and authorized the staff to seek a preliminary injunction.[18] The defendants attempted to short-circuit the litigation by asking Judge Sporkin to approve the proposed settlement, but the judge was unwilling to second-guess the FTC. On the eve of the preliminary injunction hearing, the parties dropped the proposed acquisition.[19]

**behavioral relief**

Of course, behavioral relief is typically a less satisfactory solution than structural relief, since it often involves some sort of ongoing regulation. But that does not mean that it is never used. In appropriate cases, the Commission has used behavioral relief such as firewalls and nondiscrimination provisions, particularly to remedy vertical concerns. For example, in the Time Warner/ Turner transaction, the Commission approved the merger based on a wide variety of behavioral rules. In other cases, a behavioral approach may be inadequate.[20]

**Questar/Kern River**

The proposed Questar/Kern River transaction in 1995 involved a situation in which a monopolist sought to acquire a 50 percent ownership interest in a firm that was on the verge of entering its market. Questar was the only transporter of natural gas to the Salt Lake City area, and Kern River Transmission Corp. had a gas pipeline that ran past Salt Lake to points further west. Kern River, which was jointly owned by Tenneco and Williams, planned to build a lateral pipeline to serve Salt Lake customers as well. The focus of the case was on transportation service to industrial customers, which could bypass the local utility and purchase gas directly from suppliers and pay separately to have it transported to their facility. Kern River had begun to solicit customers and was already having an effect on the market. Because of Kern River's marketing efforts, Questar sought and obtained a tariff to lower its rates to certain industrial customers, to persuade them not to switch to Kern River. Questar then sought to acquire Tenneco's 50 percent interest in Kern River, with the other 50 percent to be retained by the Williams Companies. The transaction obviously raised concerns because it would eliminate the current price effect of Kern River's presence in the market and prevent future competition and the erosion of Questar's monopoly.

Questar proposed what was in effect a competitive rules joint venture in which it would be permitted to have a 50 percent interest in the Kern River pipeline but Williams would have a large degree of independence on its decisions where to enter. There were several problems with the proposal. First, the agreement undermined Questar's incentives to discount on its own pipeline since it had a 50 percent interest in its only competitor. Questar's 50 percent interest in Kern River would have diminished its incentives to engage in unfettered competition with Kern River; even if Questar lost a bid, it would still have a big share of the business through its interest in Kern River, so it was less likely to bid aggressively. Second, Kern River shipped all the way to California, and the remedy would not diminish Questar's incentives or ability to direct Kern River's capacity away from Salt Lake City. Third, although the "competitive rules" had a "capital forcing" mechanism in which Williams theoretically could have secured Questar's commitment for capital expansion projects, it was unclear this mechanism could work. The Bureau rejected the remedy as inadequate and too regulatory. The Commission authorized a preliminary injunction action, and Questar abandoned the transaction.[21] Ultimately, Tenneco sold its share of the pipeline to Williams, which competes aggressively with Questar today.

**Barnes & Noble/Ingram**

Barnes & Noble's 1999 attempt to buy Ingram Book Group raised a different set of issues. Barnes and Noble is the largest book retailer, and Ingram is the largest wholesaler of books in the United States. Thus, it was largely a vertical transaction.[22]

The transaction raised concerns principally under the "raising rivals cost" theory. The Bureau was concerned that the acquisition of an important upstream supplier such as Ingram might enable Barnes & Noble to raise the costs of its bookselling rivals, such as independent book retailers or Internet retailers, by foreclosing access to Ingram's books and services or denying access on competitive terms. The rivals would be less able to compete, and Barnes & Noble could increase its profits at the retail level or prevent its profits from being eroded as a result of competition from new business forms such as Internet retailing. We were concerned that the combined Barnes & Noble/Ingram could do that in a number of ways, including strategies short of an outright refusal to sell to the non-Barnes & Noble bookstores. For example, Barnes & Noble/Ingram could choose to (1) sell to non-Barnes & Noble bookstores at higher prices, (2) slow down book shipments to rivals, (3) restrict access to hot titles, (4) restrict access to Ingram's extended inventory or back list, or (5) price services higher or discontinue or reduce these services.

The parties did not present a complete settlement proposal, which makes a discussion of remedies hypothetical. There were reasons to be skeptical that the deal could have been fixed. The nature of the competitive problem would have made it very difficult to address from a remedy standpoint. Structural relief would seem to require the creation of a substitute for Ingram, but that didn't seem to be a realistic possibility. The only remedy that might have addressed the situation is a set of behavioral rules--essentially, a set of non-discrimination or "fair dealing" provisions. But those kinds of rules can be

problematic. They are susceptible to evasion and difficult to monitor, particularly in a transactional setting where discrimination could be exercised in subtle ways on several different variables. While the Commission has on occasion accepted some forms of behavioral relief in mergers, those approaches may not have worked in this context. Recall the Supreme Court's admonition in *DuPont* that "the public interest should not in this case be required to depend upon the often cumbersome and time-consuming injunctive remedy" to enforce behavioral rules.[23]

Another concern about the merger was that Barnes & Noble could use Ingram to obtain competitively sensitive information about its bookselling rivals. Independent booksellers raised concerns about two types of information they provide to Ingram in the course of their supplier-customer relationship: the financial information they supply to obtain credit, and the titles and quantities of books they purchase from Ingram. Barnes & Noble might use this information for such purposes as targeting promising store locations, identifying competitors' weaknesses, and reaping the fruits of others' marketing efforts. Whether or not the fears were realistic, the fact that they were out there could have had its own dampening effect on competition. For example, independents may have less incentive to develop a market for special interest books if they believe Barnes & Noble would simply free-ride on their efforts, or might have returned their usage of Ingram and been forced to rely on other higher cost book wholesalers.

This concern has been addressed in other cases by obtaining a remedy commonly called a "firewall." Could a firewall work effectively in this case? Most of the cases in which a firewall has been used are situations, such as defense mergers, where there is a regulator which can identify violations of the firewall.[24] Even if a firewall could address the information access problem, there was the discriminatory access problem discussed earlier. In the end, we did not have to decide these rem issues--there was no proposal on the table--but it would have been difficult to find a satisfactory solution. The parties chose to abandon the transaction following press reports that Bureau staff would recommend a preliminary injunction.[25]

**divestiture of an ongoing business**

Divestiture of an entire business will usually resolve the FTC's competitive concerns, since there will be some evidence that the business unit has operated effectively and efficiently. But that will not always be the case, as illustrated by the review of the Ahold/Pathmark merger.

**Ahold/Pathmark**

Last year, Ahold, the fourth largest supermarket in the United States with over 1,000 supermarkets in fifteen states, attempted to acquire Pathmark stores, a regional supermarket chain of 135 stores in metropolitan New York, Philadelphia, and New Jersey. The acquisition was valued at approximately $1.75 billion. Unlike most of the supermarket mergers the Commission had reviewed over the past several years, this deal involved a much more dramatic and clear geographic overlap. Previous supermarket mergers were resolved through consent agreements primarily because the acquisitions enabled the acquiring firm to gain entry into new markets that did not pose competitive problems, and the limited overlap areas that in fact did present competitive problems were resolved through divestitures. The competitive concerns raised by the Ahold/Pathmark transaction were much more serious. Ahold was acquiring a supermarket chain that competed head-to-head with Edwards, a chain that Ahold already operated in the same geographic areas. This was not a geographic extension merger, but rather the elimination of a direct competitor.

The parties' initial proposal of relatively modest divestitures of individual stores in various overlap markets did not meet the standards of recent consent orders in the industry. Based on our concerns from prior supermarket mergers, we typically require divestiture of a single chain's stores to an up-front buyer to resolve competitive concerns. In almost all cases, we require a "zero delta" approach. That is, we require divestiture of a sufficient number of stores to maintain competition at the pre-merger level.

The parties eventually proposed to divest all of the Edwards stores. While that would eliminate the competitive overlap at least nominally--i.e., zero delta--a serious question remained whether a suitable purchaser existed that would fully restore

competition. Edwards was a strong rival to Pathmark to no small degree because it was funded by a much larger parent organization, Ahold. Many efficiencies of being part of Ahold would have been lost if Edwards was divested to a smaller rival. Our assessment was that divesting the entire Edwards chain still might not be sufficient to adequately restore competition because another firm might not be able to provide the level of support necessary to keep this same level of rivalry.

We insisted on a high probability of success in the Ahold/Pathmark matter because there is some sense that many of the divestitures in our supermarket merger orders do not succeed. In retail markets, a chain's assets consist of far more than just the individual stores and the fixtures inside (assets that clearly can be divested). Customer and supplier relationships are critical assets that cannot be conveyed in a divestiture. Thus, even where large numbers of stores have been divested, if the stores are not an entire ongoing business, frequently they do not succeed.

**mix-and-match approach**

Sometimes parties will offer to divest a combination of assets selected from both of the merging firms. This mix-and-match approach requires a more careful review by the agencies than the divestiture of a single firm's business, because the agencies must determine whether the mixed assets can function effectively as an ongoing business. The agencies also must determine whether the mixed assets will be capable of producing comparable efficiencies and economies of scale and scope as the acquired firm. Merging parties must recognize that this type of evaluation will delay the merger review process, and take that into account in their merger planning. The Commission has accepted a mix-and- match approach in some cases, such as the Albertsons/American Stores merger, where the divestiture included stores from both firms.[26] In other cases, such as BP/ARCO, a mix-and-match approach was rejected because the proposed divestiture could not have replicated the competitive significance of the acquired firm.

**Federal-Mogul/T&N plc**

The merger between Federal-Mogul and T&N plc[27] is an example of why a mix-and-match approach may not work. Both firms were leading producers of a wide range of automotive parts in Europe and the United States, and the merged firm would have accounted for 80 percent of sales in the worldwide market for thin-wall bearings used in car, truck, and heavy equipment engines. The merger was investigated by multiple jurisdictions. Rather than offering to divest an ongoing business unit, the parties initially proposed to divest a package of assets from both Federal-Mogul and T&N, in both Europe and the United States; they even presented an up-front buyer. Upon close examination, this offer, while substantial, was found wanting. The divestiture package included some of the parties' least efficient production facilities. More important, the offered insufficient research and development assets. We concluded that the up-front buyer's ability to maintain competition in the United States with these assets was questionable at best. We ultimately obtained the divestiture of T&N's entire thin-wall bearings business, which consisted of the assets and plants that T&N used to make thin-wall bearings, as well as the assets, including intellectual property, that T&N used to develop and design new bearings to meet the bearings needs of engines that OEMs will develop in the future. The assets were ultimately divested to the Dana Corporation.

**ongoing relationships between merged firm and acquirer of the divested assets**

Many of our consents require ongoing relationships between the merged firm and the acquirer of the divested assets. Often ongoing relationships will be required, especially in pharmaceutical cases, where the acquirer has to undertake a regulatory approval process and may need an interim source of supply during that period. Although the Divestiture Report observes that these relationships can be problematic, often they are successful. The Abbott/Alza merger illustrates where ongoing relationships may raise concerns.

**Abbott/ALZA**

Many of the FTC's recent enforcement actions have involved pharmaceutical markets. Last fall, it reviewed the proposed acquisition of ALZA Corporation by Abbott Laboratories. The investigation revealed that the proposed merger would lead to serious anticompetitive effects in the market for palliative hormone drug treatment for advanced prostate cancer. At the time of the proposed merger, Abbott already had an 80 percent market share in a two-firm market. ALZA was not yet in the market but was poised to enter within a relatively short period of time, and the investigation confirmed that ALZA would provide vigorous competition when it entered. ALZA was planning to enter with an innovative delivery mechanism providing longer drug deliveries for patients.

Over the course of the investigation the parties presented several settlement proposals that involved selling various assets related to Viadur, ALZA's product, which was still in development, to another pharmaceutical company. The staff had serious concerns about competition being restored based on this arrangement for several reasons. First, the completion and commercial scale-up of Viadur would depend upon the research and development know-how associated with individuals from throughout ALZA's organization for several years as Viadur and its manufacturing processes are optimized and made most efficient. Ascertaining the necessary ALZA individuals was impossible before the product or process variables are known. Second, the acquiring party was a pharmaceutical company that was not in the business of developing innovative drug delivery systems the way ALZA is; the potential acquirer had experience transferring technology associated with ongoing pharmaceutical businesses, not those still in development. Third, the acquirer would have taken several years to be approved by the FDA at its own facility after trying to replicate facilities and processes of Abbott/ALZA's that are not yet even in place, and would have been dependent upon Abbott/ALZA's supplying the product for several years after it completed the development and commercial scale-up process. With Abbott controlling 80 percent of the market, and having such a critical role in the success of any buyer of the assets, it was uncertain whether any divestiture could effectively work. In addition, the length of the supply contract, which would have had to be more than two years, posed significant competitive concerns.

An alternative upon which the acquisition might have been approved would have been for Abbott to divest its own cancer product. That could have resulted in something that resembled the pre-acquisition state of the market. Because this was not a viable option for Abbott, the transaction was terminated by the parties.

## potential competition mergers

Increasingly, the elimination of potential competition is a concern in mergers, especially in telecommunications, energy, and grocery markets. In many cases, where the scope of potential competition is relatively modest, divestiture may be sufficient relief. For example, competitive concerns in several supermarket mergers have been resolved through the divestiture of various land sites that were purchased in order to enter new markets. In other cases, where the scope of potential competition is far more substantial, divestiture may be inadequate as illustrated by the Staples/Office Depot merger.

### Staples/Office Depot

Staples' proposed acquisition of Office Depot in 1997 involved the two largest office supply superstore chains in the United States. In many geographic markets, the merger would have resulted in a monopoly, and at most there was only one other superstore competitor, Office Max. The parties sharply disputed that office supply superstores were a relevant market, but suffice it to say that the district court ultimately agreed with us. As with the Rite Aid/Revco merger, the parties offered to divest stores in local markets where they had direct overlaps; they proposed a divestiture of sixty-three stores, primarily in merger to monopoly markets.

There were two problems with the proposed solution. First, it did not address a significant potential competition issue. Both Staples and Office Depot had been rapidly expanding into each others' geographic markets where they did not already have a store. The evidence in the case clearly showed that prices were lower in markets where there were two competing superstores, rather than a single superstore, and lower still in markets where there were three superstore competitors. The

merger would have eliminated the likelihood of lower prices as Staples and Office Depot continued to invade the other's backyard, and the proposed divestitures did nothing to cure that.

The second problem with the parties' proposed remedy was that the most likely purchaser of the divested stores probably was Office Max, which was already in the market and could provide a basis for achieving reasonable scale economies. But a divestiture to Office Max would result in a duopoly in the overlap markets. It was clearly better to have three competitors than two. Consequently, the Commission rejected the proposed divestitures[28] and sought a preliminary injunction, which the court granted.[29]

The enforcement action has clearly led to substantial benefits to consumers. Both Staples and Office Depot have expanded at a rapid rate, and within three years after the merger was abandoned each firm has surpassed the size that the merged Staples/Office Depot would have achieved. Both firms are competing aggressively, invading each other's markets and driving prices down to levels not even seen before the merger was proposed. Both firms compete aggressively on the Internet, where Office Depot is the clear leader.

**coordinated interaction**

As markets are becoming more concentrated, there are increasing concerns over mergers that may enhance the ability of firms to engage in coordinated interaction. Almost invariably these mergers are resolved through significant divestitures, typically of ongoing businesses. But where there is no acquirer with the incentives and ability to fully restore competition, even a substantial divestiture may be insufficient.

**DuPont/ICI**

DuPont's proposed acquisition of the Tioxide division of Imperial Chemical Industries in 1998 was structured in a way that sought to avoid antitrust problems, but in our view it fell short of a satisfactory solution. DuPont was the leading supplier both in the United States and the world of titanium dioxide ("$TiO_2$") pigments, which are used in paints, plastics, paper, inks, and other products to provide whiteness, enhance brightness, and improve opacity. ICI was the second-largest supplier in the world, with plants located both in the United States and abroad. The deal was structured so that DuPont would acquire ICI's $TiO_2$ facilities outside North America, and NL Industries, another competitor, would acquire ICI's $TiO_2$ assets in the United States.

The DuPont/ICI transaction therefore avoided a production overlap in North America. But it did not avoid a *competitive* overlap, because ICI also was a significant importer of $TiO_2$ into the United States, especially for use in plastics and architectural coatings. In fact, imports accounted for a majority of ICI's sales to North American customers. ICI was also developing new sulfate-based $TiO_2$ products to compete with DuPont's chloride-based products. Consequently, the acquisition would still give DuPont control over a very substantial percentage of the supply of $TiO_2$ for North American customers. Our concern was that the elimination of an important import competitor like ICI could facilitate or increase the likelihood of coordinated behavior.[30]

DuPont tried to address our concerns by proposing a supplemental basket of other arrangements: It would exclude from its acquisition one of ICI's European plants, which instead would be acquired by NL Industries; DuPont would supply $TiO_2$ products to NL for two years; DuPont would not compete against NL for North American customers by sourcing them from plants acquired from ICI; and DuPont would divest ICI's North American customer lists, current contracts, and customer information. There were several problems with these proposals--the plant that DuPont proposed not to acquire was a relatively minor supplier to North America, and the non-competition agreement would be an oddity for an antitrust order--but the most critical deficiency was that the proposal did not address the elimination of a competitor that stood in the way of coordinated behavior. The parties abandoned the transaction in January 1999.

## an observation about these actions

Occasionally, some people question whether mergers should be challenged in court, because they expect that once a firm is "on the block" its days are numbered and it will inevitably cease to be a competitive force. That observation is not supported by the cases discussed in this article. In the ten cases in which the FTC authorized an injunction action, in only one case--Rite Aid/Revco--did the target of the acquisition cease to be an independent competitor.[31] In none of the other cases, have any of the firms exited from the market--they continue to be direct competitors.

## going forward

Having described in detail which proposed remedies the Bureau did not find acceptable in some recent cases, let us describe the basic contours of the Bureau's approach to remedies:

- The divestiture of an ongoing business is strongly preferred over more limited forms of divestiture;
- The use of up-front buyers is critical in making sure that a divestiture package is adequate;
- We appropriately have a healthy dose of skepticism about proposals that seek to "mix and match" assets from the two firms;
- Often we won't have sufficient expertise to determine how the divestiture of specific assets will work, and so we will need the assistance of interim trustees; interim trustees will also play a vital role in making sure the acquirer can seek and secure necessary regulatory approvals; and
- Other forms of relief, such as hold separate orders, will also play an important role.

We welcome your views on these or any other issues involving merger remedies.

**Endnotes:**

1. Sandra Sugawara, *Merger Wave Accelerated in '99; Economy, Internet Driving Acquisitions,* Wash. Post, Dec. 31, 1999, at E01.

2. For a more elaborate discussion of many of these factors, see Robert Pitofsky, *The Nature and Limits of Restructuring in Merger Review*, Prepared Remarks before Cutting Edge Antitrust Conference (Feb. 17, 2000).

3. FTC v. Ruberoid Co., 343 U.S. 470, 473 (1952). Courts have long and consistently held that the Commission's authority to enforce Section 7 includes the ability to condition approval of a merger on the parties' divestiture of certain assets or interests, either by negotiating a consent decree or through litigation. *See, e.g.*, Lieberman v. FTC, 771 F.2d 32, 34 (2d Cir. 1985); Yamaha Motor Co. v. FTC, 657 F.2d 971, 984-85 (8th Cir. 1981), *cert. denied*, 456 U.S. 915 (1982); United States v. Beatrice Foods Co., 493 F.2d 1259, 1273 (8th Cir. 1974), *cert. denied*, 420 U.S. 961 (1975).

4. United States v. E.I. du Pont de Nemours & Co., 366 U.S. 316, 326 (1961).

5. 366 U.S. at 330-31. *See also* California v. American Stores Co., 495 U.S. 271, 285 (1990) (divestiture is "the remedy best suited to redress the ills of an anticompetitive merger"); Ford Motor Co. v. United States, 405 U.S. 562, 573 (1972) (divestiture is "particularly appropriate" in merger cases).

6. 366 U.S. at 334.

7. *Id.* at 330.

8. 113 F.T.C. 400, 619 (1991), *aff'd*, Olin Corp. v. FTC, 986 F.2d 1295 (9th Cir. 1993), *cert. denied*, 510 S. Ct. 1110 (1994).

9. *See* K. Elzinga, *The Antimerger Laws: Pyrrhic Victories?*, 12 J.L. & Econ. 43, 65 (1969).

10. General Motors Corp., 103 F.T.C. 374 (1984)

11. Federal Trade Comm'n, *A Study of the Commission's Divestiture Process* (1999), *available at* www.ftc.go v/os/1999/9908/ind ex.htm#6.

12. Schnucks was required to divest 24 supermarkets in the St. Louis area as a result of its 1995 acquisition of National Food Markets and was subject to an asset maintenance agreement pending divestiture. As soon as it closed on the National Foods acquisition, it began treating the divested stores as second class citizens. It closed departments, failed to keep others adequately stocked and staffed, unlisted store phone numbers, and referred customers to Schnucks stores that were not being divested. During the year it had to sell the stores, the sales for those stores declined approximately 35%.

For further discussion of the Schnucks case and other supermarket mergers, see David A. Balto, *Supermarket Merger Enforcement*, Antitrust Rep., Aug. 1999, at 2.

13. FTC v. Schnucks Markets, Inc., Civ. No. 01830 (E.D. Mo., filed Sept. 5, 1997).

14. Novartis AG, C-3725 (Apr. 8, 1997) (consent order) (Commissioner Azcuenaga concurring in part and dissenting in part).

15. Statement of Chairman Pitofsky and Commissioners Steiger, Starek, and Varney at 2.

1 __ .obert Pitofsky, *The Nature and Limits of Restructuring in Merger Review*, Prepared Remarks before Cutting Edge Antitrust Conference (Feb. 17, 2000).

17. 12 F. Supp. 2d 34 (D.D.C. 1998).

18. *See* FTC v. Mediq, Inc., Civ.Act. No. 97-1916 (D.D.C. Aug. 22, 1997).

19. FTC Press Release, *Mediq Informs FTC That It Will Abandon Merger With UHS in Face Of Challenge*, Sept. 22, 1997.

20. For a discussion of remedies in vertical merger cases, see Richard G. Parker & David A. Balto, *The Merger Wave: Trends in Merger Enforcement and Litigation*, 55 Bus. Law. 351 (1999).

21. Questar Corp./Kern River Gas Transmission Co., FTC File No. 961 0001 (preliminary injunction action authorized, Dec. 27, 1995); FTC v. Questar Corp., No. 2:95CV 1137S (D. Utah 1995) (transaction abandoned).

22. Although the firms stood principally in a vertical relationship, the transaction also had horizontal implications. At the horizontal level, there were two competitive concerns. First, Barnes & Noble, which had its own distribution centers, could compete directly with Ingram by wholesaling to other bookstores. In fact, Barnes & Noble had announced publicly that it was considering providing wholesale services to other b retailers. Second, Ingram wanted to retain Barnes & Noble as a customer and so offered competitive prices, expanded its range of titles, and improved service. All of Ingram's customers, including independent bookstores, were beneficiaries of this competition, and there were concerns that the acquisition would have eliminated that stimulus to competition.

23. 366 U.S. at 333-34.

24. *E.g.*, Martin Marietta Corp., FTC Dkt. No. C-3500, 117 F.T.C. 1039 (1994); Eli Lilly & Co., FTC Dkt. No. C-3594, 120 F.T.C. 243 (1995).

25. *See, e.g.*, Stephen Labaton, *Staff of FTC Is Said to Oppose Barnes & Noble Bid to Wholesaler*, N.Y. Times, June 1, 1999, at A1, C9; Patrick M. Reilly & John R. Wilke, *FTC Staff to Fight Barnes & Noble Bid for Wholesaler*, Wall St. J., June 1, 1999, at B16.

