EC COMPETITION LAW

TEXT, CASES, AND MATERIALS

Third Edition

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INTRODUCTION TO COMPETITION LAW

1. CENTRAL ISSUES

1. Competition law is concerned with ensuring that firms (undertakings) operating in the free market economy do not restrict or distort competition in a way that prevents the market from functioning optimally.

2. The belief that competition amongst undertakings produces the best outcomes for society is based on economic theory that employs models of perfect competition and monopoly, and concepts of welfare and efficiency.

3. It is possible for systems of competition law to pursue objectives other than the economic ones of welfare and efficiency. Whether they should and, if so, what other objectives should be pursued, is extremely controversial.

4. Even if it is accepted that economics should be the sole or main goal of competition law, there is much debate as to how markets work and when, and on what basis, competition authorities should intervene. Three main 'schools' of competition analysis are known as Harvard, Chicago, and Post-Chicago.

5. A system of competition law is provided for in the EC Treaty. Article 3 EC provides that the activities of the Community include 'a system ensuring that competition in the internal market is not distorted'.

6. A school of political theory in Europe (and more particularly, Germany) called Ordoliberalism contained ideas about competition law which were influential in the development of EC competition law.

7. Recently, EC competition law has been undergoing a process of modernization. This has led to the competition rules being applied in a more economically rigorous way, based on a consumer welfare standard.

8. Three central concepts used in competition law are market power, market definition and barriers to entry.

2. INTRODUCTION

The first question any book on competition law must address is, what is competition law?

The starting point is that competition law exists to protect competition in a free market economy—that is, an economic system in which the allocation of resources is determined solely by supply and demand in free markets and is not directed by government regulation.

States which adopt a market economy do so because, on the basis of neoliberal economic theory, they consider it to be the form of economic organization which brings the greatest benefits to society. The basis of a free market is competition between firms because such competition is believed, for the reasons explored below, to deliver efficiency, low prices, and innovation. At the other end of the spectrum is an economy which is run by central government planning, such as that which existed in Soviet Russia. Adherence to a belief in the market economy leads to great importance being attached to competition policy and the introduction of competition laws. Competition rules seek to promote effective and undistorted competition in the market. This does not mean that in a free market economy every sector is left to unbridled competition. Areas such as health services or the provision of basic utilities may, for example, be subject to governmental intervention or government controls. Different States may have different views about how far the free market should be tempered or supplemented by a social component and in the European Union agriculture is controlled by the common agricultural policy.[1] The terms competition *policy* and competition *law* are often used synonymously but they can be distinguished. The former is broader since it describes the way in which governments (or, in the case of the European Community (the EC), supranational organizations)[2] take measures to promote competitive market structures and behaviour. Competition *policy* will therefore encompass within it a system of competition *law*. Those rules will seek to implement competition policy by ensuring that firms operating in the market place do not act in a way that harms competition.[3]

At first sight it might perhaps seem ironic that competition laws seek to control and interfere with the freedom of conduct of firms in order to promote free competition. Similar paradoxes face democratic governments in other spheres: how far should the liberties of individuals be constrained in order to uphold liberty itself?

In the competition context regulatory rules are necessary to deal with market imperfections. In particular, left alone to determine their own conduct, firms are likely to combine or collude in a way which is profitable to those firms but which works to the detriment of society as a whole. As early as the eighteenth century Adam Smith,[4] who first identified the 'invisible hand' of competition as a force leading to the general good, described the tendency of those operating within the same trade to conspire to fix prices. Cartels are an age-old phenomenon. Further, competition between firms may produce a 'winner' which dominates the market, or 'natural' monopolies may exist on a market. In these situations it may be thought necessary for competition law to restrain the dominating firms' behaviour. Monopolies may also be created if competitors are allowed to merge freely with one another. Competition law may thus aim to preclude mergers where necessary to preserve the competitive process on the market.

The discussion above assumes that the sole goal of competition law is to achieve economic goals and to preserve the competitiveness of markets. The position is not this simple, however. Rather, there is much disagreement about what goals should be pursued through the application of the competition rules. Some argue that the economic goals should be the sole objective, others that a wider range of objectives should be pursued. The next section discusses the objectives of competition law.

[1] Although since the 1990's the system which manipulated the market through subsidizing products and intervention buying has been gradually reformed towards a more market-oriented, environmentally friendly policy which subsidizes farmers rather than products but often makes payments to farmers dependent on them attaining standards on matters such as food safety, animal welfare, and care of the environment: see Council Regulation 1184/2006 and http://ec.europa.eu/agriculture/publi/capexplained/cap_en.pdf.

[2] In this book we talk about EC rather than EU competition law since at present the competition rules are contained in the Treaty establishing the European Community and strictly pertain to the EC rather than the EU as such. If the Reform Treaty comes into force the EC will be subsumed into the EU (see Addendum, *infra* 1399). The competition rules also impact on the European Economic Area. See further *infra* Chap. 2.

[3] The adoption of competition *laws* has, however, sometimes pre-dated the adoption of a discernible policy, see, for example, the discussion of the Sherman Act in the USA, *infra* 19 ff.

[4] See Adam Smith, *The Wealth of Nations* (1776, reprinted Penguin, 1979).

As a matter of terminology it should be noted that in general parlance competition law is often called by its American name, 'antitrust law'. However, the EC Commission (the EC competition authority[5]) now uses the term 'antitrust' to denote the areas of competition law other than merger control and State Aids.[6] The reader will find, nevertheless, that many of the sources quoted in this book use 'antitrust' in its more general meaning.

3. THE OBJECTIVES OF COMPETITION LAW

A. ECONOMIC EFFICIENCY

(i) The Maintenance of Effective Competition

One possible objective of competition law, and the one which is currently in the ascendant, is economic efficiency. This section seeks to show why competition is thought to achieve efficiency and produce the greatest benefits to society. To facilitate the understanding of these issues it is useful to understand some basic concepts of micro-economics and welfare economics (welfare economics is the branch of economics which deals with the desirability of the social consequences of the arrangement of economic activities[7]). Reference should also be made to the EC Commission's own 'Glossary of terms used in EU competition policy'.[8]

(ii) Basic Economic Concepts

a. Demand Curves and Consumer and Producer Surplus

Consumers are all different. They place different values on things, have different preferences and different incomes, and will consequently be willing to pay different prices for a particular product. The maximum amount a consumer is willing to pay for a product is his reservation price.