26. For a description of the Albertsons-- American Stores merger and the mix and match approach, see Balto *supra* note 12.

27. Federal Mogul Corp., No. C-3836 (Dec. 9, 1998).

28. FTC Press Release, *FTC Rejects Proposed Settlement in Staples/Office Depot Merger*, Apr. 4, 1997.

29. FTC v. Staples, Inc., 970 F. Supp. 1066 (D.D.C. 1997).

30. The investigation revealed that ICI had a unique incentive to import substantial quantities of $TiO_2$ into North America, because of the configuration of its extensive European facilities. ICI in fact had demonstrated a commitment to supply U.S. customers during peak demand periods, and it had been attracting increasing sales. Given its incentive to import, ICI was a potential disruptive force in any scheme to coordinate output or prices in North America. By removing that threat, it could become much easier for DuPont and remaining suppliers to engage in coordinated behavior. Concerns about coordinated behavior were sharpened by the presence of a number of factors that generally facilitate collusion--e.g., inelastic demand and substantial information flows between competitors. Firms had considerable knowledge of their competitors' capacity, pricing, and sales to individual U.S. customers. Thus, firms were capable of monitoring pricing and output and detecting cheating. In addition, DuPont already played a strong price leadership role in the industry, with other firms taking their cues from DuPont. The elimination of ICI's import competition could only strengthen that role. Those concerns were heightened by evidence that North America's price declines during slack demand periods already were shallower relative to other regions. FTC staff also were concerned that with a more commanding position wordwide, DuPont would have increased incentives to close some of the capacity acquired from ICI to demonstrate its resolve to promote higher prices and encourage investment restraint by other suppliers.

31. Revco was acquired by another firm.

**Workshop for Adjudicators in Competition Cases**
**Pretoria, South Africa**
**28-30 June 2002**

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**Diane P. Wood** is a Circuit Judge on the United States Court of Appeals for the Seventh Circuit, Chicago, Illinois, and a Senior Lecturer in Law at The University of Chicago Law School, where she teaches in the fields of international economic law and civil procedure. Prior to her appointment in 1995 to the Court, she served from 1993 to 1995 as Deputy Assistant Attorney General in the Antitrust Division of the U.S. Department of Justice, where she was responsible for international antitrust policy and enforcement, as well as for the Division's appellate litigation. From 1981 until 1995, she was a professor at the University of Chicago Law School. In 1990, she was named to the Harold J. and Marion F. Green Professorship in International Legal Studies, becoming the first woman to hold a named chair at the school. She served as Associate Dean of the Law School from 1989 through 1992.

**Sally Van Siclen** has been an economist in the Competition Division of the OECD since 1992. She has provided technical assistance to competition authorities in transition and developing countries, and supported the work of the Competition Committee in the interactions of competition policy with economic regulation and with international trade policy, and the broader work of the OECD in regulatory reform of its Member countries. From 1986 to 1992, she was an economist at the Antitrust Division, U.S. Department of Justice, primarily investigating mergers. She earned a Ph.D. in economics from Princeton University in 1987.

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## Seminar on

# Competition Policy and Regulation: Electricity

## Pretoria, 12-15 November 2002

## Competition Commission of South Africa
## and
## OECD Centre for Co-operation with Non-Members

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**The opinions expressed herein are those of the authors and do not necessarily reflect the views of the U.S. Agency for International Development.**

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**OECD PERSPECTIVES ON COMPETITION POLICY AND REGULATORY REFORM IN THE ELECTRICITY SECTOR**

**LIST OF PARTICIPANTS**



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# AGENDA

# SEMINAR ON COMPETITION POLICY AND REGULATION: ELECTRICITY
# PRETORIA, 12-15 NOVEMBER 2002

## Tuesday, 12 November—Preliminaries for Competition Officials

**9 am-12 pm** **Overview of Economic Regulation**
**--Market failures, regulatory failures, and state-led development**
What does regulation have to achieve?
Efficiency and universal service as objectives

- Cost-based pricing
- Incentive regulation
- Access regulation (a special case)
- Universal service

Who is the regulator?
--Institutional issues

10:30 am Informal discussions/coffee/tea

12-1 pm Lunch

**1-3:30 pm** **The Electricity Sector**
**--What is "special" about electricity?—*Dr. Joseph Crespo, NERA***
The main elements of the system—their functional and economic features
Demand variability
Network operation and system balancing

- Command and control systems
- Market-linked systems

The electricity sector until 20 years ago
Technological change and system reform
Informal discussions/coffee/tea

**3:45-4:15 pm** **Overview of Electricity Reforms Around the World**
**--Successes and failures in reforms**

**4:15-5 pm** **Wrap-up and Conclusion**



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## Wednesday, 13th November

| | |
|---|---|
| **9-9:30 am** | **Welcome Addresses**<br>**Adv. Menzi Simelane, Commissioner, Competition Commission of South Africa**<br>**Mr. Xolani Mkhwanazi, Chief Executive Officer, National Energy Regulator of South Africa**<br><br>Introduction to the seminar—it's structure and objectives |
| **9:30-9:45 am** | **Objectives: Why reform the electricity sector?**<br><br>Informal discussions/coffee/tea<br><br>Introduction to the country presentations |
| **10:00 am–3:30 pm** | **The Electricity Sectors and Reforms in Southern African Development Community Countries**<br>**--presentation of experiences in order to provide the context and challenges which regulation must address**<br>South Africa<br>Zambia<br>Malawi<br>Namibia<br>Mozambique<br>Tanzania |
| 12-1 pm | Lunch<br>Kenya<br>Zimbabwe<br>Lesotho<br>Swaziland<br>Mauritius<br>Informal discussions/coffee/tea |
| **3.30-4.30 pm** | **SADC Electricity Reforms—*Prof. Anton Eberhard*** |
| 4.30-5 pm | Reactions to Country Presentations |

## Thursday, 14th November

| | |
|---|---|
| **9-9.40 am** | **Overall Structure and Governance of the Sector** |
| **9.40-10.20 am** | **Transmission**<br>• Access and control<br>• Natural monopoly regulation<br><br>Informal discussions/coffee/tea |

| | |
|---|---|
| **10:40 am-1:45 pm** | **Likely Competition Problems**<br>• Generation<br>–Microstructure of markets<br>–System operation<br>• Other sources |
| 12-1 pm | Lunch |
| **1.45-2:15 pm** | **Pricing Final Supply** |
| **2:15-3 pm** | **International Trade—*Mr. Morgan Sithole***<br>• Standardisation of contracts<br>• Harmonisation of laws<br><br>Informal discussions/coffee/tea |
| **3.30-5 pm** | **Coordination of Long Term Investments, Private participation—*Mr. Morgan Sithole***<br>• What investors want<br>• What governments want |

## Friday, 15th November

| | |
|---|---|
| **9-10 am** | **Universal Service Obligations**<br><br>Informal discussions/coffee/tea |
| **10.20 am – 12 pm** | **Institutions--Regulators and the Competition Authority**<br>• Independence and governance<br>• Transparency<br>• Flexibility |
| 12-1 pm | Lunch |
| **1-2 pm** | **Sequencing of Reform**<br><br>Informal discussions/coffee/tea |
| **2.30-4.30 pm** | **Wrap-up and Conclusions** |

**KENYA**
**Monopolies and Prices Commission**

## REGULATION OF ELECTRICITY SECTOR IN KENYA

**Paper presented by Benson O. Nyagol**

### Background

The economy of Kenya before and after independence was characterized by direct excessive regulation of commercial and investment activities. The instruments of regulation were provided under several Acts of parliament, namely, Price Control Act, Trade Licensing Act, and Import, Exports and Essential Supplies Act. The following were some salient features contained in the Acts: Fixing of prices of certain goods and services, imports and exports licensing, establishment of import quotas for certain goods, foreign direct investment (FDI) controls, etc.

This rigid and direct control of economic and commercial activities by the central government underwent changes in late 1980's as a result of realization and recognition of the pivotal role played by market-based incentives and structures in enhancing economic efficiency and growth. Consequently, ambitious plans geared towards privatization and deregulation of commercial and economic activities were started. These reform programmes saw many parastatals (public enterprises) such as Kenya Power and Lighting Company and Kenya Post and Telecommunications Company being split up and/or privatized.

It is worth noting that privatization and market-based incentives and structures are not a panacea to economic bottlenecks. If independent commercial decision-makers are given leeway to indulge in unfettered competition, they would resort to concerted decision-making in determining prices, output, territories/customers, or abuse of dominant market positions. These business tendencies spawn results which are not consonant with intended benefits of market economy. Legislative frameworks in the form of competition policy and law and sector-specific regulatory laws are, therefore, prerequisite antidotes to such market distortions to maintain competitive market structures and conduct.

In Kenya, regulations have been removed in areas where they were vigorously applied, however, in areas where regulations have remained appropriate, the methods of regulations have been re-assessed. The electricity sector in Kenya is an example of sectors where regulations have remained but a lot more modified to conform with the prevailing global liberalization, restructuring and privatization programmes.

### Regulation of Electricity Sector

Direct regulation of electric power sector by the central government ended in January, 1998 when the Electric Power Act, promulgated in 1997, became operational. With the promulgation of the 1997 Act, the sector was restructured and subsequently three corporate bodies were established; Kenya Electricity Generation Company- KenGen- (generation), Kenya Power and Lighting Company -KPLC-(distribution) and Electricity Regulatory Board-ERB- (the sector regulator).

The separation of former Kenya Power and Lighting Company was to unbundle monopolies by separating natural monopoly areas (distribution) from functions which could be performed under competition



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(generation). It was also to ensure separation of commercial, regulatory and policy setting functions, with the Ministry of Energy responsible for overall policy formulation in the energy sector.

Through such reforms in the sector, the generation of electricity has been liberalized and consequently, the sector has attracted capital investment through entry of four (4) independent power producers (IPPs). However, the independent power producers account for a negligible share of electric power supply. This leaves KenGen, which is a state corporation, to dominate the generation of electric power sector in Kenya.

The distribution of electricity has remained under absolute monopoly of Kenya power and Lighting Company which is also a state corporation. Although there is a leeway in the provisions of Electricity Power Act, 1997, for the participation of a multiple number of players, no tangible effort has been made towards this end.

**Electricity Regulatory Board; the Sector Regulator**

The Electricity Regulatory Board (ERB) is a body corporate established under the Electric Power Act, 1997 and mandated to regulate the generation, transmission and distribution of electric power in Kenya. The specific functions of the Board are:

- Setting, reviewing and adjusting tariffs for all persons who transmit or distribute electrical energy for sale;
- Investigating tariff structures even when no specific application for a tariff adjustment has been made;
- enforcing environmental and safety regulations in the power sub-sector;
- Investigating complaints made by parties with grievances over any matter that is required to be regulated under the Act;
- Ensuring that there is genuine competition where this is expected; and
- Approving electric power purchase contracts and transmission and distribution service contracts between and among electric power producers[1], public electricity suppliers[2], and large retail customers.

[1]Electric power producer is defined by the Act as " a public or local authority, person or body of persons which owns or operates facilities for generation of electric power for sale to one or more public electricity suppliers or to one or more electric power producers pursuant to a license issued by the Minister".

[2]Public electricity supplier is defined by the Act as " a public or local authority, company, person or body of persons licenced by a distributing licence to distribute or supply electrical energy for any purpose".

The mandate of the Board does not extend to issues relating to policy in the electricity sector, neither does it issue licenses for the generation, transmission and distribution of electric power. These are within the realm of the Minister who directs the board on the same. However, application for a license must be submitted to the Board for consideration before forwarding to the Minister with appropriate recommendations.

Any license issued by the Minister upon recommendation of the Board must clearly state the physical/geographic area of operation and the period for which the license remains valid. License to public electricity suppliers are to be issued for a term not less than 30 years while that for electricity power producers are to be issued for a term not less than 15 years. The license can be revoked by the Minister upon the recommendation by the Board if the Minister is satisfied that the licensee is not operating in accordance with the terms and conditions stipulated in the license.

**Possible Ways of introducing Competition in the Sector**

Vigorous competition can be introduced/encouraged at the stage of generation/production of electricity, since this level can accommodate a multiplicity of players without encountering any substantial technical hitch. The government should, therefore, scout for potential investors with significant financial resources to invest in the generation of electricity. To attract such investors, the government must stipulate vividly its intention to discontinue setting, reviewing or adjusting tariffs at the generation stage once a significant entry has been realized. Liberalism in tariff-setting by the generators will enable them to use tariff rate as an effective competition parameter.

Secondly, KenGen should divest its interests in some generation plants/units which are capable of being run separately as competitive business units without compromising their viability. Such generation plants should be sold out to private investors through a competitive process. This process, too, can only be attractive to other investors if the government asserts its commitment to cease regulating tariffs set by the generators.

The third view is that Kenya Power and lighting company may be fragmented into regional operating monopolies with an unallocated area separating them. Such unallocated areas should always be lucrative or potentially lucrative to avoid remaining unattended. Competition will therefore be realized along the "no man's regions" allowing the Electricity Regulatory Board to compare rates. The compared rates can help the Board to curve a picture of a tariff rate reflective of that in a competitive environment, which can be used to set tariff ceilings in monopolized areas. The imposing of price ceiling is vital because it gives the distributors the incentive to improve on their efficiency (hence reduce costs) and consequently widen the price/rate per unit.

Fourthly, the issuing of license for a period of **not less** than 15 and 30 years for electricity power producers and public electricity suppliers, respectively, may muzzle competitive spirit and should therefore be reviewed. A period of 15 and 30 years may be appropriate, considering the massive capital investment required to put in place a viable business unit in the sector. However, the license should be issued for a period **not more** than the above time span after which the contract must be competitively contested by all interested persons. This will act as a catalyst to the incumbents to be efficient and refrain from any abusive conduct(s) so as to be able to retain the contract upon the expiry of the license.

Another option that can be adopted is allowing interconnection to the electricity infrastructural network of the public electricity suppliers. A regulation should be put in place restraining public electricity suppliers

from imposing unreasonable terms on the sub-contractors due to the latter's dependence on them. This has worked in many countries and may also work in Kenya. The government should therefore make earnest effort to learn from such countries the possibility of its adoption.

**KENYA**
**Electricity Regulatory Board**

## Competition and Regulation of the Electricity Industry in Kenya

### 1. General

Kenya's principal sources of electricity comprise hydro, thermal and geothermal. Figure 1 shows the contribution of the alternative sources of electricity for the 2000/1 interconnected system capacity, while Table 1 shows the annual gross generation by source for the period 1997/8 to 2001/2[3].

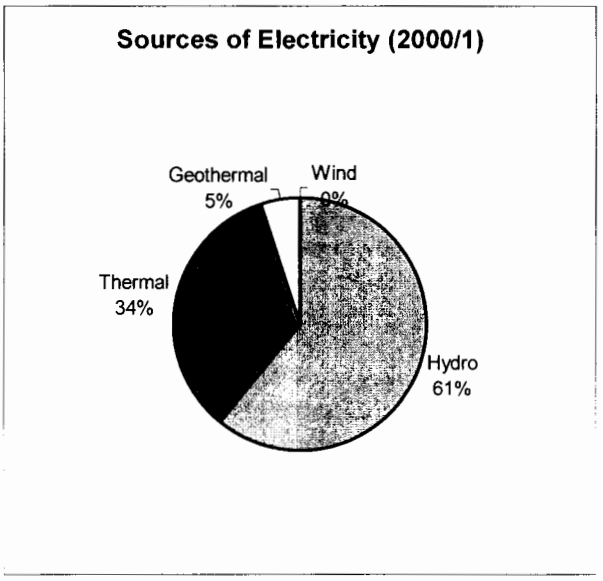


**Figure 1**

[3] 2001/2 are preliminary and have not been audited.



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**Table 1: Gross Generation (GWh) by Source (1997/8-2001/2)**

| Sources | Year | | | | |
|---|---|---|---|---|---|
| | 1997/8 | 1998/9 | 1999/2000 | 2000/1 | 2001/2 |
| Hydro[4] | 3,405 | 3,414 | 2,590 | 1,523 | 2,588 |
| Thermal | 713 | 799 | 1,458 | 2,099 | 1,512 |
| Geothermal | 366 | 390 | 383 | 429 | 459 |
| Wind | 1 | 0 | 0 | 0 | 0 |
| TOTAL | 4,485 | 4,603 | 4,431 | 4,051 | 4,559 |

A significant feature of Table 1 is the wide variation (from 38% to 76%) in contribution by hydro in the generation mix. Accordingly thermal generation also varies (16% to 52%) as system managers attempt to bridge the energy shortfall created by unavailability of hydro usually occasioned by poor hydrological conditions.

In addition to the interconnected system capacity by the principal power stations, there are a number of embedded generating plants mainly in the sugar belt (co-generation using bargasse). Kenya also has 9MW isolated generating capacity providing about 20GWh of energy to the off-grid towns of Garissa, Lamu, Lodwar, Mandera, Marsabit and Moyale.

Once dispatched, electricity is conveyed from the principal generating stations to load centres via transmission and distribution networks.

Kenya's transmission network comprises of 132 and 220 kV systems with total circuit lengths of 2,032 km and 885 km respectively (as at 30 June 2001). For the corresponding period the distribution network comprised 576 km for 66 kV; 126 km for 40 kV; 4,639 km for 33 kV; and 10,397 km for 11 kV. Low voltage supply is at 415/240 volts.

## 2 Competition and Regulation of Kenya's Electricity Industry

Following the restructuring of the electricity industry in Kenya, which started in earnest in 1996, generation was unbundled from dispatch, transmission, and distribution functions with commercial type-relationships governing the trading between the electric power producers and the public electricity suppliers.

The Kenya Power and Lighting Company Limited (KPLC), which is partly owned by the Government of Kenya (GoK), is the only licensed public electricity supplier. In generation, however, there are five licensees namely, the Kenya Generating Company Ltd. (KenGen), which is wholly owned by the GoK and Independent Power Producers (IPPs) namely, Iberafrica (E.A) Power, OrPower 4 Inc., Tsavo Power Company and Westmont Power Kenya Limited.

[4] This includes the non-firm 30MW imports from Uganda

Under current trading arrangements, which set the rules between buyers and sellers of electricity, KPLC is currently the sole public electricity supplier, purchasing electricity in bulk from electric power producers under long-term Power Purchase Agreements (PPAs). This electricity is then dispatched, distributed and supplied to consumers.

In addition, the Electric Power Act, No. 11 of 1997 (the Act) provides for sale of electricity or transmission services between and among electric power producers, public electricity suppliers and large retail consumers[5]. However for purposes of off-grid supplies, the Act provides for local generating licences which allow both generation and distribution of electricity over areas covered by such licences.

The Electricity Regulatory Board (ERB) is responsible for reviewing and approving the electric power purchase contracts and transmission and distribution service contracts between and among electric power producers, public electricity suppliers and large retail customers in accordance with the provisions of the Act.

**Figure 2 shows the current structure of the electricity industry in Kenya.**

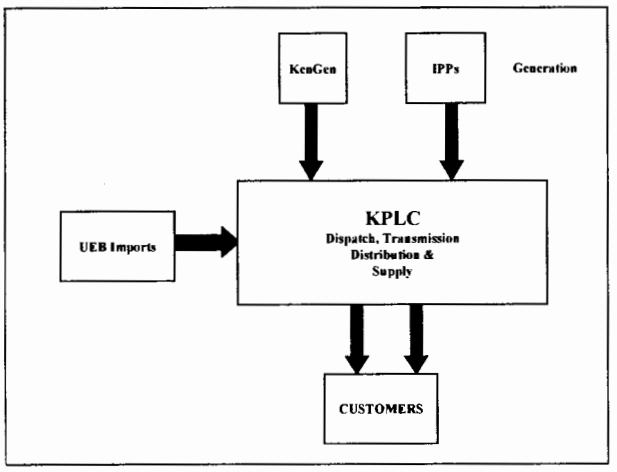


**Figure 2**

ERB is also responsible for ensuring that there is genuine competition in the electricity industry as provided in the Act.

The tools currently used in regulating Kenya's electricity industry comprise the relevant statutes, specifically the Electric Power Act, 1997 and the Restrictive Trade Practices, Monopolies and Price Control Act, 1990 and the licences issued under the Act. Rules and regulations, which are vitally important in the administration of the regulatory process, are in the process of being formulated.

[5] The Act defines a "large retail customer" as a customer that contracts for firm capacity in excess of twenty (20) megawatts per annum for minimum of five years.

### 2.1 Generation

To date ERB has issued generation licences to Tsavo Power Company and OrPower 4 Inc. with respect to their respective operations. KenGen, Iberafrica and Westmont power production licences were issued prior to the establishment of ERB but were validated by Section 131 of the Act which states that, *"Any licence validly issued prior to the commencement of this Act shall be deemed to be a licence issued by the Minister under the provisions of this Act."*

The existence of licences issued prior and after the commencement of the Act, which are materially different, negates the basis for a uniform regulatory environment. ERB is therefore faced with the challenge of harmonising the licences. In this regard, the development of standard licences under an ongoing consultancy to *Draft Regulations, Rules, Procedures, licences and operational guidelines under the Act,* will be a key milestone.

In an electricity system the generation function is recognised as being amenable to competition. The principles of competition regulation should therefore apply. In this type of regulation focus is on ensuring and protecting genuine competition through statutes and rules dictating against anti-competitive behaviour.

In Kenya, however, the interconnected generation system is inherently capacity constrained, which means that for the foreseeable future, certain generators will continue to monopolise sections of the load curve. This limits competition in generation to procurement of capacity.

Cognisant of this situation ERB periodically monitors dispatch in order to ensure that this is in accordance with economic merit order. The main challenge facing ERB therefore is to ensure that mechanism(s) for objective and non-discriminatory dispatch is in place.

### 2.2 Transmission and Distribution

Transmission and distribution businesses, or wires/networks business as it's popularly known are recognised to be natural monopolies. Accordingly, the appropriate regulation model is utility regulation whereby control is achieved through price and quality of service regulation typically articulated through laws, rules, licence conditions and concession agreements.

Presently the Act does not distinguish between the networks business and supply. Instead it provides for a public electricity supply licence in which a licensee would perform the transmission, distribution and supply functions. Although KPLC through its successor company the East African Power & Lighting Co. Ltd has in accordance with Section 131 of the Act valid distribution licences[6] these need redrafting to bring them in line with modern distribution practice.

To date regulation of transmission and distribution is primarily through price control during tariff reviews. The on-going consultancies to *Draft Regulations, Rules, Procedures, Licences and Operational guidelines under the Act* and the *Review of Electricity Tariff Policy in Kenya* will play a significant role in ensuring the creation of a suitable framework for the effective regulation of transmission and distribution functions.

## 2.3 Supply

Like in generation competition in supply is feasible, either at the wholesale or retail level depending on the

[6] Most of the distribution licences were for 50-year periods commencing on or about 1950.



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degree market structure.

Presently Kenya's industry structure confers monopoly to public electricity suppliers in their areas of supply. In the absence of competition in supply and in order to protect customer interest regulation oversight is therefore required. ERB therefore sets retail tariffs and to the extent possible intervenes to ensure that quality of supply and service are improved.

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**MALAWI**
**National Electricity Council**

## COMPETITION AND REGULATION OF THE ELECTRICITY SECTOR IN MALAWI

### 1 The Electricity Supply Industry in Malawi

The electricity supply industry (ESI) in Malawi involves electricity generation by hydro, thermal (largely diesel and gas based) and to a lesser degree solar photovoltaic (PV) systems. Hydropower generation is the largest component. A significant number of commercial and industrial enterprises have also installed their own diesel and petrol powered generation units.