Although suppliers might like to be able to charge each consumer his individual reservation price, in practice this is not normally feasible. The supplier must therefore consider the relationship between the consumer's willingness to pay and the quantity which will be bought on the market as a whole. If only buyers with very high reservation prices are supplied, the quantity produced will be smaller than if buyers with lower reservation prices are supplied. Conversely, if greater quantities are produced the price will have to fall to incorporate buyers with lower reservation prices. The relationship between price and supply is represented by the market demand curve. The demand curve normally slopes downwards from left to right.

[5] The organization and functions of the EC Commission in respect of competition law is explained *infra*, Chap. 2.

[6] See, for example, the web site of the Directorate General responsible for competition policy, http://www.europa.eu.int/comm/competition/index_en.html.

[7] Welfare economics is described as 'normative' as it depends on value judgments about how well the economy works.

[8] Brussels, July 2002. Available also on the European Commission web site, http://www.europa.eu.int/Commission/competition/publications/glossary_en.pdf and in on-line format at http://www.europa.eu.int/Commission/competition/general_info/glossary_en.html. The Commission now subjects the Glossary to a rider that some of it is no longer valid after 1 May 2004 in view of the changes in enforcement procedures.

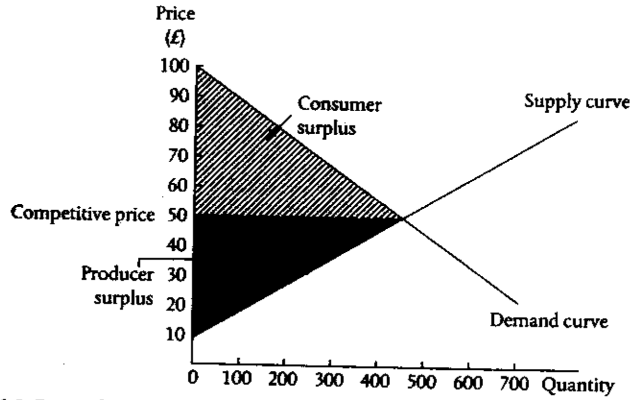

Figure 1.1 Demand curve and consumer and producer surplus

If we assume that the market price is £50 we can see that some consumers will be paying £50 for a product for which they would have paid more. This results in what is known as *consumer surplus* and is shown by the hatched area in Fig. 1. It is the difference between the buyers' reservation prices and the market price.[9]

The supply curve shows the marginal cost[10] of production. In Fig.1 we see that the producer is selling the output for more than it costs to produce. This results in what is known as *producer surplus* and is shown by the shaded area in Fig.1.

b. Elasticity of Demand (Own Price Elasticity)

The amount by which the quantity demanded increases as price reduces (and vice versa) will depend on the market in question and the elasticity of demand for the product.

Price elasticity of demand measures the sensitivity of the quantity demanded to the price. Demand is said to be *inelastic* if an increase in price leads to an insignificant fall in demand. For example, the demand for oil is inelastic since for many of its uses there are no substitutes which perform the same function. Conversely, demand is *elastic* if an increase in price leads to a significant fall in demand. The demand for foreign holidays is elastic.

Technically, price elasticity of demand is the percentage change in the quantity of a product demanded divided by the corresponding percentage change in its price. The result will be a negative figure as the fall in demand will be expressed as a negative figure from the starting point. If demand for widgets[11] falls by 2 per cent as a result of a 1 per cent price increase the change in demand will be expressed as −2 per cent. The demand elasticity is then −2 divided by

[9] The concept of consumer surplus was first described by Alfred Marshall, *Principles of Economics* (8th edn., Macmillan, 1920).

[10] See *infra* section iii.a. for an explanation of marginal cost.

[11] A widget is traditionally a mythical product with no specific characteristics used in competition law examples. Despite its recent metamorphosis into a device in the bottom of cans which introduces nitrogen into the liquid and therefore puts a head on canned beer (it won the Queen's Award for Industry in 1991, more than 100 million are made annually and in November 2003 it was reported in the *Daily Mirror* as coming top of a web site poll to find the 'greatest technological invention of the last 40 years') it still retains its characterless role as the Everyman of competition law discourse.

1 (the price increase), which is -2.[12] Typically, elasticity falls as one moves down the demand curve, so that at higher prices demand is more elastic. Economic theory puts the dividing line between elastic and inelastic demand at -1. Demand is elastic at a figure below, or more negative, than -1. It is inelastic between -1 and 0. In markets where demand is inelastic shortages will lead to higher prices. So a bad harvest may be better for food producers than a good one. This was true, for example, when a frost disaster struck the Brazil coffee harvest in 1995.[13]

The position of an individual firm on the market will be different from that of all producers on the market as a whole. Even if the demand for petrol is inelastic, the price for any individual brand will be elastic. If Esso puts up the price of its petrol but Shell does not, drivers will look for Shell garages and purchase the latter's petrol instead. If, however, all the sellers of petrol collectively agree to increase the price of their petrol the quantity demanded may not change significantly.[14]

c. Cross-elasticity of Demand

Elasticity of demand measures the relationship between the price of the product and the demand for it. In contrast, *cross price elasticity of demand* measures how much the demand for *one* product (A) increases when the price of *another* (B) goes up. It is measured by the percentage change in the quantity demanded of product A divided by the percentage increase in the price of B. Cross-elasticity of demand is crucial to market definition.[15]

Cross price elasticity is positive if the price increase in B leads to an increase in demand for A, and this suggests that A and B are substitute products. The Brazil coffee shortage, although leading to an increase in the price of coffee, did not cause consumers to stop purchasing coffee and to purchase tea instead. This indicated that consumers did not consider tea was a substitute for coffee and that the demand for coffee was inelastic. An important point to note is that when considering two products there may be cross price elasticity in one direction and not in the other. Although coffee drinkers may not purchase tea when the price of coffee increases, this does not mean that tea drinkers would not purchase coffee if there was a similar price rise in tea. So in *Microsoft*,[16] the Commission found that while a streaming media player was a substitute for a media player which delivered less functionality, substitution the other way round was not readily available as less performing media players did not satisfy consumer demand for features such as streaming or video playback.