The commercial ESI is dominated by a publicly owned and vertically integrated power utility, the Electricity Supply Corporation of Malawi Ltd (ESCOM), which was established in 1965 by an Act of Parliament. In the year 2000, ESCOM's total installed capacity was estimated at 304 MW. Of this, approximately 285 MW (94%) is generated from hydropower sources and the remaining 19MW (6%) is thermal. ESCOM's generation capacity is located along the Shire River, the main natural outlet for Lake Malawi. This makes Malawi's power generation system highly vulnerable to the vagaries of nature affecting Lake Malawi levels and hence flow rates on the Shire. The commercial generation capacity according to a recent survey by our office is estimated at 51.3 MW. This gives rise to a total national power installed capacity of 355.3 MW, making Malawi's power system relatively very small by regional standards.

Access to electricity in Malawi is very low even by regional standards. Of the country's population of 9.8 million, only around 5% have access to grid electricity. This access rate is made up of 30% for the urban population and 0.5% for the rural population. ESCOM's records show that there are around 140,000 billed electricity customers of whom 78.8% are domestic while only 1% are industrial maximum demand (MD) customers.

Of the total energy sales for ESCOM, MD consumers account for 54% and domestic consumers account for 32%. While this number is very low, the domestic electricity consumption level for Malawi is very high by sub-Saharan African standards, averaging 3,600kWh/year. Peak demand in 2000 was 196.5MW and total consumption was 902GWh. The demand for electricity has been growing at between 6% and 8% a year.

### 2. Issues and Challenges for ESI in Malawi

Challenges that affect the overall efficiency and effectiveness of service delivery in the ESI in Malawi, for ease of assessment could be grouped into technical, financial and environmental.

#### 2.1 Technical Challenges

high technical and non- technical losses, averaging 15% over the last three years;
poor supply reliability, characterised by load shedding and reductions in voltage;
low labour productivity of ESCOM;
a low rate of connection of new consumers;



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poor plant performance, characterised by relatively low availability rates for both the hydro (averaging 86% for the past three years)and thermal plants i.e. poor maintenance and a high incidence of faults on the distribution network (around 40 faults per 100 consumers);
system instability and non-reliability;
poor plant performance;
poor maintenance record; and
non-connectivity of the transmission system to neighbouring countries.

### 2.2 Economic Challenges

a) inadequate investment in all parts of the sector during the 1980's and 1990's and an inability to finance required investments, particularly in distribution;
b) non-payment by large consumers and some government institutions;
inadequate commercial performance by ESCOM;
low-tariff charged at below long run marginal cost (LRMC);
in appropriate tariff system (return on investment instead of incentive based);

### 2.3. Environmental Challenges

(a) environmental degradation of the catchment areas of hydro generation plants and siltation of dams; and
lowering lake levels and intermittent flow rate of Shire river.

## 3. Regulation and Competition of the ESI in Malawi

In order to address the challenges listed above, the Government of Malawi intend to reform the ESI through market restructuring and promotion of private sector participation (PSP). The GoM sees competition and PSP as key components in enhancing ESI efficiency, effectiveness and ensuring that its investment requirements are met within the industry without recourse to the GoM budget. Market restructuring of the ESI is required to allow competition and the private sector to play their full role in the development of the ESI.

The GoM has reviewed the different options for the introduction of competition into the various parts of the ESI. These include:

competition in the generation market through a power pool;

competition for the provision of new capacity (such as independent power producers (IPPs)); and

competition for the provision of certain services at the retail level, such as billing and collection based on the letting of short term franchises.

The ESI reforms for the immediate future build on those introduced in 1998 with the passing of the Electricity Act, 1998 and the resultant corporatisation of ESCOM which led to its registration as a limited liability company.

The Electricity Act 1998 liberalised the ESI by introducing the separate licensing of generation, transmission, and distribution, and permitting private sector participation in all parts of the industry under an independent regulator, The National Electricity Council. It also allowed ESCOM Ltd to be operated on

the basis of Business Units (BU) in generation, transmission and distribution. Under this arrangement a total of five (5) BUs were established, namely: 1 x generation, 1 x transmission, 3 x distribution (i.e. North, Centre and South).

The proposed Energy policy statement for Malawi, lays down the framework for consolidating these changes and introducing additional reforms that are deemed necessary to promote competition and effective PSP.

The proposed reforms are founded on two positions. First that the reforms of 1998 did not go far enough to trigger the necessary results. Up until today there is no single IPP or IPD that has registered as a result of these reforms. Secondly, GoM takes the position that a vertically integrated ESI is not conducive to competition and would not encourage PSP. This makes it imperative that the sector be vertically separated into its natural components of Generation, Transmission and Distribution markets, and in the medium term arrangements be made for the implementation of horizontal separations where necessary.

Since there are significant quantities of own-generating capacity in Malawi and in order to encourage competition and ensure that electricity demand is met at least cost, the reforms will permit third party access to the grid. A cost reflective and non-discriminative tariff will be developed to encourage own-generators and others to sell energy to the Transmission Operator. The tariff will be subject to review and approval by the National Electricity Council.

In addition to these policy interventions, the GOM passed the Competition and Fair Trading Act in December 1998 which encourages competition in the economy by prohibiting anti-competitive trade practices and the establishment of the Competition and Fair Trading Commission to regulate and monitor monopolies in all the sectors of the economy including the ESI. The Commission has wide functions including carrying out investigations to determine whether any enterprise is carrying on anti-competition trade practises or unfair trading practises. The Commission has not yet been established.

**MAURITIUS**
**Ministry of Commerce & Co-operatives**

## Competition and regulation of the Electricity sector in Mauritius.

The supply of Electricity is regulated in Mauritius, i.e any authority, company or person has to be authorised to supply electricity for public and private purposes. The Central Electricity Board (CEB), a para -statal body under the aegis of the Ministry of Public Utilities is the sole institution responsible for the control and development of electricity supplies in Mauritius. It is also responsible for sale of electricity for public and private purposes.

During the year 2000, the total electricity generated was 1,564 GWh – 61.6 % of which were produced by the CEB and the remaining 38.4% by the Independent Power Producers (IPP) i.e sugar factories as detailed hereunder:

| | Gwh | % of Total |
|---|---|---|
| **CEB** | | |
| *Thermal Diesel/Gas turbine* | 868.46 | 55.50 |
| *Hydro* | 95.25 | 6.10 |
| **Independent Power Producers** | | |
| *Bagasse / Coal* | 493.29 | 31.50 |
| *Other S.E Bagasse/Hydro* | 107.90 | 6.90 |
| **Total** | **1564.90** | **100.00** |

➢ The Centrale Thermique de Belle Vue Ltee (CTBV) produced 231 GWH from coal and bagasse, , that is 14.79% of total production. The two other private power producers, namely FUEL Steam and Power Generation Co.Ltd and consolidated Energy Ltd produced 164 GWh (10.5%) and 97 GWh ( 6.2 %) respectively.

➢ Electricity consumption rose by 10.51% to reach 1 358 GWh in the year 2000 compared to an increase of 4.49% the preceding year. The number of customers at the end of the year totaled 313 963 compared to 304 029 at the end of 1999, i.e an increase of 3%.

➢ Two power stations namely the Centrale Thermique de Belle Vue and Fort George have the potential of generating up to 50% of expected generating requirement up to horizon 2009 and constitute an interesting power generation technology mix from the economic and technical standpoint. The installation at Belle Vue should pave the way to the implementation of similar coal/bagasse power generating stations in the south and west regions of the country.



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- In the year 2000,the Government of Mauritius took the decision to abolish the Value Added Tax (VAT) introduced in July 1999 and the rates were consequently revised.

- As regards use of renewable sources of energy, the CEB is in the process of identifying two ideal sites for the installation of new energy converters with lowering and anchoring facilities within a short period at the approach of cyclones.

- It is clear that there is no monopoly in the production of electricity in Mauritius. With the coming into operation of the other independent power producers, the share of electricity produced by the CEB will continue to decline.

- Electricity services have been excluded from the new Competition Bill which is to be enacted soon.

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**MOZAMBIQUE**
**National Directorate of Energy**

## COMPETITION AND REGULATION OF ELECTRICITY SECTOR IN MOZAMBIQUE

Mozambique has a population of 18 million, Gross Domestic Product (GDP) of USD 3.9 billion and Per Capita income of USD 90, making it one of the poorest countries in the world.

The country is, however, well endowed with a rich and diversified energy resources base sufficient to meet both local demand and contributing to large-scale energy exports, including hydropower, natural gas, coal and biomass.

The electricity supply industry in Mozambique includes the following key players:

- Electricidade de Mocambique (EDM), the national public vertically integrated company being involved in both generation, transmission, distribution and sale of electricity;
- Hidroeléctrica de Cahora Bassa (HCB), a joint venture company between the Governments of Portugal and Mozambique, which owns and operates the Cahora Basa Scheme;
- Mozambique Transmission Company (MOTRACO), a joint venture between EDM, ESKOM South Africa and SEB of Swaziland, which owns and operates a 400 kV transmission system from South Africa to Southern Mozambique;
- A number of local authorities in small towns that own and operate isolated systems.

At present there are at least a couple of concrete projects where international investors are involved in the extension of the existing transmission grid related to development of the mining industry.

The current installed generation capacity in Mozambique is 2390 MW out of which 2075 MW is installed in HCB and 315 MW is owned by EDM. The Cahora Bassa Plant exports 1500 MW to South Africa and Zimbabwe.

Mozambique is the third largest power producer in the SADC region. The Government of Mozambique is promoting new power projects, namely Mepnda Uncua Hydropower Plant (1300-2400 MW), Lurio Hydropower Plant (120 MW), Alto Malema Hydropower Plant (60 MW), Massingir Hydropower Plant (60 MW), Massingir Hydropower Plant (60 MW), Cahora Bassa North Station (500 MW) and related transmission lines. Due to their capital intensive nature, these projects require private capital participation. Therefore it was necessary to create a conducive investment environment both at regulatory and institutional level.

Hence, the Government of Mozambique has initiated a radical process of reforms in the power sector. As part of the overall strategy in 1997 a new Electricity Act was promulgated.

The main features of the Electricity Act are that it:

- Creates a framework for restructuring the electricity supply industry and the electricity sector;
- Opens the Mozambican power sector to competition and introduction of new private participants.

The Electricity Act created the National Electricity Council (CNELEC). The present mandate of CNELEC covers conciliation, mediation and arbitration between different concessionary companies or between the concessionary companies and their consumers. In the future it is envisaged that CNELEC will develop into the regulator of the electricity sector.

As an interim arrangement, the regulation is the responsibility of the National Directorate of Energy, under the Ministry of Mineral Resources and Energy. DNE's main regulatory functions are to: establish appropriate tariffs; establish quality of supply targets and ensure least cost expansion; monitor the concession contracts.

The Government has initiated the works to develop a comprehensive regulatory framework for the electricity supply industry, and the first phase of this work will be completed within the next 6 months.

**NAMIBIA**
**Electricity Control Board**

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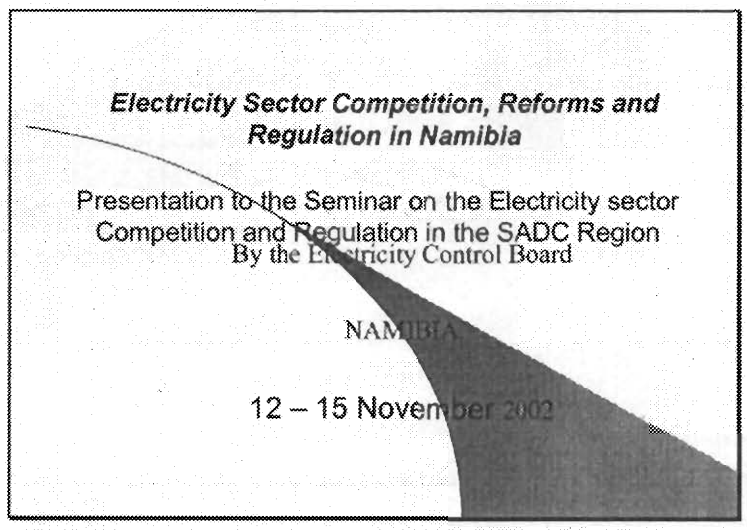


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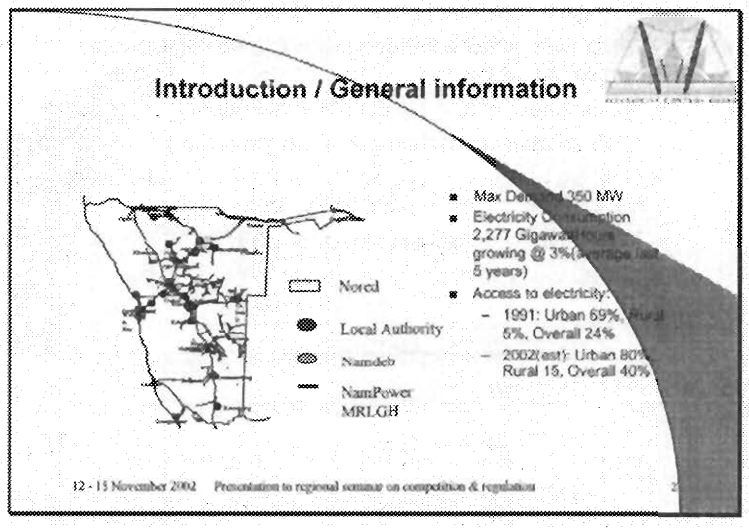


**- Installed capacity : 384 MW**



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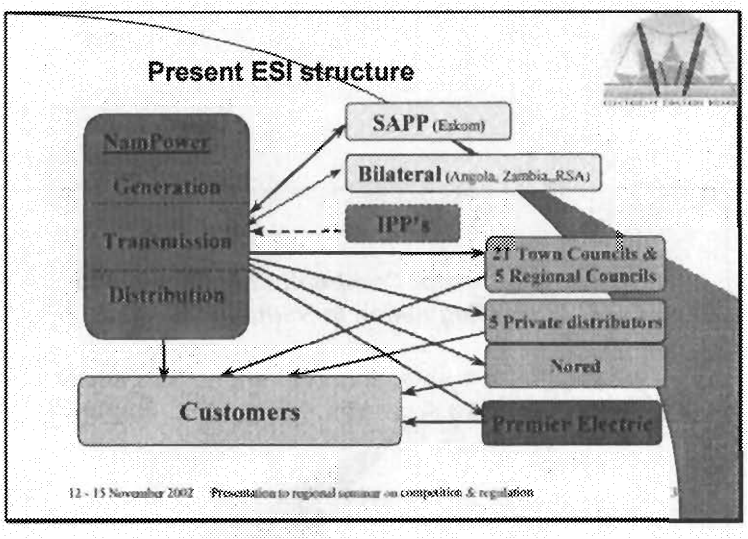


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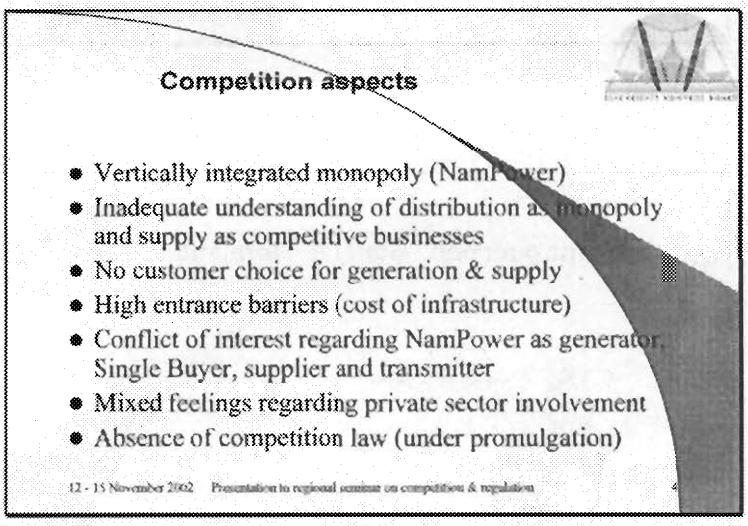




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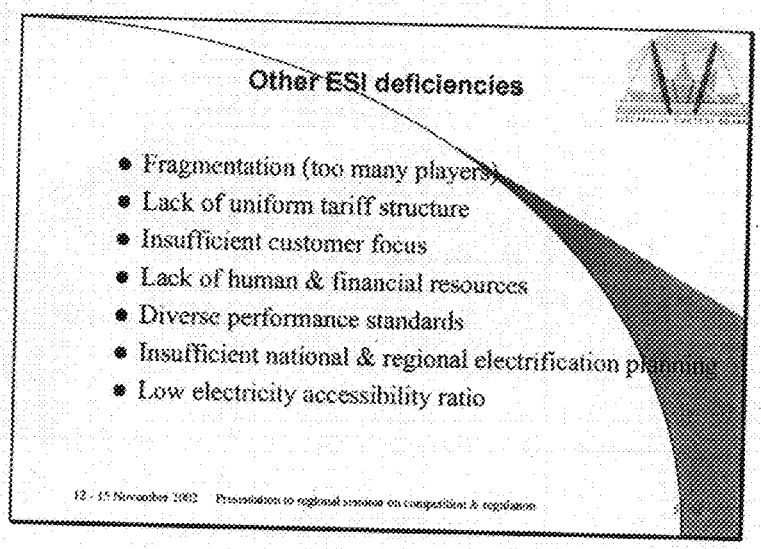


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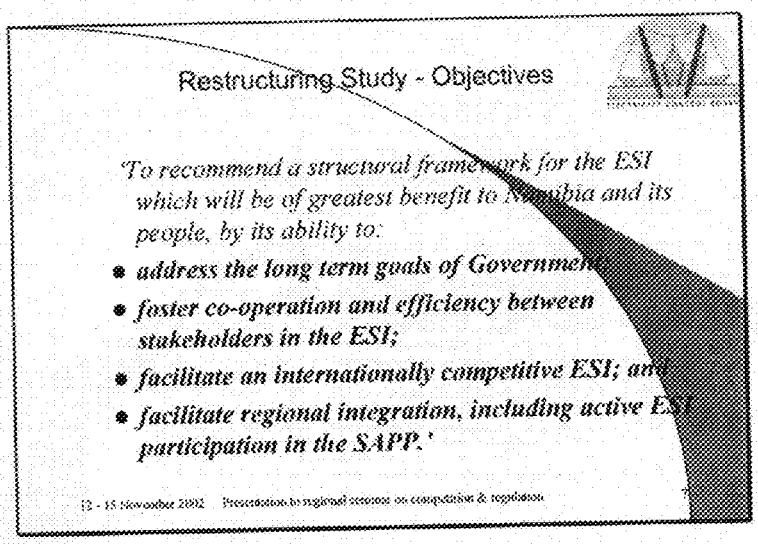


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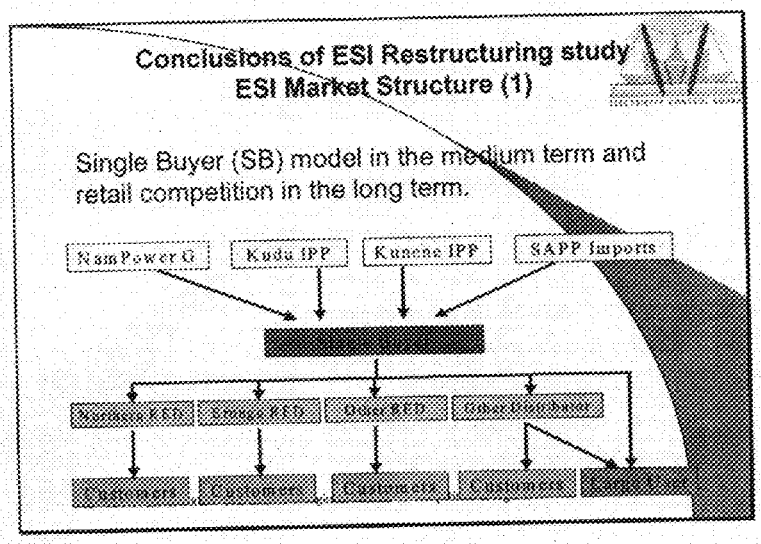

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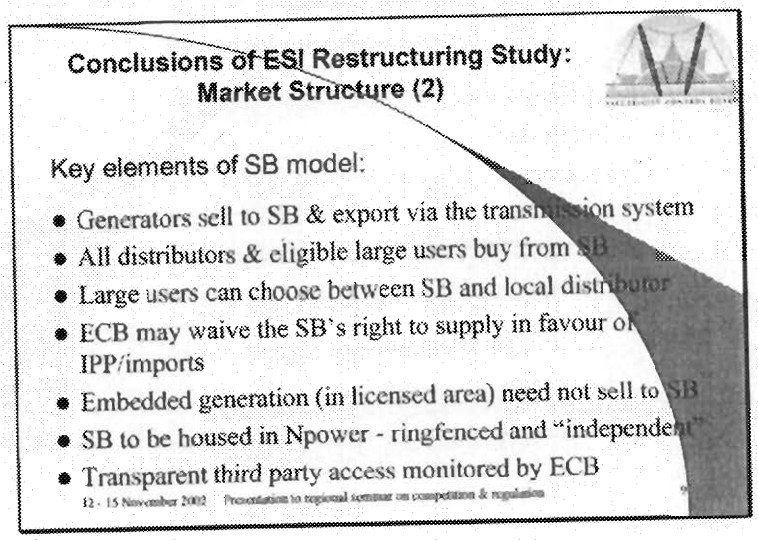


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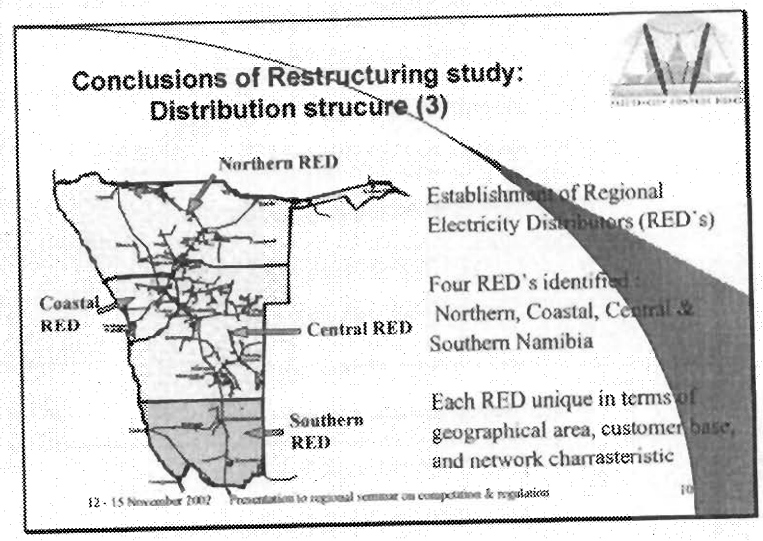




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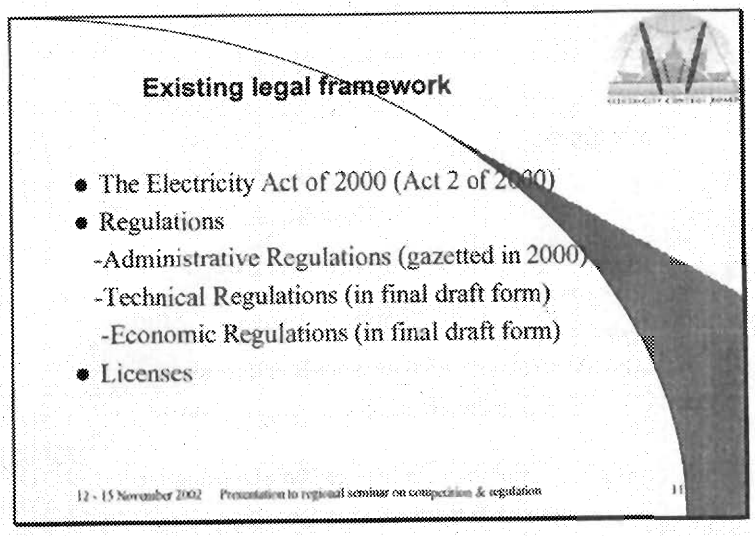


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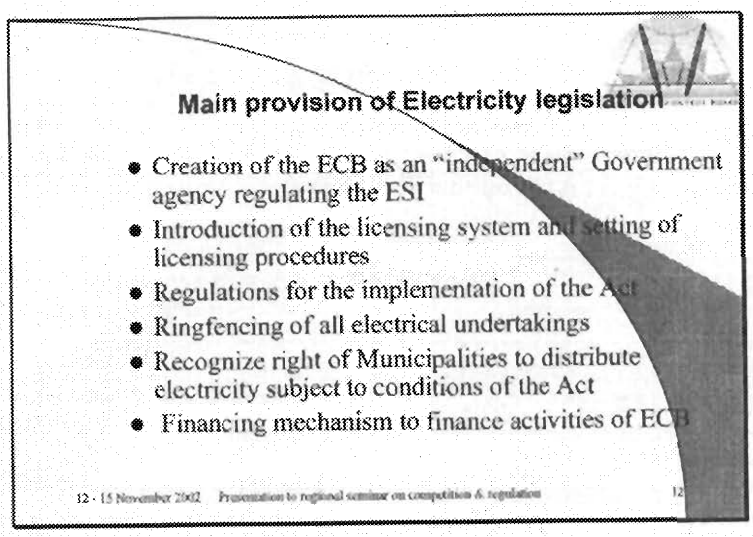




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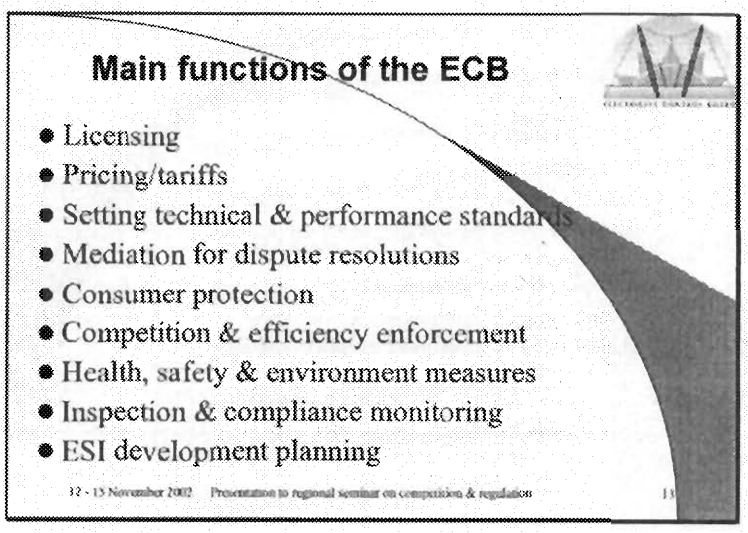


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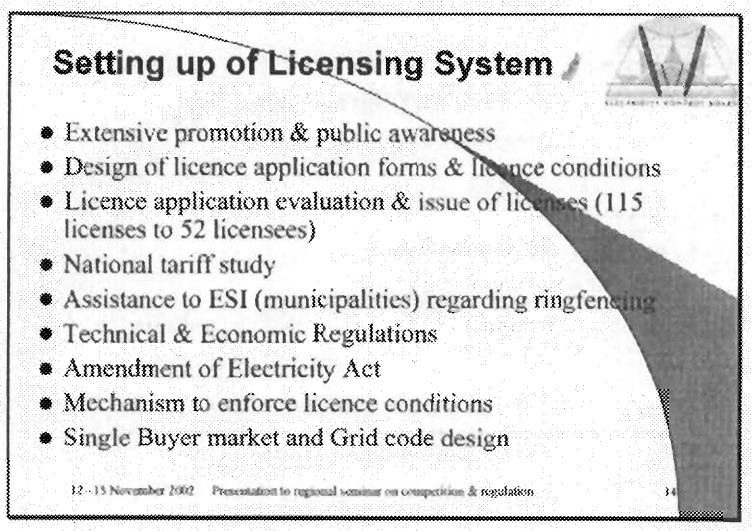




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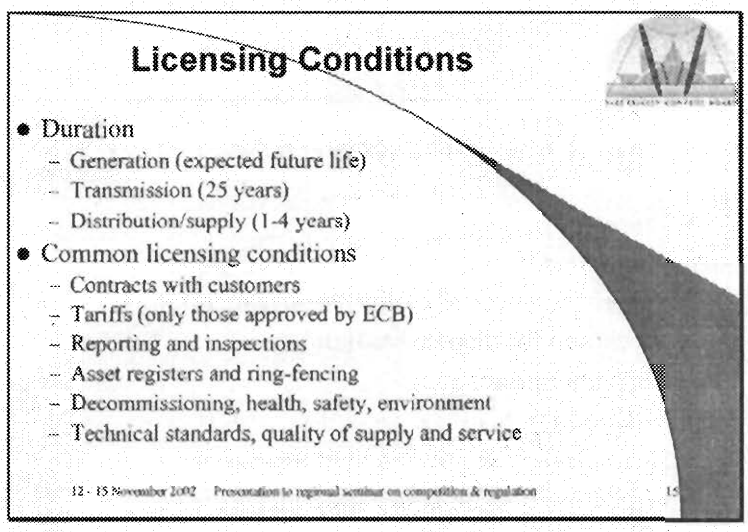


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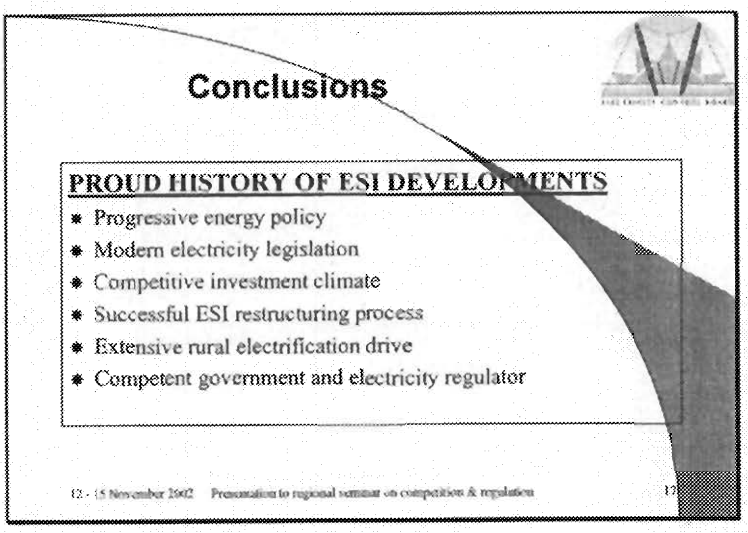


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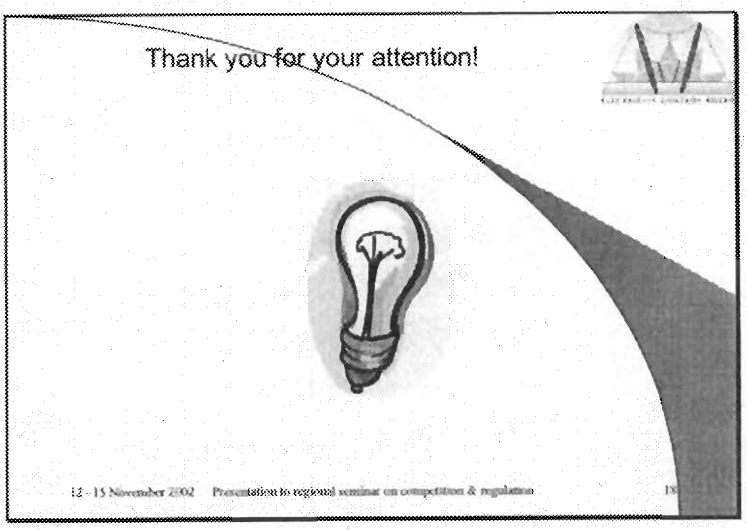




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**ZAMBIA**
**Zambia Competition Commission**

## Competition and Regulation of the Electricity Sector in Zambia

Prepared by
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(Director-Consumer Welfare & Education)

### 1.0 Introduction:

Since 1991, the Government of the Republic of Zambia (GRZ) has pursued polices of economic reform such as liberalization and creation of a market economy, turning a way from the command type of economic management of the previous government. More than 200 state owned enterprises, including the copper mines have been privatized, pricing of most commodities have been liberalized, regulatory bodies for public utilities have been established and procedures for establishing business enterprises have been simplified.

### 2.0 Current Status of the Privatisation Programme:

The privatization programme is still on going. There still exists state monopolies like Zambia Telecommunications Limited i.e. Zamtel Limited and Zambia Electricity Supply Corporation Limited, i.e. ZESCO Limited. In addition there are other state controlled organizations which are not monopolies but which should be privatized i.e in the financial sector, there is the Zambia National Commercial Bank which is state owned and is inefficiently run. The current thinking of the Zambian Government is to find the best ways of privatizing such companies to make them more efficient and competitive so that they provide the necessary choice and quality service to the customers.

### 3.0 The status of the Energy sector in the current privatisation era:

In 1994, Government promulgated the National Energy Policy (NEP). The objective of the NEP with respect to electricity is to increase accessibility and developing the most cost-effective sites for the domestic and export market. The NEP sets a number of policy measures including: restructuring of the electricity industries, improving accessibility to electricity, promoting electrification of productive areas and social institutions and developing hydropower generating potential. To achieve these objectives, the government's main strategy is to open up the power industry to the private sector, thus abolishing the statutory monopoly of the state owned public utility, ZESCO Limited.

The NEP also sets the institutional framework under which these policy measures would be implemented. The policy defines the 'roles of the ministry of Energy and Water Development (MEWD), the Department of Energy and the Energy Regulation Board (ERB). One of the recommended functions of the Energy Regulation Board in the NEP is to regulate against monopoly tendencies of energy undertakings.
In 1998, the government further launched the framework and package of incentives (FPI) for private sector participation in hydropower generation and transmission development. The FPI among other things established the office for promoting Private Power Investment (OPPPI) within the MEWD. The OPPPI is



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responsible for promoting the FPI, soliciting and evaluating proposals, negotiations and awards of contracts and finalizing implementation and power purchase agreements.

**4.0 Competition in the Electricity Industry:**

The existing structure of the electricity industry in Zambia is characterized by three main players. ZESCO Limited is a state owned, vertically integrated utility which generates, transmits, distributes and supplies (sells) power to consumers. ZESCO Limited also supplies bulk power to copperbelt Energy Corporation (CEC) for the mining industry on the copperbelt province. The CEC is a recently (1997) privatized company that owns part of the transmission and distribution network on the copperbelt province. CEC purchases bulk power from ZESCO Limited and supplies this power to the mines on the copperbelt province. Kariba North Bank Company (KNBC) is a state owned generation company which until recently was run under leasehold to ZESCO Limited. In 1999, the Government of Zambia issued an order to separate KNBC from ZESCO Limited and KNBC is set to be the first Independent power Producer (IPP) in the Zambian electricity industry. There are also two relatively small hydro stations belonging to ZCCM (now privatized) at Mulungushi Lunsemfwa at KABWE in the central province.

**5.0 Promotion and Regulation of Competition in the Electricity Industry:**

At present ZESCO Limited Owns most of the transmission and distribution network resulting in independence and problems for would be competitors in accessing the network The government in its effort to regulate against monopoly tendencies of energy undertakings, established the Energy Regulation Board (ERB) as a statutory body.

**5.1 What is ERB?**

The Energy Regulation Board was established as a statutory Board, under section 3 of the Energy Regulation Act, CAP 436 of 1995 of the Laws of Zambia. The ERB is the independent regulator of the entire energy sector in Zambia (comprising of electricity, petroleum, new and renewable energy sources). The functions of the Board include the following:

(a) Monitoring of efficiency and performance of energy undertakings. The objective of this function is to promote rational and efficient allocation of scarce resources in production and provision of energy, thereby contributing to improving national welfare. It is also meant to protect consumers from unfair practices and pricing by energy undertakings that may have market power, and

(b) Monitoring the levels and structures of competition within the energy sector with a view to promoting competition and free entry in the energy industry for persons that meet requirements for operating business in Zambia. In other words, the Board acts as a referee to ensue that there are no barriers to entry, all players in the market are fairly treated and rules that promote competition wherever possible are set so as to improve efficiency on production and provision of energy.
As an additional measure of promoting competition in the various sectors of the economy, of which the energy sector and in particular the electricity sector is conclusive, the government went further and established the Zambia Competition Commission.

**5.2 What is the Zambia Competition Commission (ZCC)**

The Zambia Competition Commission is a statutory body established under section 4 of the competition and Fair Trading Act, chapter 417 of the Laws of Zambia. The Act has generally two principal aims:

(a) To prevent anti-competitive conduct thereby encouraging competition and efficiency in business, resulting in greater choice for consumers in price, quality and service and

(b) To ensure the interests and welfare of consumers are adequately protected in their dealings with producers and sellers.

5.3 What is the working relationship between Zambia Competition Commission (ZCC) and the Energy Regulation Board (ERB)?

The two organizations have several things in common. They are all statutory bodies whose major objective is "to prevent, monitor and control the levels and structures of competition industries/the Zambian economy with a view of promoting competition and free entry into the Zambian market thereby encouraging efficiency which ultimately results in greater and varied choice for consumers in terms of price, quality and service."

The major difference between the two statutory bodies is, however, that the Energy Regulation Board (ERB) is highly focused in that it only concentrates on the energy sector (comprising of electricity, petroleum, new and renewable energy) which is just a fraction of the Zambia economy. But the Zambia Competition Commission looks at the whole of the Zambian economy. As a matter of fact the principal objective of the Zambia Competition Commission is to establish conditions of free and effective competition in the Zambian economy, to ensure that the anti-competitive practices do not create barriers to trade or other forms of protectionism. The competition rules set down minimum standards and allow enterprises to penetrate market and establish themselves without barriers or restrictions thereby facilitating intra-market trade. In other words, the Commission acts as a referee to ensure that there are no barriers to entry, and players in the market are fairly treated and rules that promote competition wherever possible are set so as to improve efficiency in the economy.

In summary, in addition to its wide national responsibilities in the economy, the Zambia Competition Commission works together with other regulatory bodies in the country, including the ERB, to promote conditions of free, fair and effective competition in the economy, to ensure that the anticompetitive practices do not create barriers to trade or other forms of protectionism.

**6.0 What is the way forward of the Electricity Sector in Zambia?**

In order to achieve effective regulation, promote private sector investment and improve efficiency in the electricity market, the Zambian government is seriously examining the need for restructuring the electricity to allow competitive components of the market to freely and fairly compete.

6.1 The intended objectives of Restructuring the Electricity Market in Zambia:

The overriding objectives of restructuring the electricity market in Zambia are:

(a) To increase accessibility to the majority of the Zambian population through expansion of the national electricity network to cover areas that have production potential.

(b) To promote private sector participation in the electricity industry by ensuring that the structure of the electricity market and market rules are attractive to private investors.

(c) To promote competition in the segments of the electricity market that are potentially competitive namely, generation and supply.

(d) To improve efficiency in the electricity industry through determination of price by market forces in competitive sectors and regulatory oversight in the monopolistic segments.

**6.2 What are the current constraints to the objectives of Restructuring?**

The following are some of the constraints that inhibit accessibility to electricity by a majority of Zambians, prevent private sector participation in the electricity industry and prevents the improvements of efficiency, quality of supply and service:

(a) Lack of capital to carry out massive electrification projects in both rural and urban areas.

(b) Un economic nature of grid extension in rural areas

(c) Inability of the people to pay for connection

(d) Lack of incentives for private sector to be unsolved.

(e) Small local market for power

(f) Undeveloped capital market

(g) The current parastatal, ZESCO Limited, owns most of the transmission and distribution network resulting in independence and accessibility to network problems.

(h) Existence of long term contracts which may inhibit new entrants

(i) Aged infrastructure resulting in poor quality service

(j) Vandalism of electrical infrastructure

(k) Lack of capital to acquire appropriate technology and innovation.

**ZIMBABWE**
**Competition and Tariff Commission**

# COMPETITION AND REGULATION OF THE ELECTRICITY SECTOR IN ZIMBABWE

***(Sector description for the Seminar on Competition Policy and Regulation in the Electricity Industry, Pretoria, November 12-15, 2002)***

## *Introduction*

The Zimbabwean energy mix is dominated by carbon-based fuels. Ninety-six percent of the total supply is from such fuels. Hydro-electricity also accounts for a portion of the energy supply, however the electricity supply is mainly from coal-based thermal fuels.[7]

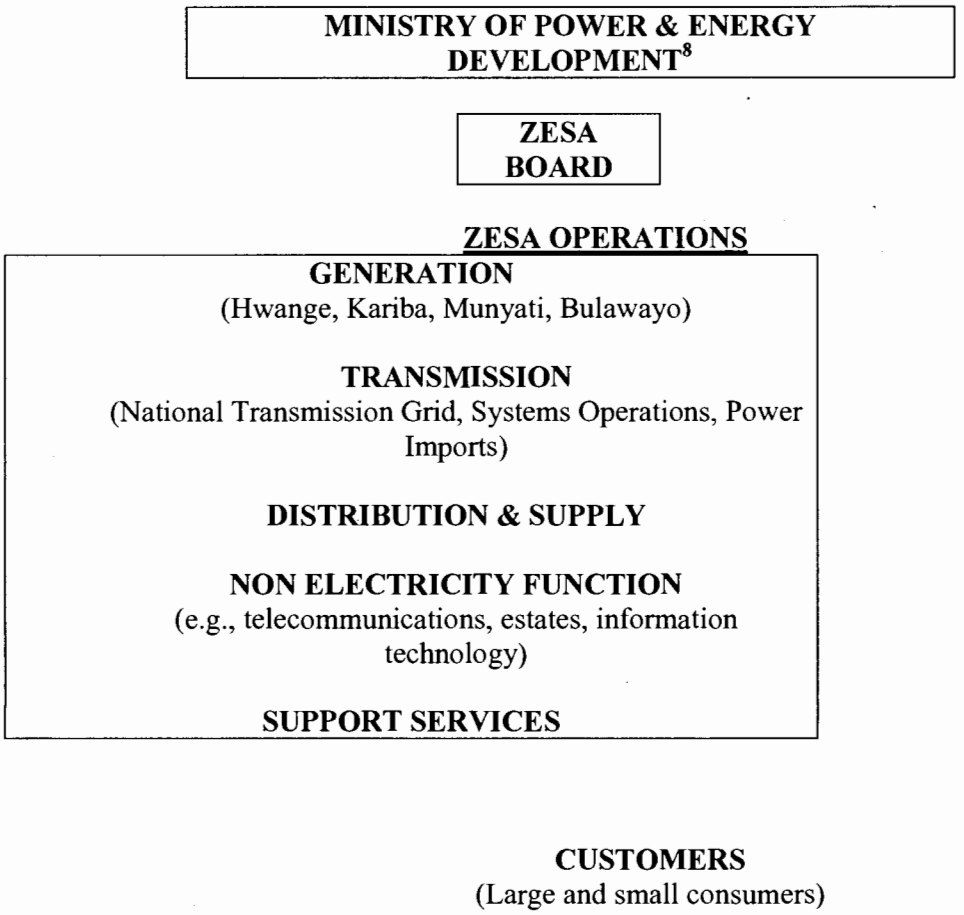
The generation, transmission, distribution and supply of electricity in Zimbabwe is regulated by the Electricity Act [*Chapter 13:05*]. The same Act also established the Zimbabwe Electricity Supply Authority, ZESA. The functions of ZESA are to generate, transmit, distribute and supply electricity in Zimbabwe. ZESA is a parastatal which is subject to control by the Government.

## *The structure of electricity supply in Zimbabwe*

ZESA is responsible for the generation, transmission, distribution, power purchases and supply of electricity in the whole of Zimbabwe. ZESA has other non-electricity business. ZESA is responsible for setting tariffs (prices) for electricity. However the approval of the tariffs is the responsibility of the government. The current structure of the electricity supply industry is as shown in Figure 1.below.

[7] See African Industry & Climate Change Project Proceedings. UNIDO publication. pp177-198.

**Figure 1. Structure of the Electricity Supply Industry in Zimbabwe**




***Regulation and competition***

The minister of power and energy development is the regulator of the electricity industry as shown in the above structure. However the presence of only one player in the electricity industry is the dominant feature of the structure of the industry in Zimbabwe. Effectively there is a monopoly in the electricity supply industry, there is therefore no competition to talk about.

Part V of the Electricity Act entrenches this monopoly. Section 33 which falls under Part V of the Act is very restrictive on the class of players who are permitted to engage in the business of electricity production. The effect of section 33 is that, unless otherwise permitted by ZESA *and* the Minister, no person or company can operate any undertaking, the plant of which has a rated

[8] Formerly Ministry of Energy and Mines.

generating capacity at the site where it is installed of one hundred kilowatts or more, from which transmission, distribution or supply of electricity occurs to any other person.

Even a local authority is prevented from operating such an energy production business unless it has entered into a contract with ZESA in terms of section 35 of the Electricity Act. A further restriction affects this possible arrangement, this is section 35(2) which makes the possibility of such a contract subject to the approval of the minister. Apart from ZESA itself, only the Zambezi River Authority is exempt from the restrictions of section 33.

In the remote chance of a private sector player being granted permission to generate and transmit electricity that player has to cope with the provisions of sections 34(5) and 40 of the Act. These sections empower the Minister to impose price controls on electricity. These controls can easily hamper the viability of the industry and destroy any possible competition. The existence of a regulator who is part of government is not conducive to a competitive environment. Regulatory mechanisms have to be perceived of as fair and impartial, the current regulatory mechanism with a cabinet minister as the regulator is far from satisfactory.

The Electricity Act therefore contains stringent regulatory restrictions against private sector involvement in the business of electricity generation, transmission, distribution and supply.[9] The practical effect of these restrictions is the creation and entrenchment of a monopoly in the electricity industry.

***Future Prospects for Competition***

The government has realised that the current situation in the electricity industry is problematic. In December 2000 the government published a draft White Paper on the reform of the electricity sector in Zimbabwe. The white paper proposed changes in the current structure of the industry, including the unbundling and privatisation of ZESA, and the creation of a new regulatory mechanism. The contents of the proposed reforms are summarised below.

*Unbundling*
The unbundling of the electricity sector from its present vertically integrated structure into separate business units in generation, transmission, distribution and supply activities is intended to establish a high degree of competitiveness. The government hopes to attract new players into the electricity sector.

*Privatisation*
The privatisation of business entities of ZESA at all levels is aimed at maximising value, and attracting private investors. A Wholesale Electricity Market (WEM) is envisaged where power brokers and the power generating businesses will participate.

*Regulation*

[9] See too by the same author, *Legal Barriers to the Implementation of Industrial CDM Projects*, Southern Centre for Energy and Environment publication, 2001.

A regulatory commission is proposed. The commission is meant to ensure that customer and investor interests are balanced.

*Rural Electrification Fund*
A separate entity, the Rural Electrification Fund (REF) is necessary to ensure the acceleration of electrification in Zimbabwe.