If products are complements of each other, rather than substitutes, the cross price elasticity figure will be negative rather than positive. If the price of petrol goes up the demand for big-engine gas-guzzling cars may go down.

d. Profit Maximization

An assumption is made for the purposes of welfare economics that firms will act rationally and in a way which maximizes profits.[17] Whether firms really do always behave in this way may be

[12] Economists often express this figure without using the minus (as it is always negative). The bigger the negative number the 'higher' the elasticity, for example, elasticity of -5 is higher than elasticity of -1.

[13] D. Begg, S. Fischer, and R. Dornbusch, *Economics* (8th edn., McGraw-Hill, 2005), 53–4.

[14] The demand for petrol is not totally inelastic. Arguments about whether governments should take action on the environment by discouraging driving through higher petrol taxes are predicated on the assumption of some elasticity in the demand for petrol.

[15] See *infra* 60 ff.

[16] COMP/C-3/37.792, [2005] 4 CMLR 965, para. 415, on appeal Case T-201/04, *Microsoft v. EC Commission* (judgment pending).

[17] Profits represent the difference between the total cost of producing goods or providing a service and the revenue earned by selling them.

doubtful.[18] It will be seen below that, in particular, where a firm has a monopoly the managers may prefer a 'quiet life' to profit maximization. Nevertheless, welfare economics is predicated on this basis. It is certainly a safe assumption that a firm will be concerned not to make long-term losses, otherwise it will ultimately have to leave the market. It should also be remembered that a firm which does not deliver profits to its shareholders will be attractive to a predator and so vulnerable to a take-over bid.[19]

e. Economies of Scale and Scope

Economies of scale occur when the average cost of producing a commodity falls as more is produced. If a widget factory produces only one widget then that widget must bear the whole cost of establishing and running the factory. If it produces 100,000 widgets, however, the costs are spread over 100,000 widgets instead of one. Of course, some costs (variable costs) may increase with production (energy and labour for example, although they may not increase proportionately to the number of extra units). However, some costs may not increase at all: if a lorry is delivering widgets, for example, the driver will be paid the same, and the petrol will cost the same, whether the lorry is full or half empty.

Economies of scale result where efficiency in production is achieved as output is increased. There inevitably comes a point, however, when the average cost ceases to fall and economies of scale can no longer be reaped. That point is called the minimum efficient scale (MES). The MES is of great significance for competition law since it has very important repercussions for market structure. Where the MES is very large in relation to the market, i.e., a producer has to supply a large quantity of products on the market before the MES is reached, only a few firms, possibly only one, will be able to operate efficiently on the market. What is called a 'natural monopoly' is where it is less costly for just one firm to serve the market than for the market to be divided between more players. On a competitive market, however, the MES is low in comparison to overall demand so that numerous firms can operate efficiently on the market.

Economies of scope occur where it is cheaper to produce two different products jointly than each separately. This may result from factors such as shared assembly lines or shared personnel which enable the firm to make costs savings by producing a range of goods rather than the individual products on their own. Economies of scope may mean that a multi-product firm has lower unit costs than a single product firm.

[18] There is an enormous literature on this subject. The seminal work was A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (revised edn. 1968, Harcourt Brace and World, 1932). For an extensive discussion see J. E. Parkinson, *Corporate Power and Responsibility* (Oxford University Press, 1993), particularly chaps. 2–4. This doubt arises partly because of the separation of ownership from control in all but the smallest companies. In the layers of complex organization which make up modern businesses, decisions may be made by managers and executives facing uncertain future events and a large number of variables. Their expectations may be misplaced, they may be averse to risk-taking, and they may be most concerned with corporate or individual survival or the growth of the company rather than its profitability. Management may pursue of policy of 'satisficing'. This is a theory of firm behaviour that is contrary to that of profit maximization. 'Satisficing' is when management adopts certain goals for profits, sales, etc. and tries to meet, but not necessarily exceed, them. The goals may not be set high in the first place, so that management will not seem a failure if it does not achieve them, and it is unwilling to be in a position where the shareholders demand ever higher goals in the future. See H. A. Simon, 'Theories of Decision-making in Economic and Behavioral Sciences' (1959) 49 *American Economic Review* 253 and Parkinson, above, 66–7.

[19] See Parkinson, *supra*, n. 18, 113–32.

(iii) Perfect Competition and Efficiency

a. Perfect Competition

If competition rules are designed to achieve efficiency they should be utilized where there is no effective competition on the market. The theory of perfect competition presents a model of a market on which efficiency is maximized and cannot, therefore, be improved by the application of competition rules.

A perfectly competitive market is one in which there are a large number of buyers and sellers (firms with very small market shares can operate at minimal costs since the MES is small in comparison to the size of the market), the product is homogeneous, all the buyers and sellers have perfect information,[20] and there are no barriers to entry or exit. Sellers can come onto, and leave, the market freely.[21] The result of this state of affairs is that each seller is insignificant in relation to the market as a whole and has no influence on the product's price. Consequently, sellers are described as *price-takers*, not price-makers.

In a perfectly competitive market the price never exceeds marginal cost. The marginal cost to a firm is the cost of producing one extra unit of the product. So if it costs £100 to produce ten widgets but £105 to produce eleven, the marginal cost is £5. On such a market the firm will always be able to add to profit where the marginal cost of producing a unit is less than the price. The producer will therefore keep increasing the units it produces until the price obtained equals marginal cost. If the price is below marginal cost the firm will have to respond by reducing output. In other words, in a perfectly competitive market a firm's marginal revenue (the rise in what the firm earns by one extra unit of output) equals marginal cost.[22]

Where the price charged for a product is at marginal cost this does not mean that the firm makes no profit at that price. It does make a profit, but only a 'normal' one. All the factors of production used to make the product have to be taken into account when computing the cost, and this includes the capital. The firm has to make enough of a return on the capital employed in the business to make it worthwhile staying on the market. When economists talk of zero profits they mean that there is no profit above the 'normal' level, which is assessed in relation to the 'opportunity cost'. An opportunity cost is the value of what has to be given up to do something else. The capital employed in the business must therefore reap a profit to compensate the business for the profit which would come from a different outlay. If the firm does not do this it will leave the market.