The reforms acknowledge that competition is a guarantee for the interests of consumers. The proposed structure includes the entry of new players such as small grid suppliers and power brokers. The physical flow of electrical energy from the generating sources via the transmission and distribution to the customers will be managed by an independent entity which will not be involved in the production, delivery and procurement of the electricity. The administration of contracts between purchasers and sellers will also be managed by an independent entity, the Electricity Market Operator (EMO).

***Draft Electricity Bill 2000***
As part of the reform of the electricity sector a Draft Electricity Bill (2000) was produced. The Draft Bill is the legal embodiment of the proposed changes in the electricity sector. The proposed legislation seeks to:
- establish the Electricity Regulatory Commission;
- provide for licensing and regulation of the generation, transmission, distribution and supply of electricity;
- enforce such matters as performance standards, consumer rights and obligations; and
- provide for the determination of price and tariff setting.

Significantly, the proposed legislation also seeks to *"facilitate competition and private sector participation"* in the electricity industry.

***Conclusion***
As explained above the current structure of the electricity industry is monopolistic and anti-competitive. Reform is certainly necessary. However a lot of the proposed changes will introduce very new concepts to the Zimbabwean economy. These concepts, such as the whole idea of wholesale electricity markets, and power brokers will introduce new challenges to the competition authority. It is crucial that the Zimbabwean competition authority be exposed to the new concepts which are being proposed and learn from the experiences of other countries before the changes occur. To this end the Competition and Tariff Commission is grateful for the invitation to take part in the seminar that has been arranged.

The Commission would be grateful for any insight that the organisers can share on:
- the origins and the practicalities of wholesale electricity markets;
- the experiences of regulatory authorities with energy trading; and
- legal and policy issues relating to competition in such trading arrangements.

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CHAPTER 8

# Regulation of Infrastructure

*No one can argue that a monopolist is impelled by "an invisible hand" to serve the public interest.*

—R. H. Tawney, 1921

Infrastructure sectors, because of scale economies and demand externalities, have traditionally been thought of as the exception to the rule that competition improves the provision of goods and services. In many countries government provision of infrastructure services was considered the only way to avoid both the monopolistic abuses of infrastructure operations and the vagaries of the market, given its importance for the general population. This led, first, to the regulation of private infrastructure providers and then, in many countries, to the nationalization of infrastructure enterprises.

In practice, publicly provided infrastructure services have often delivered poor quality and inadequate coverage. Governments in many countries have begun to allow private provision of infrastructure services, both to enhance efficiency and to ease the strain on public finances. Changes in technology have created the conditions for competition in some areas once considered "natural monopolies," particularly the energy and telecommunications sectors. This has spurred increasing private provision. Private provision has been less prominent in the water sector, where technological progress has been less pronounced and political barriers to reform can be strong.

Overall, private sector provision of infrastructure rose tremendously during the 1990s in all sectors in all regions (table 8.1). Countries in Latin America and the Caribbean, which were in the vanguard of infrastructure reform, attracted almost half of the investment commitments in infrastructure projects with private participation during the 1990s. Regional differences were also the result of disparities in market size and investor perceptions of risk.

But the increase in private provision during the 1990s, although large by historical standards, has been smaller than might be possible. By 1999 total private investment in infrastructure provision in the developing world had fallen significantly from its peak in 1997, although there were signs of some recovery in 2000. To encourage private investment, two factors need attention: political and regulatory reform, particularly in pricing, and efforts to enhance the credibility in the government's new regulatory framework.[1] Policies that allow for full cost recovery and that ensure the investor a reasonable rate of return without government contributions are the preferred alternative for expanding private investment. Often, governments have failed to adopt such policies or to implement them through credible regulatory arrangements, deterring private investment.

Sometimes, even such pricing policies have not been sufficient to ensure that coverage goals are met. When this happens, governments may complement user fees with subsidies. Experience indicates that subsidies, when needed, should be transparent and carefully designed to serve poor people. When budget constraints limit the scope for financing subsidies, governments may need to reconsider their coverage goals.[2]

On average, private provision has relaxed capital constraints, enhanced efficiency, and increased investments.[3] A recent survey of studies on privatization in the past 30 years showed that out of 24 studies on the relative performance of public and private enterprises in infrastructure, half found significantly superior performance by private or privatized enterprises, seven



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Table 8.1
**Investment in infrastructure projects with private participation in developing countries by sector and region, 1990–99**
*(billions of U.S. dollars)*

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Sector** | | | | | | | | | | | |
| Telecommunications | 6.7 | 13.3 | 8.1 | 11.0 | 19.6 | 24.0 | 29.9 | 42.8 | 54.3 | 39.2 | 249.0 |
| Energy | 1.6 | 1.2 | 12.1 | 14.6 | 17.0 | 24.1 | 33.7 | 47.9 | 25.7 | 14.9 | 192.8 |
| Transport | 8.0 | 3.1 | 4.2 | 7.7 | 8.2 | 10.1 | 16.5 | 22.4 | 17.6 | 8.4 | 106.1 |
| Water and sanitation | — | 0.1 | 1.9 | 7.5 | 0.7 | 1.7 | 2.2 | 8.9 | 2.6 | 5.9 | 31.4 |
| **Region** | | | | | | | | | | | |
| East Asia and Pacific | 2.6 | 4.1 | 8.9 | 16.2 | 17.7 | 23.4 | 33.4 | 38.8 | 9.5 | 14.1 | 168.6 |
| Europe and Central Asia | 0.1 | 0.3 | 1.3 | 1.5 | 3.9 | 8.6 | 11.6 | 15.1 | 11.5 | 8.7 | 62.5 |
| Latin America and the Caribbean | 13.2 | 12.6 | 15.8 | 18.5 | 18.9 | 19.4 | 28.8 | 51.1 | 71.0 | 36.3 | 285.6 |
| Middle East and North Africa | 0.0 | — | 0.0 | 3.4 | 0.3 | 0.1 | 0.4 | 5.3 | 3.5 | 2.4 | 15.3 |
| South Asia | 0.3 | 0.8 | 0.1 | 1.3 | 4.0 | 7.6 | 6.1 | 7.1 | 2.3 | 4.0 | 33.5 |
| Sub-Saharan Africa | 0.1 | — | 0.1 | 0.0 | 0.7 | 0.8 | 2.1 | 4.5 | 2.4 | 2.9 | 13.6 |
| **Total** | 16.3 | 17.8 | 26.1 | 40.9 | 45.5 | 59.9 | 82.3 | 121.9 | 100.2 | 68.5 | 579.3 |

*Note:* 0.0 means zero or less than half the unit shown. Data may not sum to totals because of rounding.
*Source:* World Bank, PPI Project database.

found the differences small or ambiguous, and only five concluded that public enterprises had performed at a level superior to private enterprises.[4]

Among the reasons for private sector successes have been more careful preparation and preliminary analysis of sectors and the establishment of appropriate and transparent regulatory structures. Emerging evidence on the design of concession arrangements for private participation in infrastructure (box 8.1) provides some lessons for policymakers. For example, governments have enhanced competition in infrastructure services by making structural changes before privatization. In developing countries where the capacity for enforcing regulations is particularly weak, there is a strong argument for introducing competition as much as possible in those infrastructure sectors where it can substitute for regulation. Competition, by changing incentives of agents, has added benefits in weak institutional environments; it reduces dependence on regulation (such as price reviews) to achieve desired outcomes. Governments have also ensured greater coverage of poor people by, for example, incorporating coverage targets in the initial contract design or by allowing flexibility in prices and quality.

The regulation of private providers is complicated when there is the possibility of competition in some branches of infrastructure provision while natural monopoly conditions persist in other branches. Under such circumstances policymakers must decide whether the operators of the monopoly enterprise will be permitted to participate in the related competitive sector as well. Inexperienced regulatory agencies, particularly in poor countries, will face challenges in dealing with possible discrimination in access. Institutional design needs to account for this. There are typically two alternatives: *vertical separation* could be imposed, or the sector could *remain integrated.* In the second case, reliance on intersectoral or source competition could reduce the need for regulations.

Building effective regulatory structures in developing countries requires accounting for the quality and existence of supporting institutions and capacity. Sometimes this translates into fewer, simpler, or more cost effective regulations, or into economizing on structure. Because of differences in the capacity of complementary institutions, standards of regulation imposed in industrial countries may not be appropriate for poorer ones, and particularly for poorer regions, which are often served by smaller or informal providers. Distributional concerns can be met with flexibility in price-quality standards, the establishment of investment and access targets, encouragement of the informal sector, or direct subsidies.

Costs of infrastructure provision can be reduced by innovative approaches that involve community participation. Greater information flows between the users

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**Box 8.1**
**Private provision: recent evidence from concession arrangements**

Concessions (or franchises) are one way to introduce private provision in infrastructure—and to stimulate competition *for* the market. Concessions grant a private company the right to use assets, to operate a defined infrastructure service, and to receive revenues from it, usually following a competitive bidding process. The competitive bidding mechanism for concession contracts should eliminate monopoly rents and hence reduce the regulatory burden. In Côte d'Ivoire, for example, the World Bank supported concessions in the water sector. The winning bidder, SODECI, now provides water throughout the country at rates comparable to state companies in neighboring countries, but at excellent quality and with very high repayment rates from private consumers.

But a recent study on concession contracts in Latin America indicates that they can produce mixed results, for reasons that are applicable to privatization in general. (Concessions are the dominant mode of private entry in the region.) Many of the problems are attributable to initial contract design and regulations. The study finds that of more than 1,000 concessions awarded since the late 1980s, over 60 percent appear to have been renegotiated within three years—over 80 percent of these in the water and transport sectors (Guasch 2000). The concession holder has initiated the overwhelming majority of renegotiations. The degree of renegotiation is higher than is warranted by changes in economic conditions. One reason may be that investors submit low bids to secure the contract because they expect that after the contract is awarded, they can renegotiate for better terms on a bilateral basis, without competition. This means that the most efficient provider may not win the contract.

Contract renegotiation initiated by governments can reflect lack of commitment to the protection of investors. There are some ways to guard against this. First, in developing countries with well-established and effective judicial court systems, such as Jamaica, the government may sign a concession or franchise contract with the provider that may be enforced by the courts (Spiller and Sampson 1996). Second, governments can gradually establish a reputation for nonexpropriation by structuring a concession or franchise agreement so that it calls for a gradual sinking of investments over time. The investor sinks more resources after observing government behavior. This is how Hungary structured its national telecommunications concession (Armstrong and Vickers 1996). Or the government may seek to attract domestic private investors so that future expropriation would be at the expense of locals as well as foreigners, making expropriation more politically costly and thus less likely. A variation on this strategy is to use the existence of an international lending program as a commitment device, or "hostage": the investor knows that bad behavior by the government in this sector may be punished by international lenders in a variety of other sectors (Armstrong and Vickers 1996; Levy 1998; Ordover, Pittman, and Clyde 1994).

Before concession negotiations and privatization, a careful study should focus on the objectives of the liberalization and privatization program, taking into account the experience of other countries. This was done for the Peruvian toll road sector, for example. It is also important to undertake price reform while the enterprise is still in public hands. Prices have to be increased to cover costs (or be headed in that direction), or investors will lack confidence that they will be allowed to earn a profit on their investments. This problem affected privatization of the electricity sector throughout Central and Eastern Europe and elsewhere (Stern and Davis 1998). A system of transparent cross-subsidies or lifeline services designed to benefit all citizens, including the poorest, should be agreed upon at the start.

Any vertical unbundling—for example, separating electricity generation from transmission and distribution—should be done before privatization to avoid creating strong opposition to restructuring later on. Even if a sector is not to be unbundled at the point of privatization, the necessary separation in cost accounting should be done in preparation for any future restructuring or access issues. Several Latin American toll road projects have caused severe regulatory problems because the policymakers did not establish a mechanism for the transmission of information to regulators at the time the concessions were granted (Estache, Romero, and Strong 2000).

A critical component of a privatization strategy is an independent regulatory body. This is supported by the finding from Latin America that if a regulatory body existed at the award of the concession, the probability of renegotiation was 28 percent; if it did not, the probability was 62 percent (Estache, Romero, and Strong 2000). Although the effectiveness and independence of any regulatory authority vary between countries, the preexistence of a regulatory agency has helped, on average. Hungary tried—and failed—to open up its gas sector to private investment without having a regulatory structure in place.

Regulators need information to regulate. To obtain information, they need their rights to information to be in the contract. An important complement to such contract design is to ensure that firms use good regulatory accounting and that regulators have the capacity to analyze such data.

The presence of an independent regulatory agency mitigates the risks of political interference in the privatization process and hence provides more comfort to investors. Moreover, an independent regulatory body provides a focal point for negotiation of the concession contract and technical expertise to deter unwarranted contract negotiations. And, a regulatory agency generally has specific knowledge that reduces uncertainty and better predicts the path of technology and demand. The study on Latin America found that the presence of a regulatory agency facilitates a careful review of the contract itself and of the qualifications of the bidders before the contract is awarded.

The study also found that a rate-of-return type of regulation (which ensures the investor a guaranteed rate of return by adjusting prices according to costs) was less likely to lead to renegotiation of contracts than a price-cap type of regulation (which limits the price a firm is able to charge). A firm that is regulated by a price cap bears all the risks associated with cost change and is subject to significant regulatory discretion. In Latin America the probability of renegotiation is 9 percent with a rate-of-return price regime and 56 percent with a price-cap regime (Estache, Romero, and Strong 2000).

Finally, using a single one-time payment as the principal award criterion, rather than the lowest tariff to be charged or the lowest annual subsidy to be provided, seems to reduce the likelihood of renegotiation, since the latter criteria are operationally more conducive to future dispute and subsequent adjustment. The one-time payment locks the investor in and strengthens his commitment (Guasch 2000).

and providers of services can also produce institutional designs that serve communities better.

Competition between firms and benchmarking across jurisdictions can improve service provision and help reduce the burden on regulators. For example, competition in a sector may reduce the need for frequent price reviews.

Establishing credible regulatory systems is one of the most important factors affecting private investment in infrastructure. However, countries' success in building such systems depends as much on political issues (chapter 5) as on technical factors and human capacity. Relevant political issues range from lack of independence of the regulator to weak systems of checks and balances for the regulatory agency. Transparency for both the regulator and the regulated is also key. For example, accounting standards increase transparency for the regulated. Open disclosure of the rules of the game enhances transparency for the regulator.

This chapter reviews how competition may reduce the regulatory burden on the state; the form that regulatory institutions should take; and how institutional design may affect access by poor people. It does not discuss all the important issues in the design of regulation, but it does cover areas where recent evidence has shed some light or those that were not covered extensively in *World Development Report 1994*. Governance issues within *public* infrastructure firms are not discussed here except in certain cases, such as the design of subsidies for poor people.

## Competition in infrastructure sectors

There are different ways to introduce competition *in* the market (as opposed to *for* the market) in infrastructure sectors. This section addresses this issue.

### *Competition and regulation*

As noted in *World Development Report 1994*, services such as electricity generation and long-distance telecommunications can be provided competitively. Some services still subject to economies of scale may face competition from other services using separate technologies.

Under either scenario, competition may substitute for regulation in protecting the economy from monopoly abuses. This is all the more important in developing countries, where the capacity for enforcing regulations is generally weak. First of all, regulation is not a simple task and can lend itself to arbitrary government action. This is more likely to happen in countries where governance is weak and where there are insufficient checks and balances to curb abuse of power by a particular branch of government. Regulation imposes costs on both the enterprises being regulated and the government doing the regulating.[5] Sometimes government inefficiency and corruption within state firms may be replaced by corruption in the regulatory agency. Moreover, government authorities in developing countries are frequently unable to gain adequate access to the information needed for effective regulation.[6] They may also be unfamiliar with the concept of an independent regulator and have difficulties enforcing regulatory orders. In other words, competition can avoid many of the incentive, information, and enforcement problems created by regulatory regimes and, where it is effective, can substitute for regulation.

Another form of competition that could help reduce the burden on regulators is yardstick competition. Regulators can assess the performance of an infrastructure service provider—for example, in terms of prices and coverage—by comparing it with one in another locality (such as in a neighboring country) and can adjust regulation accordingly. Although this is not competition in the market, it can have similar effects on incentives for infrastructure providers.

Competition among "monopolists" can reduce the need for sectoral regulation in sectors such as petroleum and electricity distribution.

- The long-distance transmission of petroleum by pipeline between two points may well be a natural monopoly. Producers at a particular location, however, may not require regulatory protection if they have alternative customers to a particular pipeline—for example, local buyers, or shipment by water, or a pipeline from the same producing location that serves different destinations. Similarly, customers at a particular point on a pipeline that is an origin-destination monopoly may not require regulatory protection if they have alternative sources of petroleum—for example, local producers, or shipment by water, or a pipeline to the same destination that comes from a different origin.[7] Similar conditions hold for some natural gas pipelines. For example, pipelines from two different gas-producing areas in Argentina, Gas Atacama (a joint venture of Chile's Endesa and the U.S. firm CMS Energy) and Norandino (Belgium's Tractebel), are just beginning to compete to bring natural gas across the Andes Mountains to northern Chile.[8]

- Similarly, even if the long-distance transmission of electricity between the generation facility and the consuming enterprise or municipality is a natural monopoly, generators at a particular location may not require regulatory protection if they are served by different long-distance transmission lines serving different sets of customers. Customers at a particular location may not require regulatory protection if they are served by different long-distance transmission lines carrying power from different generators. Municipal and large industrial users are currently enjoying such competition from different generation facilities in Argentina, Brazil, Chile, and Peru.[9]

Other examples include competition provided to the railroad sector by truck and barge operators and competition among different energy sectors such as oil and gas. A more recent development is competition between telecommunications networks and cable television providers in communications services. Moreover, both these natural monopolies face competition from wireless communications technologies.

Sometimes competition may create new regulatory problems or may simply displace old ones. In many of the cases where competition is recognized as an effective way of organizing the provision of service, that service is part of a larger infrastructure sector where some natural monopoly elements may remain. If electricity generation is considered a potentially competitive sector, electricity long-distance transmission and local distribution are less clearly so. If long-distance telecommunications is considered a potentially competitive sector, local wireline telecommunications are less clearly so.

Many of the most important issues involving risks, contracts, incentives, and knowledge have involved sectors where "unbundling" is possible—that is, where *some of the* services formerly provided by vertically integrated monopolies are being opened up to competition but other services remain monopoly provided. In these broader sectors, therefore, competition and regulation are *complements* rather than *substitutes.*

The next section focuses on an issue that is currently very important in developing countries. Vertical separation can provide more opportunities for competition in developing countries.

### *Vertical integration or separation*

In virtually every infrastructure sector there is some service that can now be provided competitively, while there remains some service that is likely to remain a monopoly "bottleneck" in the production chain.[10] This raises the question whether the traditional vertically integrated model of the infrastructure enterprise should be maintained when it might be possible to introduce competition. One problem of undertaking cost-benefit analysis in this area is that it is not possible to measure the dynamic benefits of competition, while the costs of restructuring and evidence of scale economies may be known.

It seems likely that in particular infrastructure sectors there are economies of scope to the coordinated provision of all services, for example, generation of electricity with long-distance electricity transmission and local electricity distribution. But where there remains a monopoly bottleneck to which all competitive suppliers require access, there is an incentive for the monopoly provider to discriminate in favor of its own integrated subsidiaries over their competitors (for example, in access prices or access quality). There are three main institutional options to consider:

- Option A, in which the owner of the monopoly bottleneck enterprise continues to operate in the "competitive" sector in competition with other providers in that sector (that is, an integrated firm subject to competition in the nonbottleneck market)
- Option B, in which the owner of the monopoly bottleneck enterprise operates as a monopolist in the (otherwise) competitive sector as well (that is, an integrated monopolist)
- Option C, in which the owner of the monopoly bottleneck enterprise is not permitted to operate in the competitive sector but, rather, provides connecting service to the competitive firms operating there (that is, vertical separation with competition).

In practice, intermediate forms of vertical separation may be used (this is a subset of option A) because they facilitate detecting discrimination. For example, accounting separation between different units, or restructuring the units into separate corporate entities with common ownership, could help detect discrimination.

The option most appropriate for a particular sector in a particular country depends on four main issues (table 8.2). First is the *extent of economies of scope between the provision of different services within the sector.* It appears that the extent of economies of scope may not be that large, based on the fact that, in the infrastructure sectors in most industrial countries, at least

Table 8.2
**Strategy for vertical separation or integration**

| | | Vertical integration with competition in non-bottleneck market (Option A) | Integrated monopolist (no competition) (Option B) | Vertical separation (with competition) (Option C) |
|---|---|---|---|---|
| **Economies of scope** | Large | ✓ | ✓ | |
| | Small | | | ✓ |
| **Detection of discrimination** | Easy[a] | ✓ | | |
| | Difficult | | ✓ | ✓ |
| **Consequences of discrimination** | Little effect on competition | ✓ | | |
| | Bad for competition | | ✓ | ✓ |
| **Likelihood of competition in nonbottleneck market** | Significant competition | ✓ | | ✓ |
| | Little competition | | ✓ | |

a. Requires separation of the accounts of the different units of the vertically integrated producer.

some vertical transactions take place between enterprises rather than within enterprises. For example, under certain circumstances integrated electricity providers buy some power from independent generators, and integrated railroads allow some other train operators to operate on their tracks.

Second is the *ease of detecting discrimination by the integrated owner of the bottleneck in favor of its subsidiary.* Difficulty in enforcing interconnection quality even in the United States was one reason for the breakup of the integrated telecom supplier AT&T in the early 1980s.[11] Independent electricity generators have argued that there are so many dimensions of quality of access to long-distance transmission lines that it is virtually impossible for a regulator to prevent favoritism.[12] In contrast, the use of neutral railroad schedulers (dispatchers) in both the United States and the Czech Republic seems in some cases to have been successful in preventing discrimination against nonintegrated train operators.[13] In the absence of separate accounts between units of the integrated producer, discrimination can be difficult to detect.

Third is the *consequences of undetected discrimination for competition.* Financial data for the United States suggest that the long-distance transmission costs of electricity are less than 5 percent of the total delivered cost to end users, while track and structure costs make up nearly 20 percent of the total delivered cost of railroad service.[14] This suggests that a competing train operator, facing discriminatory access to the track, may be at a greater potential disadvantage than a competing electricity generator facing discriminatory access to the long-distance transmission grid. The possibility of discriminatory access is even more acute in the case of water and sewerage, where the fixed network costs in a developing country may be as much as 75 percent of the total cost of the delivered product.[15]

Fourth is the *likelihood that there would be sufficient competition in the nonbottleneck market which would significantly improve efficiency or access for users.*[16] Where there are strong economies of scale in the competitive sector, as in water and rail, for example, this sector may attract at best only a very small number of entrants, making large gains from competition unlikely. This is likely to be more of a problem the smaller or poorer the country—since demand levels will support fewer suppliers with given scale economies. This limitation can be addressed where international trade of the service is feasible.

Both information availability and contract enforcement are important for combining competition and regulation in an infrastructure sector. The owner of an integrated bottleneck asset may be required by the terms of its privatization or concession contract to supply nondiscriminatory access to the bottleneck asset to all who want to use it. But someone must enforce this contract, and whoever enforces it may require a great deal of complex information. In both these areas, de-

veloping countries are at a disadvantage. This suggests that it will often be more beneficial in a developing country to impose vertical separation on an infrastructure sector as competition is being created (option C) or continue to keep it an integrated monopolist (option B), rather than have it remain as an integrated firm subject to competition in the upstream market (option A). These questions have attracted policymaker attention in the developing Internet services sector (box 8.2).