The relationship between marginal and average cost is also an important one. The average cost is the costs of the firm evened out over all the units produced.[23] When the marginal cost of the next unit exceeds the average cost of the existing units, producing the next unit raises average costs. In that case the firm can decrease costs by reducing supply. If, on the other hand, the marginal cost of the next unit is less than the average cost of the existing units, an extra unit

[20] Buyers and sellers know of every change in price or demand and so respond immediately to such changes.

[21] For a discussion of barriers to entry, see *infra* 84 ff.

[22] The reason for this is that although the *industry's* demand curve is downward sloping, the demand curve for *each individual firm* is horizontal, which means that however much it sells it will get the market price. For further explanation of this, see D. Begg, S. Fischer, and R. Dornbusch, *Economics* (8th edn., McGraw-Hill, 2005), chap. 8; D. W. Carlton and J. M. Perloff, *Modern Industrial Organization* (4th edn., Pearson Addison Wesley, 2005), chap. 3.

[23] See further, *infra* Chap. 7 for a discussion of costs in relation to predatory pricing.

reduces average costs. In that case the firm can decrease costs by increasing supply. So the producer will produce at the point at which the average cost curve and the marginal cost curve intersect.

b. Allocative Efficiency

The fact that on a perfectly competitive market the market price equals the marginal cost is said to lead to *allocative efficiency*.

Allocative efficiency results from the fact that goods are produced in the quantities valued by society. The supplier will expand production to the point where market price and marginal cost coincide. The supplier will not make more but neither, if it is acting rationally to maximize profits, will it make less. Everyone who is willing and able to purchase the product at its cost of production will therefore be able to do so. The result is a market which is in equilibrium. Allocative efficiency is a state in which none of the players, sellers or buyers, could be made better off without someone being made worse off. It is sometimes known as *Pareto optimal* after the Italian economist, Vilfredo Pareto,[24] who first developed the theory.

c. Productive Efficiency

Similarly, *productive* (or technical) efficiency results from perfectly competitive markets. Goods are produced at the lowest possible cost. Every firm has to produce at minimum cost or it will lose its custom to others, make losses, and eventually will be obliged to leave the market. Given the perfect information in the market any cost-cutting techniques will be copied by the other firms and the market price will be lowered generally. There is therefore downward pressure on costs and cost reductions are passed on to customers because of the competitive pressure from other suppliers.

d. Dynamic Efficiency

Dynamic efficiency is a third type of efficiency. Allocative and productive efficiency describe static situations, but dynamic efficiency is concerned with how well a market delivers innovation and technological progress. The relation of dynamic efficiency to the concept of perfectly competitive markets is complex for, as we see below,[25] it can be argued that innovation may be better delivered by monopolistic rather than competitive markets and that the ability to achieve market power is an important spur to innovation.

(iv) Monopoly

At the opposite end of the spectrum to perfect competition lies monopoly. This is a market where there is only one seller. This may be because there are barriers which prevent other firms from entering the market (perhaps legal barriers) or because there is a natural monopoly, as the MES of production means that only one undertaking can operate profitably on the market.

The theory predicts that as the firm is not constrained by any competitors it will price as high as it possibly can. The monopoly price will be above the competitive market price. However, the price that the monopolist charges is still affected by demand and is constrained to some extent by products from outside the market. As the price rises some customers will not purchase the product but will use their resources to purchase something else instead. The firm usually faces

[24] 1848–1923.

[25] *Infra* 15.

a downward sloping demand curve, so the higher the price it charges the lower the demand for its product.

If a monopolist chooses to sell just one unit it may receive an extremely high price for that unit but that price is unlikely to cover its cost. The monopolist will therefore wish to produce more units but each time it sells one more unit it has to lower the price. Unless the monopolist can *price discriminate* between customers, the monopolist must lower the price on *all* units, not just the extra ones. The producer's marginal revenue is the extra amount the monopolist obtains from selling the extra unit, but because it involves lowering the price across the board the marginal revenue is less than the selling price. This means that the monopolist will sell units only up to the point at which the marginal revenue equals the marginal cost. A monopolist's marginal revenue is below the market price. This in turn means that the quantity supplied of the product will be less than that which would be supplied on a competitive market. Thus prices are higher than those resulting on a competitive market *and* output is restricted. This is illustrated by the following diagram.

Figure 2 shows that, in the absence of price discrimination, the marginal revenue curve is always under the demand curve.[26] Because price is above the competitive price the monopolist makes abnormal profits but some consumers who would have paid the competitive (marginal

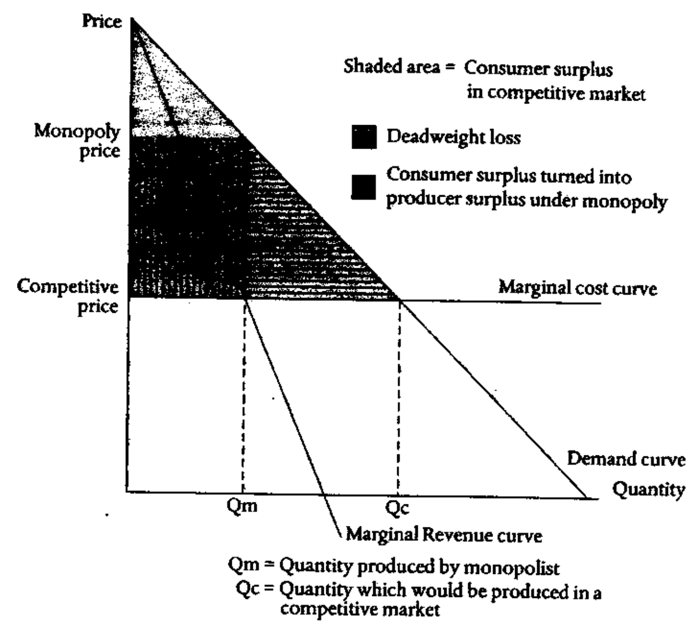

Figure 1.2 The deadweight loss due to monopoly

[26] If the monopolist is able to practise perfect price discrimination, that is, charge each customer his reservation price, the marginal revenue curve and the demand curve are the same.

cost) price are deprived of the product. Some of the consumer surplus identified in Figure 1 is therefore transferred to the producer as monopoly profit but some is lost altogether. The horizontally hatched area in the diagram shows this *deadweight loss of monopoly*, the loss of consumer surplus which is not turned into profit for the producer.

According to the above theory, therefore, the main distinction between perfect competition and pure monopoly is that the monopolist's price exceeds marginal cost, while the competitor's price equals marginal cost. This monopoly pricing leads to a transfer of wealth from consumer to producer. It is for this reason that firms operating on a competitive market may wish to emulate the effect of monopoly by colluding, for example, to set their prices at above the competitive level and by reducing output. From an efficiency point of view the transfer of wealth to the monopolist may be immaterial. The behaviour does not, however, simply lead to a redistribution of income but it also results in the misallocation in resources and a deadweight loss. It is this loss to efficiency as a whole that is of concern to economists.

> This seeming technicality, so trivial at first glance, is the basis of the economist's most general condemnation of monopoly: it leads to an allocation of resources that is inefficient in the sense of failing to satisfy consumer wants as completely as possible.[27]

In economic theory, therefore, the objection to monopoly is not simply the one which would occur to most lay people—that the monopolist is able to charge excessively for its product—but that monopoly is inefficient.[28] Consumers who would have bought the product at the competitive price will spend their money on other things and welfare is not maximized as allocative inefficiency occurs.

Another important objection to monopoly is that a monopolist will not have the same pressure as firms operating on a perfectly competitive market to reduce its costs. This was identified by Leibenstein as, and has become known as, the 'X-inefficiency'. It describes internal inefficiencies and rising costs due, for example, to high salaries, excessive perks, over-manning, and the lack of need to minimize the cost of production.[29] A monopolist may also waste resources, for example, defending its monopoly position, maintaining excess capacity, and indulging in excessive product differentiation.[30] These inefficiencies will be reflected in higher prices. Another possible inefficiency is that a monopolist not subject to competitive pressures will have little incentive to innovate and to improve its production methods, but as we have already said, it can be argued that the opposite will be true on some markets.[31]

[27] F. M. Scherer and D. Ross, *Industrial Market Structure and Economic Performance* (3rd edn., Houghton Mifflin, 1990), 23.

[28] Economists have often sought to quantify the deadweight loss. The starting point was Harberger's article in 1954 in which he calculated the loss in the USA as less than 0.1% of national income: see A. C. Harberger, 'Monopoly and Resource Allocation' (1954) 44 *American Economic Review* 77–87. In a mass of further studies this has been found to be a great under-estimate (for the literature on this, see Scherer and Ross, *Industrial Market Structure and Economic Performance* (3rd edn., Houghton Mifflin, 1990), 661–7). Cowling and Mueller calculated it as 7%: see K. Cowling and D. C. Mueller, 'The Social Costs of Monopoly Power' (1978) 88 *Economic Journal* 724–48, although Scherer and Ross, *supra*, 665 describe these results as 'exaggerated'. In this, as in much else in economics, there are wide differences in views.

[29] H. Leibenstein, 'Allocative efficiency vs. "X-efficiency"' (1966) 56 *American Economic Review* 392–415.

[30] See, e.g., R. Posner, 'The Social Costs of Monopoly and Regulation' (1975) *Journal of Political Economy* 83.

[31] And see *infra* 15.

(v) Oligopoly

Oligopoly is a type of market structure that lies between perfect competition and monopoly on the spectrum. An oligopolistic market is one on which there are only a few leading firms. Given their small number they know each other's identity and recognize that they are affected by the output and pricing decisions of the others. They are not only competitors but rivals too. The result of this mutual awareness may lead on some markets to tacit collusion (that is, understood or implied without being stated) between them. It may also lead them to collude expressly. However, other oligopolistic markets are characterized by fierce competition. Thus in some markets the price appears to be set above the competitive level and to approximate monopoly pricing, but in others it is not. A wealth of economic literature has been produced setting out economic models of oligopoly in an attempt to explain why this occurs. The differences in behaviour on these markets also cause problems for those responsible for drafting and applying the competition rules. The mainstream explanations of oligopolistic behaviour and the way in which EC competition law attempts to deal with oligopolistic markets are described in Chapter 11. It is important to note however, that many markets are oligopolistic and that since these markets may also lead to allocative and productive inefficiency they present a major problem for competition authorities.

(vi) Perfect Competition, Monopoly, and Competition in the Real World

Monopolies and oligopolies do exist. Monopolies may be created and maintained by government regulation (utilities and transport markets, for example) and/or may be natural. Pure monopoly is rare outside these circumstances but other markets, although not monopolized, may be dominated by one firm which holds a very large share of the market. Other markets may be oligopolistic, dominated by two, three, or four sellers. Even though there may be a fringe of smaller sellers on this type of market, they may present the same concerns for competition law as those arising on a monopolistic market, as explained in the preceding section.[32]

The analysis set out of perfectly competitive markets above does, however, present a number of problems. The main problem is that in the real world perfectly competitive markets hardly ever exist.[33] Rather, the model of perfect competition is just that—a model. It is a useful starting point because it demonstrates the concepts of productive and allocative efficiency. In reality, however, markets do not possess all the characteristics of perfect competition, and even if they did, the process of competition would tend to alter the situation. For example, goods are rarely homogeneous. Rather, players on competitive markets will usually strive to differentiate their products from those of their competitors, by improvements in quality or service, building up a brand image or adding individual features. They will seek to attract customers with better credit terms, delivery terms, or other conditions of sale. Further, it is very unlikely that an infinite number of firms will be operating at identical costs levels, that producers will not benefit from economies of scale, and that sellers and buyers have perfect information across an atomistic market.[34]

[32] For a more detailed discussion see, *infra* Chaps. 5–7 and Chap. 11.