In countries where regulators tend to be experienced and skilled, the relevant question may be simply, given that competitive access is desired, is vertical integration or vertical separation likely to provide the better outcome? In the context of the information and contract enforcement problems in the developing world, however, the more relevant questions may be: Are the benefits of competition likely to be achieved, and do they exceed the costs of implementation? Are the price and quality delivered to the final consumer really likely to be significantly improved by the first or third option compared with the much simpler to implement second option? Five infrastructure sectors are considered in turn.

*Telecommunications.* As wireless technology continues to progress, it is less clear than in the past that even the local service is a natural monopoly.[17] Nondiscriminatory access appears increasingly to be a possibility, especially in those conditions where competing providers of long-distance and other auxiliary services have a presence in the local market as well. This was a feature of Morocco's successful telecommunications reform in 1999, which was supported by the World Bank. In Chile competition in local service provision has come mainly from long-distance carriers entering into the provision of local service.[18] In Guatemala the (integrated) incumbent monopolist has also been required to provide interconnection to new market entrants.[19] Throughout the transition world individuals and businesses have avoided the traditional endless waiting periods for installation of fixed line service by signing up for wireless service.[20] Thus this appears to be a sector where *competition can often coexist with vertical integration,* that is, option A.

*Water.* The fixed costs of the network are so high in the water sector that competition in supplying water may not offer much benefit in the way of increased efficiencies, so the regulated, integrated monopoly model (option B) may work best in this sector. It appears that no country has actually instituted competition in the supply of water to the system, although Chile has studied the option.[21] It may be argued that this is a sector in which it is easiest to detect and prevent discrimination against nonintegrated suppliers, so, especially if the quality of different suppliers can be adequately monitored and as regulatory capabilities develop, *vertical integration can coexist with competition in supply* (option A).

*Oil and natural gas.* Like the water sector, oil pipelines and natural gas pipelines have expensive networks, so the relative cost savings from competitive product supplies may be smaller than in other sectors, but with

**Box 8.2**
**Vertical integration and discrimination in the provision of Internet services**

Internet "content" (information, music, and graphics) is carried over long distances by Internet "backbone" providers and then delivered to users by Internet service providers (ISPs), such as America Online (AOL) and Mindspring, which in turn must (at least under current technological circumstances) use the wires of local telecommunications or cable television providers to reach final users. An important consideration for regulators and competition enforcers has been the degree to which vertical integration among enterprises operating at these various levels may be harmful.

For example, when AOL recently agreed to merge with Time Warner, a major content and cable television provider, U.S. antitrust enforcers were concerned that AOL might discriminate in favor of its own content and against the content of suppliers competing with Time Warner. The antitrust enforcers and the merging companies eventually agreed that AOL would provide access to its network on the same terms as were applied to all content providers. At the same time, the Federal Communications Commission, the U.S. telecommunications regulator, was concerned that the cable operations of the integrated company would discriminate against rival, nonintegrated ISPs, and it insisted on a similar settlement agreement designed to prevent discrimination. Both settlement agreements will arguably require ongoing regulatory vigilance to ensure compliance, although both are designed to be incentive-compatible and hence, to a degree, self-enforcing.

In another example, the Lithuanian Competition Council has been concerned about possible discriminatory behavior vis-à-vis independent ISPs by the local telecommunications provider, Telecom, since it has its own integrated ISP. The council has already fined Telecom for installing "filters" on its lines that reduce the speed of data transmission by the independents, although this case has been appealed to the courts.

*Source:* United States Department of Justice, available at www.usdoj.gov; United States Federal Communications Commission, available at www.fcc.gov.

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relative ease of detection and prevention of discrimination. Where discrimination can be detected and prevented—and this will not be the case in every country—vertical integration may be consistent with a competitive supply market (option A). Where discrimination cannot be prevented, the benefits of competition are not great enough compared with the costs of regulation and the harm from discrimination to justify option A, nor are they great enough compared with the costs of vertical separation to justify option C; in this case an integrated monopoly operating in both markets—that is, option B—is probably the best outcome available. *Source competition among integrated monopolists may be a possibility* in these sectors in larger countries. As noted above, pipelines from two different gas-producing areas in Argentina are beginning to compete to supply natural gas to customers in Chile.

*Railroads.* One model of rail reform, favored by the European Union, entails separation of ownership and control of infrastructure ("tracks") from operations ("trains"), with the ultimate goal of having multiple private train operators compete with each other for the business of shippers over a common track system. The experience of the United Kingdom—one of the few countries that have tried to implement this model of reform fully—has not been encouraging. It raises the question whether *vertical integration without competition at the train level* (option B) *may be the best of imperfect choices* in this sector.

In medium-size and large countries, option B may allow for competition between vertically integrated firms through services offered to different destinations, or from different origins, to particular customers (that is, "parallel" or "source" competition).[22] This is the model that was eventually chosen by reforming governments in both Brazil and Mexico and that has been the arrangement for some time in Canada and the United States. Competition from other types of carriers such as trucks is also a probability.

Smaller countries with sophisticated regulators may find that discrimination is easy enough to detect that some entry may be allowed—for example, entry of large shippers that may already own their own railcars, or entry of foreign train operators from neighboring countries. The European Union (EU), for example, has enacted regulations requiring its member countries to allow train operators from other EU member countries to use the tracks of national integrated firms. In the Czech Republic, for example, the vertically integrated rail company must permit other train operators on its tracks.

*Power.* In the power sector, it is difficult to detect and prevent discrimination against nonintegrated electricity generators even in industrial countries with experienced regulators, and the problems facing new regulators charged with monitoring the behavior of entrenched, powerful incumbent monopolists are that much more formidable.[23] Nevertheless, except in the smallest of economies (where economies of scale even with the most modern generation technology may rule out the presence of more than one or two generation enterprises), the benefits of competition in generation are potentially so massive that *vertical disintegration may be the best outcome* (option C).[24]

A recent study shows that vertical disintegration in the power sector is the most widely followed approach for countries (Malaysia and many EU countries being the exceptions).[25] It concludes that vertical disintegration—breaking up integrated power companies into separate generating, transmission, and distribution entities—can introduce competition into power generation. Results indicate that introducing competition can be positive.

In Argentina, for example, the switch to a private competitive system quickly resolved urgent problems of power shortages. In contrast, some recent experiences have illustrated how political considerations and incomplete reform can dilute the benefits of competition in the power sector. While vertical disintegration of power companies obviates the need to regulate generation operations (as these are subject to competition), power distribution and transmission operations remain monopolies and need to be regulated. As a caveat, there is some evidence that even vertical disintegration may not significantly improve efficiency unless some type of end-user competition is also introduced.

### Structure of the regulatory system

By now it is well accepted that a country should have *independent* regulatory bodies following *transparent* procedures (chapters 5 and 10), subject to oversight by a *strong and independent judiciary* (chapter 6). In practice, each of these requirements is difficult to establish. Further, without checks and balances, bureaucratic inefficiencies may be replaced by private corruption. Moreover, human capital is scarce in many developing countries (chapter 1). All these factors call for modification of institutional design. This section addresses

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some other attributes that are necessary for a regulatory body to function effectively in developing countries, taking into account in particular the informational and capacity constraints in these countries.

*Courts versus regulatory tribunals*

Regulatory agencies may play more than one role. They may design rules, monitor compliance with rules, and enforce compliance with rules. While many regulatory agencies may do the first two well, they may still need courts for enforcement. Even in cases where the regulator has strong enforcement powers, courts are important for hearing appeals after a regulatory decision. In most developing countries the courts are overburdened, and judges may lack strong technical skills. For these reasons it would be advisable to build regulatory systems that lower their burdens. The regulator needs to be given strong enforcement authority in the first instance. Since courts are weaker in developing countries, many international investors rely on international arbitration.

One question is whether courts relying on competition laws provide sufficient oversight for service providers. The experience of New Zealand demonstrates the importance of a regulatory body that monitors compliance with the laws. As part of its broad program of deregulation in the 1990s, New Zealand eliminated sector-specific regulation and sought to rely on the competition authority, enforcing the competition law through the court system, to prevent monopoly abuses in the telecommunications and electricity sectors. Policymakers found, however, that in the absence of sector-specific regulation, proceedings were lengthy and the outcomes unsatisfying. Courts at three levels took five years to try to determine the appropriate price for a new entrant to pay to have access to the incumbent's local network. At the end there was still no general principle or direction for the companies to follow.[26] Recent reports by the Ministerial Inquiry into Telecommunications and the Ministerial Inquiry into the Electricity Industry have concluded that, at least at the current stage of technological development of these sectors, specialized regulatory tribunals will be an important part of an effective regulatory regime.

*Scope of regulators*

A second set of questions concerns the scope of action for particular local regulatory agencies. Should such bodies operate at the national level, or should local regulatory bodies control local infrastructure enterprises? Should there be a different regulatory body for each principal infrastructure sector or for a particular function?

*Local versus national regulation.* There are some arguments made in favor of localized regulation of infrastructure enterprises: (a) the better knowledge of local conditions of a local regulator; (b) the more direct political accountability under which a local regulator is likely to work, with the resulting greater involvement of the affected population in regulatory decision-making (as urged in *World Development Report 1994*); (c) the more effective monitoring of the regulated enterprise that proximity is likely to provide; and (d) the frequent difficulties faced by national- or federal-level regulators in coordinating with local governments, especially in matters as politically sensitive as access to infrastructure.

These factors, however, are opposed by others in favor of centralization of regulation at the national level: (a) the technical sophistication required of regulators, at least in some sectors, leading to economies of scale in regulation; (b) the shortage of local experts; (c) the presence of external effects (such as the network demand effects mentioned above, but not limited to those) among users at different locations in a single country, which may require both a single set of rules and a single agency; and (d) the increased likelihood of industry "capture" of an agency, the more limited is the agency's jurisdictional scope. (Some would argue in favor of centralization on the basis of a perceived lesser likelihood of corruption, but the evidence here is mixed; see chapter 5.)

The arguments in favor of local regulatory agencies are probably weaker, and the first three in favor of national regulation are stronger, the smaller a country is. For small developing countries, national regulatory agencies may be preferable. Technologically less complex sectors such as water provision and highway repair are an exception. In both of these sectors the local population has been especially important in directing the provision of services (again, see *World Development Report 1994*). Even in these sectors there are often centralized bodies and rules that take care of broad interconnection and pricing issues and externality-generating activities (such as watershed management), activities that may benefit from specialized expertise (such as overseeing the bidding process for highway construction). More decentralized actors such as municipal governments and NGOs may be responsible for monitoring performance, setting local standards, dealing with

customer complaints, and in general ensuring accountability to the local citizenry.[27]

With larger countries, it may be preferable to decentralize regulatory functions. In some cases, even though regulatory rules may be set at the national level, monitoring compliance with rules may be done at the local level, for example, by NGOs or communities. Arguments in favor of decentralization are affected by political factors. Central governments in larger countries have sometimes lacked the power to impose regulation (including demands for the basic information required for regulation) on local or regional enterprises without the agreement of the local or regional governments. However, there are still areas where it does not make sense to decentralize responsibility—such as in long-distance telecommunications regulation and interstate power and gas transmission—since much of the service is *between* areas.

There are two striking examples from the toll road sector in Brazil. First, on the toll road between Rio de Janeiro and Teresopolis, the mayor of a small town along the route has refused to cooperate in preventing illegal access by nonpaying drivers. Second, in the state of Parana the governor forced the concessionaire to charge only half the toll level agreed upon in the contract between the concessionaire and the central government.[28] Large developing countries such as Argentina, Brazil, India, and Russia have devolved regulatory power (sometimes completely, but often only partially) to local or regional governments in the face of these difficulties of national-level regulation and policy enforcement.

Yet a third form of regulatory structure that has emerged is supranational regulatory organizations such as those established among the smallest and poorest countries in Africa. Such supranational structures have been established for apparently the same reasons that in other countries have led to centralization: the complexity of regulation, economies of scale in regulation, and the shortage of qualified personnel to staff regulatory agencies. Another factor in this case may be the increased bargaining power of a multinational regulator, compared with a regulatory body in a small country, vis-à-vis large multinational investors.[29] The Organisation for Eastern Caribbean States has recently created a regional regulator for telecommunications and is considering the possible extension of this arrangement to other infrastructure sectors. Similarly, in 1995 the countries of the Southern African Development Community formed the Southern African Power Pool to coordinate national-level power production and regulation.

While these are compelling arguments for and against centralization of regulatory structure, in practice the design of effective regulatory structures depends on political realities. For example, France, which has a very centralized political system, has mostly adopted a centralized structure (except for water and local transportation, which are largely controlled by municipalities). By contrast, in the United States, the states, being large and autonomous, have large regulatory powers. Since it is generally politically costly to remove those in power, regulatory structures have shown a strong inertia over time.

This provides an important lesson for transition and developing countries: their political structures will also determine the types of regulatory institutions that can be implemented. Reforms or regulatory designs are likely to be extremely difficult to implement without recognition of these obstacles and without efforts to overcome them. Sometimes the establishment of a new institution rather than modification of the old authority can deliver benefits. Such seems to have been the case in the privatization of the Moroccan telecommunications industry.

*Sectoral specialization.* Factors that are important for the choice between local and national regulators are also important for the consideration of sectoral specialization of regulatory bodies and have led to similar answers. Arguments in favor of having a specialized agency for each broad sector (transportation, energy, telecommunications, and so on) are that different sectors have different characteristics, so there are economies of specialization and no particular economies of aggregation; that more agencies diversify the risk of institutional failure; and that more agencies allow for more policy experimentation.

Conversely, there are without question some issues that cut across sectoral lines and that would benefit from a coherent policy framework. Sectoral lines are not always very clear and are probably becoming less so (as in the case, noted above, of telephony and cable television). Further, as in the localization/centralization debate, many developing countries face a shortage of qualified personnel to staff multiple regulatory agencies, and an agency with broader jurisdiction probably has a lower likelihood of "capture" by industry (or by sectoral ministries).

Again, many of these arguments are principally related to country size and capacity. Smaller developing countries such as Costa Rica, Jamaica, and Panama have responded to the scarcity of regulatory experts by creating multisectoral regulatory bodies (although regulatory rules are obviously specialized to the sector)—a practice followed at the state level in Australia, Brazil, Canada, and the United States. Hungary has followed the example of the United Kingdom in combining its electricity and gas regulators.[30] At the same time, following from the economic arguments above, some larger developing countries—such as Argentina, Brazil, and Russia—have created different regulators for different sectors.

*Functional specialization.* In some countries different agencies have responsibility for different functions; for example, an agency may do economic regulation of, say, the water sector but may not have responsibility for the sector's technical and environmental regulation. In the United Kingdom, for example, the Office of Water Regulation has responsibility for controlling end-user prices and ensuring the viability of suppliers, while the Drinking Water Inspectorate oversees the quality of tap water and the Environment Agency is responsible for maintaining the quality of rivers, canals, and groundwater. Along these lines, it is possible to have similar divisions of responsibility regarding, say, the economic and the technical, environmental, and safety aspects of electricity generation and transmission. But there are costs to the creation of multiple agencies, and likely economies of coordination.[31] Where there is a clear need to rely on detailed knowledge of local conditions and to have the endorsement of local political forces, there may be an argument for different levels of regulation for economic versus technical regulation. For a developing country with scarce human capital, functional specialization is more difficult.

One strategy that has been attempted to "stretch" the limited supply of qualified personnel for regulatory agencies is to contract out some aspects of regulation, such as the design of pricing schemes or the monitoring of compliance, to private firms. Chile contracts out the technical monitoring of water standards, and Angola and the Philippines have considered doing the same.[32] The telecommunications regulator in Argentina has hired private consultants to assist in rate rebalancing between both commercial and business customers and long-distance and local rates.[33] There seems to be wide scope for expansion in this area.

*Competition authority versus infrastructure regulator.* One question frequently raised is whether a competition law enforcement agency can be relied upon to act as a day-to-day economic regulator. Every country in Central and Eastern Europe and the former Soviet Union that has set up competition authorities has done so before creating sectoral regulators, relying—at least initially—on the competition authorities to use the abuse-of-dominance provisions of the competition statutes to prevent monopolistic abuses.[34] Subsequently, they have complemented the economywide competition authorities with infrastructure regulators. With the increasing introduction of competition into utilities, however, the interface between competition authorities and regulators is gaining increasing attention.

Competition authorities in developing countries as diverse as Venezuela and Poland have shown that they can, like their North American and Western European counterparts, act as effective "competition advocates" in the regulatory arena without assuming the regulatory portfolio themselves. In other countries, as diverse as Australia, Bolivia, and Russia, the competition authority has at least overall coordination and management authority over the regulatory bodies—though in all three of these cases some of the details remain to be worked out.

### Designing infrastructure regulation to deliver services to poor people

The quality and coverage of infrastructure services such as electricity, water, telecommunications, and transport have a major impact on living standards. Many of the world's poor today continue to lack access to many basic infrastructure services.

The findings of a recent study on the impact of infrastructure reforms on poor people in Latin America may provide lessons for policymakers elsewhere on how to design such reforms to take into account distributional and welfare effects.[35] The two main findings of the study are as follows.

First, private sector provision has had mixed effects on tariffs and hence mixed effects on the poor. Tariffs have fallen in cases where competition and effective regulation have cut costs. For instance, in Chile liberalization of the long-distance telecommunications market in 1994 reduced call prices by more than 50 percent. Prices fell by a similar magnitude in the mobile telephony industry when the number of mobile phone

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Table 8.3
**Access to electricity, water, sanitation, and telephone services in 22 Latin American countries, 1986–96**
*(percentage of households)*

| | Weighted | | | | Unweighted | | | |
|---|---|---|---|---|---|---|---|---|
| | Water | Sanitation | Telephone | Electricity | Water | Sanitation | Telephone | Electricity |
| 1986 | 75.99 | 66.99 | 5.46 | 82.19 | 68.34 | 73.63 | 4.58 | 72.16 |
| 1989 | 80.85 | 79.85 | 6.13 | 85.37 | 69.88 | 77.21 | 5.23 | 76.26 |
| 1992 | 81.33 | 79.84 | 7.44 | 87.72 | 70.16 | 77.50 | 6.54 | 80.19 |
| 1995 | | 79.65 | 9.41 | 89.37 | 73.19 | 79.67 | 8.54 | 81.76 |
| 1996 | | | 10.30 | 90.10 | | | 9.42 | 80.91 |

*Note:* Weighted—equal weights assigned to all countries; unweighted—represents population-based access rates.
*Source:* Estache and others 2000a, p.16.

companies rose from two to four in 1998. In Argentina wholesale prices of electricity fell by 50 percent in the five-year period after privatization due to intense competition in the generation sector with the entry of 21 new generators. Residential customers enjoyed a 40 percent drop in tariffs in the five years after privatization (1992–97). In contrast, there are also examples where tariffs have risen because of the need to ensure the financial viability of service providers.

Second, the reforms have brought about increased provision of infrastructure services by the private sector. This improves access in general and can perhaps also increase access for poor people, since they have been particularly lacking access in the past. Table 8.3 shows the increase in access to electricity, water, and telephone services in 22 Latin American countries over the 1986–96 period.

The policy challenge for governments seeking to improve access to infrastructure services on the part of the poorest citizens is to square the circle of providing incentives for service to the poor while keeping the rates charged to the poor affordable, taking into account their willingness and ability to pay. This is illustrated in the case of the water concession in the Tucumán Province, Argentina (box 8.3).[36] Although the causes of the failure of this water concession are many and complex, earlier attention to social and distributive issues could have increased its chances of success, or an explicit subsidy program could have helped ease the situation.

There are five main ways in which regulatory policy can promote distributional objectives: (a) setting investment targets; (b) being flexible with respect to price-quality combinations in regulatory decisions; (c) allowing liberal entry of informal infrastructure providers; (d) involving communities in the regulatory process; and (e) subsidies.

*Setting investment targets*

Some governments have tried to promote access to infrastructure services by including investment targets at the time of privatization or award of concession contracts. Bolivia adopted such an approach in La Paz and El Alto, where enterprises bidding for the water supply concession in 1997 had to say how many connections they would make in return for a specified tariff. The winner, Aguas del Illimani, committed to achieving 100 percent water coverage by December 2001.[37] Similarly, in Monteria, Colombia, specific water and sewerage expansion targets were set.[38]

The way a contract or company is tendered in the privatization process and the variable chosen to award the contract will determine the distribution of benefits among all stakeholders. If poor households are connected to the service, then they tend to benefit more if tariffs are chosen as the competitive variable. If they are not connected, then choosing investment commitments as the tendering variable has a higher potential for benefiting the poor.

*Flexibility in price/quality combination*

In awarding concession contracts, if quality standards are set too high (using industrial country standards, for example), the service may be too expensive for poorer households and poorer countries. This means that there should be some flexibility in the contract to allow for the company, the regulator, and future users to agree to

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**Box 8.3**
**Water concession in Tucumán, Argentina**

In 1995 the concession for water and sanitation services for Tucumán Province, Argentina, was awarded to Compania de Aguas del Aconquija (CAA) for a period of 30 years. To fund the required investment program, the concessionaire bid a tariff increase of 68 percent. The tariff increase was to be immediate and to affect all consumer groups equally in a population with a significant share of urban and rural poor.

The tariff increase proved very unpopular and was considered unjust by low-consumption users. The situation deteriorated with a series of episodes of turbid water. The result was a nonpayment campaign by consumers, which provoked a financial crisis for the concessionaire. Provincial elections brought to power a new administration that was much more hostile to the concession program. At first the authorities and the concessionaire began renegotiating the contract. One initiative was to introduce a special tariff for low-income users and a system of rising block tariffs for regular customers. The negotiations did not prosper, however, and the case ended in international arbitration.

*Source:* Estache, Gómez-Lobo, and Leipziger 2000.

a different price-quality combination when it is necessary (as in specific geographic areas).[39] Insisting on high quality and safety standards for all providers will only prevent small, local enterprises from providing "imperfect" but essential services to the poor. Regulators could tighten quality and safety standards for such providers over time as incomes improve.

The principles of such a multitiered regulatory structure, in which different regulatory treatment is provided for different technologies or dimensions, have already been employed by regulators under other circumstances. For instance, in the telecommunications sector just about every country imposes different regulatory requirements on cell phones and fixed-wire operators, with the latter presumed to have greater market power and hence greater need for more intensive regulatory scrutiny. Also, many countries (Bolivia, for example) establish different regulatory requirements for the "interconnected system" (that is, those parts of the national grid) and "isolated systems," with the former requiring closer regulation for many reasons, including the need to ensure system reliability.

Providers could also be allowed to offer a menu of services and to charge a corresponding menu of tariffs. Users could make their own choice; this type of flexibility would benefit low-income users. This also reduces the informational requirements for the regulator in determining best quality or service standards. Aguas del Illimani in Bolivia, for example, offers a choice between the regular connection fee for the water service or a lower fee if households supply their own labor for connection activities. In Brazil jointly owned sewers have been introduced in shantytowns as a form of lower-quality, affordable sewerage system.[40]

Regulating outputs or outcomes rather than inputs or processes can provide incentives to providers (formal or informal) to search for and apply lower-cost ways of achieving the required result. For example, the private water concessionaire in La Paz and El Alto, Bolivia, was able to keep access costs down because regulations specified outputs (type of service and service quality) rather than inputs (material standards and construction techniques).[41]

*Liberalizing entry*

New and innovative approaches may be needed to enhance services to poor users. Such approaches include, for example, community participation in the construction and operation of networks, which may reduce their costs. An example is the water sector in Argentina, where the population in some neighborhoods provides the labor needed to work on the connections or on maintenance. Similar programs were implemented in the early 1990s in Mexico for road maintenance. Regulators need to be open to experimentation in institutional design.