[33] D. W. Carlton and J. M. Perloff, *Modern Industrial Organization* (4th edn., Pearson Addison Wesley, 2005), 84, suggest that the buying and selling of shares on the New York Stock Exchange comes close to satisfying the assumptions for perfect competition.

[34] Where markets are oligopolistic, on the other hand, with only a very small number of firms in the market, the position may be quite different, see *infra* Chap. 11.

Important caveats must thus be attached to the theory that the perfectly competitive market is superior. In particular, in most markets economies of scale make the attainment of perfect competition impossible. In some markets monopolies or different structures are 'natural' because of the MES. Further, it is not actually clear[35] that profit maximization is the policy which firms always pursue. In addition, as Scherer and Ross point out, it might not always be wise to rely on the sovereignty of the consumer.

F. M. Scherer and D. Ross, *Industrial Market Structure and Economic Performance* (3rd edn., Houghton Mifflin, 1990), 29–30

For one, the whole concept of efficient resource allocation is built upon the fundamental belief that the consumer is sovereign—that individual preferences are what count in the ledger of social values . . . . If, for example, consumers freely choosing in the market demonstrate that they would prefer at the margin to give up fifty bushels of grain to get an additional twenty hair shirts, we conclude that society is really better off because of the shift. Yet in practice our respect for consumer sovereignty is by no means universal—not, in any event, for infants, convicted criminals, dope addicts, the mentally ill, and others whose preferences cannot be trusted to generate rational choices. And in this age of widespread neuroses and psychoses, the line between rationality and irrationality is not all that easy to draw. One might even entertain doubts about the soundness of consumption decisions made by presumably normal, rational adults whose tastes (assumed in the standard theory of consumer behaviour to be stable) have been remolded under a barrage of advertising messages. Further qualms intrude when we recognize that there are external diseconomies in consumption, for example, that the purchase of a new hair shirt by Mr Willoughby may not only increase his utility, but simultaneously reduce the utility of envious neighbors. All this warns us that the theorems of welfare economics are erected upon sandy foundations. This does not mean that their conclusions are wrong. The demonstration of a competitive system's allocative efficiency makes considerable sense even when complications related to advertising, ignorance, and the like are introduced. But blind faith is also uncalled for.

The reality is that most markets lie somewhere between perfect competition and monopoly, in a state of 'imperfect' or 'monopolistic' competition where firms make differentiated or heterogeneous products[36] which consumers regard as imperfect substitutes, so that each firm has some degree of market power in that if it raises its prices it will not lose all its customers. The model of perfect competition is nonetheless still useful as a benchmark against which to measure the competitiveness of real markets. The difference between the perfectly competitive and monopolistic (or oligopolistic) market focuses attention on the crucial question: whether the firm or firms have sufficient market power to raise prices above the competitive level and keep them there.

[35] See *supra* n. 18.

[36] Or products which consumers think of as differentiated. The differentiation and heterogeneity may mainly be in their minds, perhaps as the result of clever branding or advertising (one can think of the results of blind tastings of different brands of cola drinks).

The value of any model lies not in the absolute fidelity of each element to real world phenomena, but in the model's ability to make useful predictions and, more importantly, its ability to give us meaningful verbal accounts of our observations.[37]

(vii) The Concept of Welfare: Total Welfare, Consumer Welfare and Efficiency Trade-offs

Welfare is the measure of how well a market is performing. A perfectly competitive market maximizes welfare because it leads to efficiency. However, there are different concepts of welfare: total welfare and consumer welfare.

We have seen above that producer surplus is the profit a producer makes by selling goods above the cost of production. Consumer surplus is the difference between what consumers would be prepared to pay for goods and what they do pay. Total welfare is the sum of these two surpluses. The objection to monopoly, it will be recalled, is that it does not just transfer some consumer surplus to producers but that some surplus (the deadweight) is totally lost to the market. That is a loss to total welfare. In a perfectly competitive market both producer and consumer surplus are maximized, but there are few perfectly competitive markets in the real world.

Although, as we will see below, it is arguable that EC competition law may have a more diffuse conception of the welfare of consumers,[38] consumer welfare can be defined for present purposes as consumer surplus (the aggregate measure of the surplus of all consumers).[39] If competition policy is concerned with consumer welfare rather than total welfare it will be concerned with the transfer of surplus from producers to consumers and consider it to be harmful.[40] However, *total* welfare may be maximized by such a transfer. In other words, prohibiting conduct and transactions which reduce consumer welfare may not allow efficiency gains which maximize total welfare. A competition policy which chooses to pursue total welfare as an objective is not concerned about the redistributive effects of efficiency gains (redistribution can be achieved by other policies, such as taxation). This is sometimes called 'the constant dollar' (or constant euro) philosophy, as no value judgment is made as to who, producer or consumer, has the dollar. It is worth remembering, when considering this idea, that in reality 'producers' and 'consumers' are often not separate entities. Consumers may also be shareholders, and many companies have institutional shareholders such as pension funds and life assurance firms whose members will benefit from increases in company profits. We are all consumers but we play other roles too.

Although theory accords prime position to allocative efficiency, improving overall efficiency may require a trade-off between different types of efficiencies and this may have an effect on the relationship between producer and consumer surplus. This is discussed in the following extract, which explains what is meant by a *potential Pareto improvement*.

[37] H. Hovenkamp, *Federal Antitrust Policy: The Law of Competition and its Practice* (3rd edn., West, 2005), 39.

[38] *Infra* 48.

[39] See M. Motta, *Competition Policy* (Cambridge University Press, 2004), 18.

[40] See R. J. Van den Bergh and P. D.Camesasca, *European Competition Law and Economics: A Comparative Perspective* (2nd edn., Sweet & Maxwell, 2006), 37.

R. J. Van den Bergh and P. D. Camesasca, *European Competition Law and Economics: A Comparative Perspective* (2nd edn., Sweet & Maxwell, 2006), 29–30

In some cases, allocative efficiency may conflict with other efficiency goals: productive efficiency and dynamic efficiency... Productive or technical efficiency implies that output is maximised by using the most effective combination of inputs; hence internal slack (also called X-inefficiency) is absent. The goal of productive efficiency implies that more efficient firms, which produce at lower costs, should not be prevented from taking business away from less efficient ones. Obviously, the achievement of productive efficiency is not a Pareto improvement since the less efficient firms are made worse off. Dynamic efficiency is achieved through the invention, development and diffusion of new products and production processes that increase social welfare. Whereas productive efficiency and allocative efficiency are static notions, progressiveness or dynamic efficiency refers to the rate of technological progress. Again, there will be losers in the dynamic competitive struggle, so that Pareto improvements cannot be reached. To enable policy decisions when the different efficiency goals are not consistent with each other, welfare economics offers the alternative criterion of Kaldor-Hicks efficiency.

A Kaldor-Hicks improvement allows changes in which there are both winners and losers, but requires that the gainers gain more than the losers lose. This condition being satisfied, the winners could compensate the losers... and still have a surplus left for themselves... A Kaldor-Hicks improvement is also referred to as a potential Pareto improvement, since actual compensation would again satisfy the Pareto criterion. The central value judgment underlying Kaldor-Hicks efficiency is that an exchange of money has a neutral impact on aggregate well-being, which may not be the case when the incomes of gainers and losers differ. By the using the Kaldor-Hicks criterion total welfare is maximised. This welfare notion may allow clearing mergers that enable the merging firms to achieve important scale economies and thus improve productive efficiency, but at the same time enable previously independent firms to collude and raise prices above competitive levels. In terms of total welfare, it is irrelevant that producers rather than consumers capture the surplus produced by achieving efficiencies, as the monopoly overcharge paid by purchasers to stockholders is treated as a transfer from one member of a society to another and so is ignored in the balance.

The question of trade-off between efficiencies and the relationship between efficiency and consumer welfare poses difficult problems for EC competition law and raises the issue of what is called the 'efficiency defence'. For example, a merger may put an undertaking in a position of market power, leading to a loss of allocative efficiency and higher prices for consumers, but also lower costs and increase productive efficiency (through economies of scale for instance). These issues are discussed further in the following chapters of this book.[41]

[41] See in particular Chap. 4 (Article 81(3)), Chap. 7 (in relation to abuses of a dominant position), and Chap. 12 (mergers).

(viii) Dynamic Competition

The trade-off between different types of efficiencies mentioned above is particularly acute when dynamic efficiencies are concerned:

... an improvement in terms of dynamic efficiency does not satisfy the Pareto criterion, since this will harm less innovative firms which will lose customers to their technically superior competitors. However, such improvements may satisfy the Kaldor-Hicks criterion since benefits both to pioneering firms and consumers may outweigh losses to non-innovative firms.[42]

It can be argued that monopolies have fewer incentives to innovate than firms in competitive markets but it is also possible that some degree of market power is an incentive to innovate. The Austrian economist Joseph Schumpeter took issue with the idea that competition is a better spur to innovation than monopoly. He considered that a monopolist may be more willing to bear the risks and costs of invention and technical development.[43]

Schumpeter's argument is that competition in innovation is more important than price competition because it is a more effective means of obtaining an advantage over one's competitors. This is known as 'Schumpterian rivalry', where firms compete in a constant race to bring new products on to the market in 'gales of creative destruction', competition is dynamic and positions of market power are short-term as further innovation hands the advantage to another player.

This involves accepting that short-term positions of significant market power may arise but that this is not necessarily inimical to consumer welfare. The following extract from an article by an economist explains why this is so.

D. Hildebrand, 'The European School in EC Competition Law' (2002) 25 *World Competition* 3, 8–9

In the static welfare analysis of market power, it is evidenced that a consumer surplus loss will occur where the consumer willing to pay the marginal cost is not supplied. Indeed this normally occurs when there is an unregulated monopoly that raises price above marginal cost of supply. A measure of the static inefficiency that results is analysed in terms of the actual cost of production in comparison with the minimum production cost (productive inefficiency), and in terms of price set above marginal cost of supply (allocative inefficiency)... In this static analysis there is a clear total welfare loss associated with the exercise of market power. The static analysis, however, has no time dimension because it is looking at an equilibrium situation. Such an analysis is unable to explain or incorporate technological development or product and process innovation: it is concerned solely with the allocation of resources in the context of fixed technology and a given cost situation. In the real world, product markets evolve over time because of new technological discoveries and the introduction of new and improved products. Such innovation generates

[42] R. J. Van den Bergh and P. D. Camesasca, *European Competition Law and Economics: A Comparative Perspective* (2nd edn., Sweet & Maxwell, 2006), 31. And see Case T-168/01 P, *GlaxoSmithKline Services Unlimited* v. *Commission*, 27 September 2006, discussed *infra* Chap. 4, where it was argued that increased prices to consumers were outweighed by dynamic efficiencies resulting from the undertaking concerned having more profit to plough back into the research and development of pharmaceuticals.

[43] J. A. Schumpeter, *Capitalism, Socialism and Democracy* (Harper, 1942).

welfare gains due to dynamic efficiencies. This means that a proper welfare analysis of market power needs to take into account both the static and dynamic efficiencies—and any trade-off between them.

Where dynamic efficiency aspects are introduced into the competition analysis, it is evident that the presumption that market power leads to a loss of allocative efficiency and to a loss in consumer welfare is crucially predicated on the assumptions that the costs of the firm concerned do not fall due to production rationalization or that product innovation does not occur. According to the European School, the following conclusion can be drawn: market power may speed productivity and growth and reduce the costs of the growth process despite a tendency to a less than optimal allocation of resources in static equilibrium.