In many parts of the developing world, small-scale private vendors or networks have sprung up in response to the needs of poor users who do not have access to formal providers. For example, in Paraguay about 300 to 400 private firms and individuals—called *aguateros*—supply piped water to households not served by municipal water companies. The *aguateros* range from very small operations supplying a local neighborhood to larger companies with as many as 800 connections.[42] Similar service is provided by men driving 15-ton tanker trucks carrying water around the narrow streets of the shantytowns surrounding the *maquiladoras* on the Mexican side of the Mexico-U.S. border.[43] In Yemen small enterprises provide power services to rural towns and villages that are beyond the reach of the formal utility. Suppliers range from individual households that generate for their own use and sell power to a small number of neighbors to larger operators with diesel gen-

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erators supplying up to 200 households.[44] In Senegal small private enterprises rent telephone lines from the national operator (privatized in 1998) and run telecenters for local households.[45]

Liberalizing entry for informal providers is a policy priority particularly in the lowest-income areas of low-income countries, where infrastructure networks are underdeveloped or nonexistent and potential formal providers are nowhere in evidence. Regulators could limit such liberal entry to areas or customers not served by the incumbent provider. It seems very unlikely that entry in the service of such customers would pose a threat to the viability of the overall network. Enterprises providing services through the national network should enjoy significant cost advantages over small-scale rivals (who are often providing an imperfect substitute in any case) and should be able to win over the customers if and as the network expands.

*Consultations with the community*

To address the needs of the poorest citizens in countries, regulators need to engage a larger and more diverse group of stakeholders. Public education thus becomes an important part of this special regulatory agenda. In particular, regulators need to:

- Understand the needs and priorities of the poorest, including those who are not customers of traditional utilities
- Understand the needs and perspective (including costs) of a larger and more diverse group of actual and prospective service providers, ranging from small-scale or informal entrepreneurs to more traditional utilities
- Engage municipalities, NGOs, and other groups with an interest in representing and advancing the needs of the poorest.

In this context, exclusive reliance on formal regulatory hearings will not be enough. Greater efforts to engage stakeholders will ensure that decisions are well informed and help bolster the legitimacy of the regulatory system. Some promising experiments along these lines are being undertaken in many developing countries. These include:

- Visiting communities and engaging them in a dialogue on needs and priorities or establishing specialist consultative or advisory bodies to provide the regulator with reliable access to a range of views. Regulators in Jamaica reach out to communities through local churches, and regulators in Bolivia hold town hall meetings across the country. In Brazil concessions in the power sector each include a special committee that comprises representatives of local government as well as different categories of users, including slum dwellers, farmers, and businesses.
- Developing information strategies aimed at educating citizens about the regulatory system. Regulators in Peru make extensive use of radio commercials, while regulators in Jamaica use "talk-back" radio shows.
- Delegating to municipal governments or NGOs particular roles in monitoring service provision and managing more intensive consultations with their constituencies. In Brazil there is a national system of consumer protection that delegates to subnational governments certain responsibilities for dealing with consumer issues within their jurisdictions.[46]

*Subsidies*

This section discusses how infrastructure services can be made affordable for the poor. The method used to subsidize poor people needs to be settled along with other decisions on industry structure, the standards applied to the service provided, and pricing and quality regulation. Clear definition of objectives and careful targeting of intended beneficiaries can help reduce the costs of subsidy. Competition can also do so. For example, rights (and obligations) to provide subsidized services may be allocated through competitive auctions to the bidder demanding the lowest subsidy, as is done for rural electrification and rural telephony in Chile and for passenger railways in Argentina. This section addresses five issues with respect to the provision of subsidies: (a) targeting the recipients; (b) the good or service being subsidized; (c) the source of funding; (d) the delivery mechanism; and (e) subsidy costs.

*Targeting the subsidy.* There are two broad approaches to targeting subsidies in infrastructure: according to the consumption level of the household (lifeline) or according to socioeconomic or other characteristics (means-testing).

There are two ways the *lifeline* approach can operate. The first is the rising block tariff structure, whereby a low rate is charged for an initial lifeline block of consumption and progressively higher rates for successive blocks thereafter. The second is a subsidy whose amount depends negatively on consumption, under the as-

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sumption that the poor tend to consume less than the rich. In Honduras the unit charge is reduced for customers with total consumption below 300 kilowatt-hours (kWh) per month, and the amount of the reduction has a block structure.

Both approaches are easy to implement and have low administrative costs, but the results have been mixed. In Latin America they have been found to do poorly in terms of targeting because consumption is only weakly correlated with income and, therefore, poverty.[47] In contrast, transition countries that use the lifeline approach manage to reach two-thirds of the poor for electricity and water.[48] Since there can be problems with targeting lifeline tariffs for the poor (even the nonpoor receive subsidies), policymakers need to decide whether they wish to err on the side of exclusion or inclusion.

Under the *means-testing* approach, the eligibility of households is based on observable characteristics of the household or its dwelling, under the assumption that these characteristics are correlated with income and, therefore, with poverty. The individual targeted subsidy scheme implemented in the Chilean water sector—where households are selected on the basis of a socioeconomic interview before they are declared eligible for subsidized water tariffs—appears to be one of the most effective schemes developed so far (box 8.4). In Colombia all utility tariffs are differentiated according to the characteristics of the property and its surrounding neighborhood. On the downside, means-tested subsidies can have the undesirable consequence of affecting incentives, especially with respect to labor market participation. This is sometimes labeled the "poverty trap" problem in the welfare system.

Variations on the means-tested approach described above that have been used by countries include ones that determine eligibility according to some other categorical variables or geographic zones. For instance, in Argentina subsidies are provided to specific groups (such as pensioners and students), while in Colombia consumers are taxed or subsidized in their utility bills according to a national socioeconomic classification system based on neighborhood characteristics. Operators of toll roads in some developing countries have been required by the original contract to provide free or reduced-charge access to vehicles that are likely to be driven or occupied by poorer citizens, such as farm equipment, small trucks carrying farm products, and commuter buses.[49] In both cases, however, there are large exclusion and inclusion errors, and both these approaches are found to be inferior to the standard means-tested one.

Aside from the above approaches, the government could also reach the poorest by providing the basic minimum of service to customers, such as a single public phone or water tap in a village not yet served. Yet another approach to providing lifeline services that is typical of the telephony sector is to have a telephone to receive incoming calls, with a capability to make a fixed number of outgoing calls (or a total fixed number of minutes of such calls), as well as the capability to make calls to emergency services, collect (reverse charge) calls, and calls to toll-free numbers.[50]

*Consumption or connection subsidies?* Subsidies can be in the form of a consumption or a connection subsidy. In principle, the subsidy should be directed to those goods or services with the highest difference between the willingness to pay and costs. In countries where capital market failures have a stronger impact on connections (as in many developing countries), subsidies for connections or network expansion should be favored over consumption subsidies because in these

**Box 8.4**
**Targeting subsidies: Chile's approach**

Chile replaced its cross-subsidy system with a comprehensive subsidy scheme for low-income households, assisting them with the purchase of a variety of public services. The program is financed by the central government but administered through the municipalities. Subsidies are paid to the public service operator, rather than to the household, on the basis of each subsidized user served.

In the case of water, the subsidy covers 40 to 85 percent of the charges for the first 20 cubic meters of consumption. The goal of the scheme is to ensure that water and sanitation services do not take up more than 5 percent of household income. There are multiple criteria for eligibility, including region, average cost of water, household income and wealth, and family size. Eligibility is reassessed every three years. Households failing to pay their share of the bill have their subsidy suspended. Initially, the burden of proving entitlement to the subsidies was placed on the households. Low participation rates prompted the government to ask the water companies to collaborate in identifying needy customers by examining tariff payment records. It is now believed that all eligible households in urban areas (about 20 percent of the population) are covered by the scheme.

*Source:* Brook and others 2001, *World Development Report 2002* background paper.

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countries it is almost impossible for consumers to borrow to pay for the connection, even if they were willing to do so.

*Delivery mechanism.* Direct subsidies may be transferred to the targeted beneficiary, either in cash form or as a tax deduction, or as a voucher tied to expenditure on the specified service. Cash payments and tax deductions may be efficient means of meeting distributional objectives but may raise concerns over the subsidy being expended on matters other than intended. Voucher schemes address this concern but can involve large administrative costs. Another means is for the subsidy to be channeled through the service provider, which will require the consumer to demonstrate her eligibility and may be conditional on paying the unsubsidized portion of the bill. This is the approach adopted in Chile.

*Source of funding.* The use of subsidies raises the question of the source of funding for such subsidies, which can come from general tax revenues for governments, cross-subsidies, or a common fund to which all companies contribute. Which type of funding is more convenient depends in part on the efficiency, equity, and administrative costs associated with the distortions created by the general tax system. When the tax-financed subsidies are too costly to enforce and tax reform is not a realistic option, it may be more efficient to raise funds from the utility industry, especially if done through the fixed-charge part of utility tariffs—that is, the second and third options.

*General tax revenues* are typically the source of subsidy funding in the case of urban transport and "negative concessions," such as those awarded for toll roads. The issue with this source of funding is that in most developing countries the tax system is usually quite inefficient and is unable to raise resources at a low enough cost to enable sufficient funding of a welfare system.

*Cross-subsidies* raise funding by charging certain customers a higher price than the cost of service. This has been quite standard for public utilities in Latin America and is likely to continue to be common for private utilities when governments cannot make credible commitments to finance subsidies. The drawback of this scheme is that it could inefficiently discourage use or encourage inefficient regulatory evasion or bypass.

Traditional cross-subsidies require monopolistic market structures, without which those paying the higher prices would defect to other suppliers and so undermine the basis for the cross-subsidy. Some countries have introduced cross-subsidy schemes that are more compatible with competitive markets. For instance, in the telecommunications sector in Australia and the United States cross-subsidies are funded from levies on the naturally monopolistic components of the system—the interconnection—rather than on consumption.[51]

In a variation of the cross-subsidies scheme, all companies are required to make a contribution to a *common fund* according to a rule (for example, proportional to the number of customers that each company serves or proportional to each company's revenues). Companies still charge customers a price-cost markup to pay for this contribution. But they are free to decide which prices to charge which customer. The drawback here is that this allows for less transparent subsidies.

### Conclusions

Infrastructure services are critical to the operation and efficiency of a modern economy. Improvements in infrastructure services can help promote competition in other markets, and there is evidence that infrastructure has a positive impact on growth and poverty reduction. As highlighted in *World Development Report 2000/2001*, access to infrastructure is a key concern for poor people.

Inefficiencies with public sector provision of infrastructure services and fiscal constraints led governments around the world to shift to private sector provision of infrastructure services beginning in the late 1980s. The consequent increase in private provision has expanded the provision of infrastructure services through improvements in efficiency and increases in investments. But recent experiences also shed light on institutional factors that, if improved, could increase the benefits from private provision. This chapter addresses the challenges faced by governments in regulating private infrastructure providers in order to meet both efficiency and distributional goals.

An important factor affecting service provision is the nature and extent of competition in infrastructure markets. To the extent possible, policymakers need to encourage competition in the provision of infrastructure services. Competition can help reduce the regulators' burden of monitoring prices and quality. Key factors affecting the quality of infrastructure provision are initial contract design at the time of privatization and the presence of a strong regulatory agency. Governments that have paid the most attention to detail at the time of privatization have been better able to expand service provi-

sion, particularly to poor people. Failure to set up strong regulatory agencies can result in bureaucratic inefficiencies and public corruption being replaced by corruption in the private sector or an excessive transfer of rents to private parties. Small poor countries could benefit from coordinating the regulation of infrastructure providers at a regional level. Attention to preprivatization restructuring of the sector and postprivatization monitoring, for example, through better accounting systems (chapter 3), is important. Information flows among those who are regulated, the regulators, and the customers are essential to effective service provision.

Policymakers can also expand coverage goals by encouraging new, low-technology, informal providers, and by modifying regulations to enable their operation. Regulators can benefit from flexibility in institutional design—that is, in price-quality combinations. Innovative approaches by communities—and information sharing between communities and regulators—can help improve coverage. Distributional objectives can also be met with investment targets. In cases where subsidies are needed, they need to be transparent. Targeting is a concern, and while no system is perfect, country experience suggests that some workable solutions exist.

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# OECD PERSPECTIVES ON COMPETITION POLICY AND REGULATORY REFORM IN THE ELECTRICITY SECTOR

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## *I. General Observations on Electricity Reform*

### *1. Introduction*

A well-designed reform in the electricity sector improves economic performance for the benefit of industrial and commercial consumers and households. Over the longer-term, this means lower costs (through increased efficiency), lower prices to industrial and commercial consumers, lower taxes on households as unnecessary subsidies are phased-out, higher reliability, better service, more customer choice, and more innovation than would exist absent the reforms. If prices are unsustainably low under the pre-reform structure, prices will rise under liberalisation. But, the efficiency enhancing effects of liberalisation mean that the increase of prices in these circumstances will be less than would have been necessary to achieve sustainability under the pre-reform system.

Liberalising the electricity industry brings the full potential benefits of competition only if competition actually emerges in those sectors where it is possible. The difficulties of regulation mean that it can at best only approximate competitive outcomes. Also, sunk costs of entry are high in some sectors and there are long entry delays – so the disciplining threat of potential entry on incumbents may not be strong. Fostering competition requires attention to the industry structure that will emerge as a result of the reform and privatisation. Fostering competition also requires close prior attention to the regulatory and institutional framework for the operation of some specialised electricity markets, for the regulation of natural monopoly elements and the tools to limit the exercise of market power.

Creating competitive electricity markets is difficult. The regulatory framework for such markets needs to be built – they do not evolve naturally. Decisions regarding a number of elements of reform -- the structure of the sector, transmission pricing, market design, institutional design, addressing stranded costs and provision for universal service -- must be made coherently because the design of each element affects the feasible and desirable designs of the others. The decisions should duly respect the existing physical structure of the electricity and related sectors, and the physical, legal and economic environment in which they are placed. Reforms elsewhere in the economy, such as the development of effective markets for fuels, should accompany reform in the electricity sector.

It is critical to decide early on the structural reforms and market design. Changing the structure of the industry once reforms have been implemented is difficult, since property rights—respect for which is a pre-condition for further private investment—become costly to transfer or alter. Many design decisions that seem to be "details" can have far-reaching consequences for the success of reform. Mistakes can be costly and enduring since they can affect decisions for investments that may have 40-year economic lifetimes.

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[1] This brief paper has been adapted and extended from chapter on the electricity reform in an OECD publication, "Reforming Russian Infrastructure for Competition and Efficiency", which drew on discussion among David Newbery, John Hilke, Michael Rawstron and other participants at a High Level Meeting in Moscow, May 2001.



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Reform design should be separated from implementation. Involving electricity companies, consumers, industry, and academic experts at the design phase can help ensure technical coherence. However, implementation of the reform should be left to government agencies. This arrangement best ensures that broader public objectives will be served, and it reduces the risk that consensus would be sought on each point which can result in technical incoherence. The strong linkages between competition policy and structural reform policy imply that the competition authority has a major role to play. (Experience from OECD countries suggests that the powers and resources of competition and regulatory authorities have to be significantly reinforced to carry out their new responsibilities adequately.)

Competition requires enhancement of physical infrastructure as well. Metering and payment are both essential for a liberalised market. The efficiency gains from competition in a liberalised market and from improved economic regulation require that market participants be subject to adequate economic incentives. Non-payment or not metering dampens the economic consequences of behaviour. Absence of individual meters means that consumers cannot monitor their usage, receive no benefit from energy conservation, and are vulnerable to cut-off caused by non-payment by the entity that is responsible to the power company. Real time metering in the transmission (and distribution) sector for generators and wholesale customers is a precondition for system balancing when there is wholesale competition involving generators and eligible customers.

Most OECD countries started electricity reform with excess supply capacity and prices above cost and reformed at about the time that new technology and fuel supplies were lowering costs. The substantially different position from which Turkey starts will make the reform more politically difficult. It will also put a premium on the reform generating the right investment signals early enough to ensure supply security in a few years time.

All electricity market reforms have experienced some problems and unanticipated consequences. It is essential that the reform program build in mechanisms to implement a transition to the liberalised market to address the emergence of problems in a timely manner, to make changes to market rules and where necessary adopt mitigation measures to address market failures until underlying causes can be corrected. Electricity markets are volatile by nature - demand and supply are highly inelastic in the short term, electricity is not storable, and capacity is highly capital intensive and slow to adjust. Given these properties, regulatory failure resulting in excessively high and volatile prices can occur if reforms are partial, incomplete or internally inconsistent.

## 2. *Market power in electricity markets*

Electricity cannot be practically stored in large quantities and it is subject to a wide variety of supply and demand conditions. Therefore, supply must closely match demand at each point in time, i.e. each point in time represents a distinct product market. Each product market will have a distinct geographic market associated with it is determined (in large part) by transmission constraints and demand conditions in other areas. One lesson from recent experience is that big problems can occur in just a short period in temporal electric power markets.

For each time period, only some generation sources will be at or near the margin, i.e., generating power to meet residual or marginal demand. The companies who can exercise market power are those whose plant are needed to meet residual or marginal demand. Thus, one appropriate focus for assessing the ability to exercise market power is the number and concentration of supply sources at the margin, under varying



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demand and supply conditions.[2] However, the incentives to exercise market power – such as by strategic withdrawal of generation capacity - will depend largely on ownership of infra-marginal supply sources.[3]

Market power problems are most likely to arise during peak demand periods. Transmission constraints are more likely to occur during these periods, and these constraints effectively reduce the number of suppliers and increase concentration among suppliers that can serve a given area. In addition, during these periods the cost of additional supply tends to increase rapidly, so withholding even a small amount of supply (one way to exercise market power) can create large price increases. Thus, more transmission capacity is needed in a liberalised market than in a regulated electricity sector.

Important determinants of effectiveness of competition in electricity markets include the structure of the sector, demand elasticity, transmission constraints, the rules for transmission access, the shape of the supply curve (in particular the adequacy of supply), market rules (e.g. dispatch protocols, bidding rules, arrangements for ancillary services) and entry conditions (for both new or expanded generation and transmission). Thus, restructuring cannot be isolated from other conditions affecting competition in electricity markets. The strong interactions imply that the number of generators sufficient for competition depends on these other characteristics of the market.

Using a full portfolio of market power remedies both before and after competition is introduced is needed to address market power under the vast range and speed of change in market conditions. Using only one or a limited range of remedies risks failure during some sets of market conditions.

Six key approaches to constraining market power are based on antitrust experience and economic theory:

(1) increase the scope of the product market,
(2) increase the scope of the geographic market,
(3) increase the sensitivity of demand to price,
(4) decrease concentration among existing suppliers within the relevant markets,
(5) increase the size and sophistication of customers, and
(6) reduce barriers to entry.

The topics discussed below apply these approaches.

### *3. Restructuring for competition*

- *Decide early both on a market structure and a market design that ensure sufficient competition.* Structural decisions can considerably influence the subsequent development of the sector. It has

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2 The U.S. antitrust agencies' merger guidelines about the degree of market share concentration that are viewed as problematic would thus be applied to measure the concentration among relevant suppliers (suppliers with bids 5% or less above the bid of last generator dispatched) rather than, for example, the concentration of *all* suppliers under the given demand conditions.

3 This analysis has implications for the structure of ownership of nuclear power plants. The low marginal costs and long ramp-up periods mean that nuclear plants are usually base load suppliers. Thus, they are usually the least likely to be marginal suppliers. Therefore, the structure of ownership of these units is least likely to directly affect the ability to exercise market power in a dispatch system where each generator dispatched is paid the market-clearing price. However, ownership of nuclear units by a firm that owns other generation that is at the margin more frequently, is likely to increase that firm's incentives to exercise market power because the output from the nuclear plants would benefit from any price increase.

proven very difficult, in other countries, to repair the structure or to restrict the use of market power later.

- *Restructure to reduce market power.* Market power varies a great deal due to the time of day, season, relative fuel costs, precipitation, and generation or transmission outages. To be successful, restructuring must take into account the wide variety of supply and demand conditions that are likely to occur. It is not sufficient to look at the "general structure" of a market.

Restructuring should take into account the location of generators. Distant generators may not be effective competitors to supply a load centre when transmission congestion arises. Distant generators also may face greater risk of transmission interruptions or significant line load losses that erode their competitive significance. Restructuring should aim to divide ownership such that, within each transmission-constrained area and for almost all demand conditions, there are at least five companies actively competing to set prices from their marginal plant.

If possible, each generating plant should have a single owner[4]. If, for various reasons (such as existing and unresolvable ownership constraints), adequate geographic competition can only be assured through joint ownership of plants, this can be made to work, though the risk of collusion is greatly increased. Economies of scale at the plant level, for operating plants, and for owning plants can be different. Even if operation of generating plants is concentrated due to operating economies, ownership may be more dispersed without substantial inefficiency penalties.[5]

- *Reform the demand side of the market to increase price sensitivity.* Real time metering and pricing may significantly alleviate market power because they allow consumers to reduce their consumption when prices are high. This makes it less profitable for generators to increase price. Further, real time pricing can lower average prices because consumers can shift some usage to lower-priced periods. Real time metering and pricing are important for industrial users and are likely to be useful for commercial customers. Residential customers may benefit from simpler time-of-day (day-night) meters and, when the cost of more sophisticated meters falls far enough, may even benefit from real-time metering. Introducing real-time metering costs less when done *en masse* rather than piecemeal.

- *Decisions about wholesale and retail markets should be mutually reinforcing.* Wholesale and retail competition in electric power markets can strongly reinforce each other. Effective wholesale competition is an important component of effective retail competition by giving retail customers a large choice of suppliers. Effective retail competition promotes wholesale competition by increasing the price-sensitivity of demand facing wholesale suppliers.

### *Vertical separation*

The electricity industry includes a combination of activities, some of which are natural monopolies (transmission and distribution within a defined area) and some which are at least potentially competitive (generation and final supply). Ownership linkages between these activities can distort competition in the potentially competitive activities. For example, the owner of a transmission system which also operates generation has an incentive to prevent other generators from attaining access to the transmission system as

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4 However, a single owner can own more than one generating plant.

5 In the United States, for example, many large power plants have multiple owners. Each owner independently determines the output and disposition from its share of the plant's capacity.

this may allow the transmission system operator to earn excess profits in its generation activity. Discrimination in access to transmission which may arise due to vertical integration with generation increases the total cost of the system, because the lowest-cost generation is not used and distortions to upstream or downstream competition may result. Such discrimination can arise from a number of different vertical relationships between sectors of the industry. One solution to this problem is "ownership separation" which requires separate ownership of the different industry sectors – this removes the incentive to discriminate. Other less robust solutions include some combination of regulation and less strict separation (from accounting to corporate) – this leaves the incentive to discriminate intact but reduces the ability to discriminate.

The following table sets out the different potential integration issues in the electricity sector and summarises the problems which can result. (The integration is indicated by the shaded bars.) The following discussion addresses the briefly addresses the issues and possible solutions. The table can be interpreted in a cumulative fashion where integration exists between more than two functions.

Table. Classification of Vertical Integration Problems

| **Functions** | **Vertical Integration** | | | | |
|---|---|---|---|---|---|
| | **I** | **II** | **III** | **IV** | **V** |
| Generation | | | | | |
| Transmission | | | | | |
| Distribution | | | | | |
| Retail Supply | | | | | |
| **Problems** | Discriminatory access to: Transmission | distribution | distribution | Restricts benchmark regulation of distribution | Distorts generation market, if retail supply market power |

- *I. Ownership of transmission should be separate from ownership of generation.* Separate ownership is the only sort of separation that changes incentives to discriminate. Firms can make higher profits by discriminating in favour of their own generation and against other generation. Only the change in ownership—so change in source of profits—changes those incentives.[6]

- *II. Ownership of distribution should be separate from ownership of generation.* This is for the same reason as above and is clear where distribution is separated from the supply function[7].

  - *In addition to ownership separation there should be independent, non-discriminatory control of grid and distribution system access and connection standards should be provided starting early in*

[6] Change in control can also change incentives, as the experience of independent system operators in the United States shows.

[7] The latest set of reform in the UK mandate corporate separation between distribution and supply. Some industry participants are choosing to specialise in one or other activity.



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*the reform.* Non-discriminatory access to transmission and distribution is a fundamental element of effective competition in generation.

- *III. Ownership of retail supply should be separate from ownership of low-voltage distribution.* Discrimination in access to low-voltage distribution can exclude non-integrated retail suppliers from supplying consumers located in the territory of the vertically integrated distribution company. However, the recommended ownership separation is not common in many countries, which emphasises the importance of regulation for non-discriminatory access to distribution services underpinned by some form of separation that is less strict than ownership separation. The regulatory task is more simple in the distribution sector than in transmission because distribution is generally "passive" (often there is a single one direction energy path and there are fewer network externalities that need to be reflected in tariff regulation). Consequently, regulatory solutions may be a reasonable policy approach in a reform program without requiring up-front vertical ownership separation of retail supply and distribution.

As a general observation behavioural rules aimed at preventing discriminatory access should be avoided in preference to structural separation. Behavioural rules require constant monitoring. Detecting and documenting discriminatory behaviour can be difficult because discrimination is subtle. The subtlety is due to the high sensitivity of the value of transmission or distribution access to timing and to changes in risk. The time required to resolve discrimination disputes is costly for the company seeking access.

- *IV. Integration of transmission and distribution is not recommended.* Integration between transmission and distribution does not or itself give rise to discrimination problems – both are effectively natural monopoly activities and it is integration of these activities with potentially competitive activities up or downstream that raises the problems noted above. However, transmission/distribution integration causes other problems because the geographic minimum efficient scale of distribution is usually less than that of transmission, ie it is possible to have more than one distribution company served by a single transmission company without the loss of scale efficiencies. Having more than one distribution company opens the prospect of the regulator using benchmark competition as one of the information sources to regulate the infrastructure access to the distribution sector. Clearly that will not be possible if transmission and distribution are integrated as there will be only one distribution company and hence no benchmarks[8] [9].

- *V. Integration of generation and supply should be judged on a case by case basis.* Where retail supply companies own their own generation, this too can compromise the efficiency of the market because they tend to use their own generation in preference to other, perhaps, lower-cost generation. However, such vertical integration can also lower transaction costs or lower risk in situations of supply shortfall or if longer-term contract markets are dysfunctional. Consequently, the balance between benefits and costs of vertical integration between generation and supply needs to be determined on a case by case basis. If competition in retail supply is well established and retail supply has separate

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8 It might be thought that if there is only one distribution company that the regulatory could use a benchmark from a different country. There are limits to the usefulness of such benchmarks because cost structures are likely to vary more between countries than for similar areas within a country. Also, the quality and detail of information that a regulator is able to access from a distributor in a foreign country to use a s a benchmark is likely to be constrained.

9 Of course, if the market in question is sufficiently large and population dense, it may be efficient to have more than one transmission/distribution company within one country, which would then permit benchmark regulation even though transmission and distribution is integrated. Germany is and example of a market that has evolved in this way. (check – is that right.)

ownership from low-voltage distribution then, over-time, the integration of generation and retail supply would cause less concern.[10] Most important in this respect will be whether or not there is actual competition in generation and competition in supply – if so vertical integration between generation and supply is less problematic than when there is market power in generation or supply.

- *Where distribution and supply are integrated the policy choice concerning integration with generation is more complicated.* Vertical integration between generation and supply is not necessarily problematic (see above paragraph) however, if distribution is integrated this again raises the possibility of discrimination by the distributor against other generation. Given the regulatory task is more simple in the distribution sector than in transmission, the problem of integration between generation and distribution/supply is again probably of less immediate importance than separation between generation and transmission. However, given the incentive for discrimination it is desirable to opt for more than simply accounting separation between distribution and supply.

***Transmission ownership, system operation and the power exchange***

Separating or combining system operation and transmission ownership requires tradeoffs. It is more difficult to provide efficiency incentives to a stand-alone system operator (SO) than to an integrated SO and transmission owner[11] but a combined company may favour transmission solutions over other solutions to constraints. The SO can be a not-for-profit organisation, but then it may not behave efficiently.[12]

Integrating dispatch and market operation into the same organisation may be preferable because they require intensive co-ordination.[13] This point is especially relevant where the inadequacies in the "surrounding legal and technical infrastructure" make multiple markets infeasible. Market design should take into account the flexibility of the generating plants. Compulsory pool markets which establish a single Pool marginal price are likely to be more susceptible to anti-competitive strategic behaviour by generators with temporal market power who may withhold marginal generation capacity or otherwise manipulate market rules and raise the Pool price. In such systems, the inflexible base-load plants will bid very low—perhaps zero—to ensure dispatch (since they are certain the pool price will exceed their marginal costs), but if flexible marginal price-setting plant is in short supply, then the pool price could be

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10 In England and Wales, the integration of generation and retail supply was allowed only because low-voltage distribution and retail supply were separated and all consumers had the right to seek their own electricity supplier. This allowed consumers to by-pass those suppliers who owned generation and contract instead with suppliers who did not have such conflicts.

11 The low value of the assets of a system operator (SO) compared with the value of transmission assets makes it much more difficult to provide a stand-alone SO with incentives for efficiency—through changes in profits—without distortions elsewhere, compared with doing so for an SO integrated with transmission. The NETA reforms in the UK, conceptually separate the roles of transmission owner (TO) and SO and introduces separate specific incentive regulation for the SO function.

12 Experience in the United States with non-profit independent system operators is that they tend not to have strong incentives for efficiency nor are they customer-oriented; instead they tend to manage networks too conservatively.

13 Experience in California, where the ISO and the Power Exchange were separated, was that they made inconsistent decisions. Other jurisdictions have successfully integrated the activities, for example in the PJM Interconnection in the mid-Atlantic states in the United States and in the Australian National Electricity Market.

very high during periods of shortage. Pool models need adequate capacity to restrain average prices and consumers must learn to live with (and hedge against) occasional very high spot prices. Where few generating plants are flexible, then balancing by the system operator becomes more important.

Bilateral voluntary markets are probably less susceptible to manipulation and temporal market power of generators. There is a trend away from compulsory Pool models for this reason. Where bilateral contracts and multiple markets are allowed[14], the system operator must manage balancing. The design rules of these core markets (the Pool market or balancing market) are critical for the emergence of wholesale competition. Even if the core market is small (say 5% of demand), arbitrage to the general market can be adverse if the core market is "corrupted".

- *The central market operator should include an effective market monitoring/surveillance function to detect misuse of market power and manipulative bidding strategies.* The output of market monitoring should feed into early corrective policy decisions and mitigation strategies if necessary. This may involve further changes to market rules and, in the extreme, to bid or price control measures. Care must be exercised in any mitigation measures that these do not prevent the resolution of underlying problems or longer-term adjustment and functioning of the market.

- *It is essential that longer-term contracts or hedging by major participants be allowed if a compulsory Pool model is adopted as the core market mechanism.* The volatility of wholesale spot markets will tend to involve long cycles between prices converging to variable cost when there is excess supply and prices way above entry cost when supply is short. This may generate ultimately pro-cyclical investment signals. Longer-term contracts are likely to better incorporate fixed costs into final prices and generate more stable investment signals.

- *The System Operator should face incentive regulation to operate energy balancing and ancillary services functions in an efficient way.* Direct pass through of such costs into transmission pricing is likely to yield poor performance and higher prices for consumers.

- *The system operator/central market operator should not be a participant in the market other than for the purposes of performing its system/market functions.* System operators that are also energy traders will face conflicts of interest.

## *4. Transmission pricing and access*

Despite its small share in total cost, regulation of transmission is extremely important for an electricity market. There must be enforceable access rights to transmission at non-discriminatory, transparent and efficient terms. Such access rights are needed not only for competition among incumbents but also to induce new investment by incumbents and entrants. To induce efficient behaviour, transmission prices should have components that depend on short-run phenomena ("short-run transmission prices") and components that depend on long-run phenomena ("long-run transmission prices") and include congestion costs.

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14 England and Wales and Australia offer contrasting examples of the nature of bilateral contracts. In England and Wales, more than 95% of electricity is traded in bilateral contracts. Australia has a compulsory physical wholesale market so bilateral contracts are purely financial instruments.

- *Transmission should be subjected to open access.* That is, so long as a generator meets all the technical standards to connect, then it should allowed to connect. Such a system reduces barriers to entry into the wholesale market.

- *Short-run transmission pricing should induce optimal dispatch.* Short-run pricing can depend on marginal losses (equal to *twice* average losses) and on constraints. Dealing appropriately with transmission losses is especially important in a large country such as Turkey.[15] Losses can be attributed to generators or they can be borne by all users of the system. Attribution makes dispatch more efficient, and improves location decisions of new generators.

Short-term pricing can take transmission constraints into account in three alternative ways: all generators receive the same price except for those whose output is varied to deal with constraints,[16] electricity prices can be different in different "zones," or electricity prices can be different at different "nodes." Zones are usually defined so that their boundaries are at frequently congested points on the grid. Nodes are those points of the grid where generators or load are connected. Nodes are a finer division than zones.[17] Each of the three methods is used.[18] The choice among methods depends on the topology of the transmission grid and the location of generation and loads. The wrong solution can have financially catastrophic consequences. A solution that provides incentives to reduce transmission constraints can have important pro-consumer effects on the market price of electricity.[19]

- *Long-run transmission pricing should induce optimal location decisions and expansion of the transmission network.* The location of both new generation and of energy-intensive industry can be influenced. Connection charges and spatially differentiated short-run prices can increase the difference in profitability of building new generation in different locations.[20]

"Deep connection charges" (which mean the new generator pays all consequential reinforcement of the grid—which can be some distance from the generating plant) provide spatial price signals for efficient location, in contrast to the more normal "shallow connection charges" (which mean that the new generating plant pays only the direct cost of connecting a generator to the nearest grid point). Deep connection

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15 Australia, for example, has transmission losses in some cases up to 40%. Transmission pricing in Australia does not incorporate transmission losses and provides incentives for generators to locate in high-cost places, near fuel sources and not near the load.

16 In such cases, the extra costs of paying generators to produce out of merit order to relax constraints are often socialized, or averaged across all consumers.

17 In England and Wales, for example, there are 15 zones but about 200 nodes.

18 England and Wales formerly used the unattributed method, but now uses zones. Scandinavia uses zones, defining zones as areas with constrained imports or exports. Australia uses zones, and auctions the use of the constrained transmission between zones. The receipts are used to reduce the charges to use the network.

19 In England and Wales, the introduction of a system to pay the transmission company to relieve constraints caused payments made to generators to resolve transmission constraints drop to 10% of their earlier level.

20 The charges and prices can be combined with cost recovery, in which case they would be subject to the overall revenue cap. This can mean that some generators would be paid (charged a negative price) to connect at certain points on the grid. To be sure the generator actually puts energy into the grid when it is most valuable for it to do so, such a generator might be charged a lot to be connected during the system peak but be charged nothing the remainder of the time.

charges are equivalent to a long-term contract to pay spatially differentiated connection charges, but may have the disadvantage of discouraging entry.

Pricing according to the above short-run criteria may bring in only about one-quarter to one-third of the funds needed to cover total cost. For long-term sustainability, the revenue shortfall must be collected. The least-distorting way to collect the additional needed revenue is probably to make generators pay an annual capacity fee and transmission consumers pay according to their demand at the system peak. Multi-part tariffs that include both short run and long run criteria (in the form of use and capacity charges) are more efficient than single part tariffs in most circumstances.

### *5. Universal service*

Reform should be designed to ensure "universal service" while at the same time getting the advantages of competition. Because it is a fundamental need of modern life, there is a legitimate social objective to ensure universal access to electricity. Universal service is used here to mean, "granting all citizens access to electricity at prices they can afford to pay."

- *Reform will fail unless the subsidies and cross-subsidies in the existing system, whether due to universal service obligations or other policies like subsidies to energy-intensive customers, are identified and either ended or funded from sustainable sources.* If the incumbent must internally cross-subsidise, then free entry and competition will allow new entrants to undercut the prices offered by the incumbent to those customers currently providing cross-subsidies to undercharged customers. This makes the incumbent's position unsustainable.

The cost of offering citizens below-cost prices while ensuring access for the poorest can be limited either by designating some consumers as eligible for the subsidised electricity and excluding the others, or making any citizen eligible but limiting the quantity each can buy at subsidised prices.

Failure to introduce adequate funding for subsidies may well result in under-investment by the incumbent. Under-investment is not a sustainable source of funds, and can harm other parts of the economy if it reduces reliability. Potentially sustainable sources of funds are other customers and the general tax and expenditure system. The most sustainable source of funds for subsidies is a non-bypassable transparent surcharge to which all consumers contribute. Usually, responsibility for providing universal service is assigned to the incumbent. Regulators also ensure that there is a "supplier of last resort" to supply those customers who would otherwise be without supply if their retail supplier exits the market.

### *6. Recovery of Stranded Costs*

Stranded costs arise from assets that were incurred or entered into validly under the previous regulatory regime which will not be recovered in a competitive environment. Such costs can arise under contracts that set prices that are inconsistent with competitively determined market prices. A key reform challenge is to mitigate and accurately measure stranded costs and to provide for their recovery in a way that is "fair" and does not impede efficient entry or the emergence of competition. Conceptually, stranded costs can be recovered in a variety of efficient ways. It is important that such costs cannot be by-passed by some customers, otherwise the fairness of the distribution of such charges is reduced and entry signals can be distorted. Desirably the method of recovery should not distort economic dispatch of generation.

- Putting stranded costs in a usage insensitive part of a multi-part tariff reduces their distortionary effect on future market behaviour.

### 7. *Competitive Neutrality*

Where privately owned and publicly owned entities compete in the same activities it is important that they be treated equally. If different entries are subject to different taxation treatment, regulatory rules, access to finance, or government preferences, then competition will be distorted. Similarly, government entities sometimes operate under different accounting rules or softer budget constraints than private sector entities that distort competition in their favour. Alternatively, governance arrangements and political objectives can place public sector entities at a disadvantage. Reform programs should address these problems, desirably by privatisation (which removes the problem) or though specific measures to ensure competitive neutrality between public and private competitors.

### 8. *Relationships between institutions and laws*

- *Include in the reform design an institution that is empowered to regulate the sector, especially to regulate access to transmission and the low-voltage distribution grids. The jurisdiction of the regulator should be at least as large as the interconnected areas.*[21] This avoids a situation in which the best solution to a bottleneck in a market lies outside the jurisdiction of the regulator. It also avoids inconsistent decisions in two jurisdictions that have a common market. Inconsistency can discourage and distort investment. The latter is costly when, for example, new generation is located where it is more profitable due to regulation rather than where it provides the greatest benefit to the system. Where there are both federal and sub-federal regulators, regulation needs to be consistent.[22]

- *Identify the likely future competitive problems and the tools and powers that will be needed in the likely future enforcement of the competition law in the sector.* Market monitoring can be used to reduce, indirectly, anti-competitive behaviour in the electricity markets, as well as to identify changes that should be made in market rules. The system operator rather than the regulator may monitor the market.[23]

- *The scope of the regulators' jurisdictions or co-operative arrangements between regulators should take into account integration and convergence trends in their regulated industries.* The convergence

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21 In the United States, for example, if regulators' jurisdictions were at least as large as interconnections there would be at most three regulatory agencies, corresponding to the three interconnections, rather than existing the fifty state regulators. The system of state regulators was established when electricity was highly regulated and there was little inter-state trade. Liberalisation has induced the establishment of some multi-state system operators and more large inter-state trades. There are now proposals to expand the jurisdiction of federal regulators at the expense of state regulators.

22 Australia is an example. There, the federal regulator works to induce consistent regulatory policy across the country by consulting an advisory group, consisting of the heads of the electricity regulators in the states in the National Electricity Market, in its regulatory decisions and by holding regular discussions on regulatory issues.

23 In Australia, the National Electricity Administrator screens all bids for possible misuse of market power or price manipulation. In the United States, the independent system operators in PJM (in the mid-Atlantic states), New York and New England have quasi-independent market monitoring divisions. California's independent system operator has an independent market monitoring committee led by economists from major universities in the state. They report good experience in developing guidelines to identify "suspicious" bids. Indeed, often changes in market rules are precipitated by reports of the market monitoring units on bidding and system performance, so the market monitoring has been a force for change in market rules.

and integration of gas and electricity markets calls for close co-operation between relevant sectoral regulators to avoid inconsistent approaches and biases in investment that are due to arbitrary regulatory differences. One approach to this challenge is to combine gas and electricity regulation in a single body.

- *Utility regulation and competition enforcement should be closely co-ordinated.*[24] Benefits include facilitating sharing market-specific expertise between the competition and regulatory decision-makers. Second, regulatory decisions are more likely to take the competition perspective into account. This allows competition to play a larger role than it does when competition is viewed as an alternative to regulation since it allows the aim to be to reinforce effective competition rather than to regulate to moderate anti-competitive behaviour or the use of market power. Third, it allows a broader range of instruments--regulatory and competition--to be wielded coherently in a market.

- *Regulatory institutions should be independent, both of the regulated firms and of short-term political pressure.* Independence does not mean complete independence of political control. Normally, the parliament makes broad policy decisions that are then implemented by the regulator. The regulator usually must present an annual report to the parliament, which conducts regular reviews of the regulator's activities. Independent regulation is increasingly common, with about a dozen independent regulators of electricity in OECD countries.

- *The regulatory institutions should make decisions that are neutral, transparent and not subject to day-to-day political pressures.* The regulator must have analytical expertise and not rely on the expertise of the regulated utilities. The regulator must be functionally separate from policy-making in order to maintain a neutral regulatory regime. To be seen to be fair, the regulator should have well-defined obligations for transparency, notably with respect to its decision-making processes and information on which the decisions are made. Further, the objectives of the regulator must be clearly stated and progress towards these objectives should be monitored. Finally, the powers of the regulator should be clearly stated. The combination of transparency of objectives, powers, processes, decisions and information give the public clear performance criteria to evaluate the extent to which the regulator is fulfilling its role.

## 9. Appeal Mechanisms

Courts influence regulators even if they are not well suited to regulate. In many countries, courts are too slow to be decision-makers in cases where, for example, delay in gaining transmission access can be fatal for a new generating company. However, court review can protect against some bad regulatory decisions.[25] If it is possible under a country's constitutional system there may be a case for a specialist regulatory appeal body that includes expertise in regulatory issues. If the range of sectoral regulators are all accountable to a single appeal body it can enhance the coherence of regulation by those bodies in related markets.

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24 In Australia, where the competition authority is independent, responsibility for both federal regulation of utilities including electricity and competition enforcement are combined in the same authority. This follows from the access law being included in the competition law.

25 Legal systems provide this protection in various ways. In the United States, courts may review a regulatory agency's regulatory decisions both on a procedural basis and on a "clearly erroneous" basis. In the United Kingdom, the imposition of license conditions on companies is the main regulatory instrument in the electricity sector. If a company rejects license condition changes proposed by the regulator, the dispute is referred to the Competition Commission, a specialised adjudicative institution, for resolution.

## 10. Privatisation methods

Decisions about privatisation critically affect the industry structure and potential for competition to emerge. While regulatory reform permits competition it generally does not and should not foster competition by selectively discriminating in favour of new entrants. However, privatisation can foster competition by the privatisation of inherently pro-competitive structures. This includes horizontal separation of dominant government owned generation companies to create competing generation companies – a rule of thumb is that there should be at least five companies with generation that will be at the margin in most demand situations.

It is a bad reform mistake to privatise companies with market power to increase the privatisation proceeds. The increase in sale proceeds will represent a poor "deal" for the country:

- Market prices will be subsequently higher and the excess price over a competitive price will be capitalised into the privatisation proceeds. However, the capitalised amount will be discounted at a private discount rate, which is likely to be greater than the social discount rate. It will also be discounted by a further factor that will reflect regulatory uncertainty.

- The higher electricity price is equivalent to a special tax on electricity and a priori is not likely to be efficient.

- The higher electricity price will reduce economic growth and dynamically reduce government general tax receipts

Similarly, the creation of several distribution companies each with a separate geographic area allows regulation of the sector to make use of "benchmark" information. Benchmark information is enhanced if there is more than one distribution company serving areas with similar underlying cost structures. Attention to issues of scale is also needed in privatisation decisions – there is no point in fragmenting an industry far beyond the degree of horizontal separation that is needed for the emergence of competition.

Privatisation of assets can be by 100% outright sale or sequenced sale, including with contracts that govern issues such as new investment and social performance as conditions for subsequently acquiring a majority stake. The choice between these models depends importantly on the specific country context. Where capital markets are undeveloped and regulatory frameworks are incomplete or new it may be best to adopt a sequenced sale approach. This can assist the government to achieve a higher sales price as it provides more scope for a well based assessment to be made of the potential efficiencies that can be achieved before the government disposes of its entire interest. Also sequenced sales carry an implicit regulatory commitment from the government to not damage the company by subsequent arbitrary regulatory decisions since the government maintains an interest it will not wish to damage. On the other hand, 100% sales may be called for to address fiscal needs. Also, 100% sales would be preferable if the political environment is such that on-going and distracting political influence would occur in partially government owned companies.

Golden shares may be useful if the regulatory environment is incomplete or not robust. However, the scope of government action under a golden share should be clearly specified and limited – golden share which permit arbitrary intervention in corporate governance will be counter productive.

Where there is a supply shortfall the government faces a conflict of interest in privatisation decisions. Generators will attract a scarcity value, and this may ease a difficult fiscal position, yet the government also has an interest in adequate "green fields" investment reducing supply shortfalls. It is important that the government pre-commits to mechanisms which will ensure adequate new supply.

## *11. Transition*

- *It is preferable to design the reform path from the outset* because coalitions form to make further changes in reform harder. Notwithstanding that advice, maintain an alternative reform path in the event of opposition to subsequent stages of reform.

- *Reform is easier when there is excess capacity*[26] *and when the sector is majority state owned.* The first observation follows from the absence of a reliability-driven need for continuous investment, since potential investors might hesitate to invest until the reform plan is clear. The second means that decisions can be made that are sensible rather than expedient. The position of Turkey is potentially quite difficult in this respect.

- *Use carefully chosen long-term contracts and vesting arrangements to ease transition. Inter alia*, they should have staggered ends so the market can adjust in smaller increments to the change to a market mechanism. However, foreclosure by long-term contracts should also be prevented. In particular, long-term contracts between the incumbent and customers, particularly large cheap-to-serve customers, can make entry by new generators unattractive. This hinders subsequent development of competition.

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26 This is one major reason why the recent reliability and pricing problems in California do not apply in many other countries. Reasons for the high prices and reliability problems recently experienced in California include fundamental characteristics (substantial growth in demand but no new power plants in over a decade, major transmission constraints and no new transmission capacity, and little demand-side participation due to average pricing), weather, miscellaneous short-term factors like unscheduled nuclear plant outages and traditional scheduled outages for repairs, increased cost of emissions allowances, market power, and market rules (such as forbidding hedging by traditional utilities, ineffective retail competition so less incentive to minimise cost, scheduling problems symptomatic of pay-as-bid incentives vs. one price, reliability rules aggravating inelastic demand, and pricing of ancillary services).

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