Dynamic efficiency is analysed in terms of how total surplus, consumer plus producer surplus, evolves over time with the introduction of a product of process innovation. A new product satisfied a demand that was not catered for before. If the product was supplied at its short run marginal production cost then none of the suppliers would recover their original research and development (R & D) investment. The anticipation of this by suppliers would mean that there would be no incentive to make the investment and develop a new product. Even in a competitive market situation, a firm invests in a project if the net present value of future returns matches the investment outlay and initial losses. The competitive firm's assessment will include the need for at least a normal rate of profit as an equilibrium condition. Suppliers are indifferent between investing and not, if they subsequently earn profits that exactly recover their outlay as well as the normal return on the investment. Product innovation only occurs if firms earn more than just enough to offset their investment. They will only actually invest if they anticipate making profits in excess. Such profits, however, mean pricing above short run minimal average total costs either because there are barriers to entry or because the innovating firm has market power. The market, when it is functioning well, solves this difficult balance by accommodating the creation of temporary positions of market dominance, the resulting super profits attracting all manner and types of entrepreneurial factor which bids away the excessive profit such that in equilibrium the marginal investment will be just offset by the present value of future normal profit.

Concepts of dynamic efficiency and dynamic competition are particularly important now in respect of what is called the 'new economy' of high technology markets.[44]

B. OTHER OBJECTIVES OF COMPETITION LAW

(i) Other Goals for Competition Law?

As we will see in the next section, competition laws have not always pursued, and still do not always pursue, the single goal of economic efficiency. Different jurisdictions may have different goals, and may change their goals over time. Even if one accepts that the goal of competition law is to achieve allocative efficiency and maximize consumer welfare there is the question whether this should be the *only* objective.

Once this has been resolved it will have to be decided what competition law should be adopted and *how* it should be applied in pursuit of these goals. We look first at what other goals competition law might pursue.

[44] See *infra* 54 ff.

(ii) Preservation of Liberty and Dispersal of Economic Power

The use of the competition rules to preserve competitive markets may achieve economic efficiency but may also uphold the foundations of liberal democracy. Competitive markets will generally preclude the creation of excessive private power.

G. Amato, *Antitrust and the Bounds of Power* (Hart Publishing, 1997), 2–3

Antitrust law was, as we know, invented neither by the technicians of commercial law (though they became its first specialists) nor by economists themselves (though they supplied its most solid cultural background). It was instead desired by politicians and (in Europe) by scholars attentive to the pillars of the democratic systems, who saw it as an answer (if not indeed 'the' answer) to a crucial problem for democracy: the emergence from the company or firm, as an expression of the fundamental freedom of individuals, of the opposite phenomenon of private power; a power devoid of legitimation and dangerously capable of infringing not just the economic freedom of other private individuals, but also the balance of public decisions exposed to its domineering strength. On the basis of the principles of liberal democracy, the problem was twofold and constituted a real dilemma. Citizens have the right to have their freedoms acknowledged and to exercise them; but just because they are freedoms they must never become coercion, an imposition on others. Power in liberal democratic societies is, in the public sphere, recognized only in those who hold it legitimately on the basis of law, while, in the private sphere, it does not go beyond the limited prerogatives allotted within the firm to its owner. Beyond these limits, private power in a liberal democracy (by contrast with what had occurred, and continues to occur, in societies of other inspirations) is in principle seen to be abusive, and must be limited so that no-one can take decisions that produce effects on others without their assent being given.

The question whether government regulation or the private power of the firm is more frightening is an ideological one which pervades many arguments in competition law, and is a fundamental dilemma of liberal democracy itself. However, one of the most important arguments in favour of a competitive market structure, where the individual sellers and buyers are insignificant in relation to the size of the market, is that it decentralizes and disperses private power and protects individual freedom.[45] This conception of the value of competition is central to the ideas of Ordoliberalism, as discussed below.[46]

(iii) Protecting Competitors and Fair Competition

The preservation of liberty supports competitive markets and may in some markets result in economic efficiency. In other cases the goals may be inimical. Competition laws which are aimed at the dispersal of power as a matter of ideology may favour small businesses and seek to protect them from big business. Instead of protecting *competition* the tendency may instead be to use the competition rules to protect *competitors*. For example, competition law could be used to protect

[45] See F. M. Scherer and D. Ross, *Industrial Market Structure and Economic Performance* (3rd edn., Houghton Mifflin, 1990), 18.

[46] *Infra* 34.

small firms from the dominant firm's (efficient) low pricing, or to force a dominant firm to give access to resources it controls to a smaller firm in order to allow the latter to compete with it.[47]

Such a policy may accord with popular sentiment which is distrustful of 'large' firms.[48] It is what is described by some schools of thought as 'populist', as we see below,[49] and can be seen as 'fair' rather than 'free' competition. It will, however, enable a government to nurture small businesses, and to promote a society in which citizens are encouraged to be their own boss, run their own business, and behave in an entrepreneurial manner. The dispersal of market power may prevent the redistribution of wealth from consumers to firms with market power but the protection of small and inefficient businesses may also take wealth from consumers.

(iv) Socio-political Issues

Competition law may also be used to service other policies, such as social, employment, industrial, environmental, and/or regional policy (for example, by prohibiting mergers which will cause job losses, or allowing restrictive agreements which will preserve declining industries for a little longer or produce environmental benefits). The pursuit of such policies may be inconsistent with the pursuit of efficiency.

(v) The EU Dimension

In the European Union there is an added dimension. The competition rules are at present set out within the Treaty establishing the European Community and when/if the new Reform Treaty comes into force they will be set out in the Treaty on the Functioning of the Union. The EU competition rules must therefore be viewed in their context and as one of the tools set out to achieve the aims and objectives of the European Treaties. The history of the EC Treaty, the European Community, and the European Union is explained in Chapter 2. The aims and tasks of the Community, the Union, and the competition rules are, however, introduced in section 5 below.

C. CONCLUSIONS

There seems to be a consensus at present that competition law should be adopted and applied in pursuit of economic efficiency. It will be seen in subsequent sections, however, that there are different views as to how competition law rules can best achieve this. Further, the extent to which competition laws should also be used to pursue goals other than efficiency such as the protection of competitors, jobs, or the environment is controversial.

The pursuit of these other goals may favour small firms, individuals or environmental concerns at the expense of consumer welfare.[50] Supporting small businesses for the sake of it at the expense of more efficient competitors will be a drag on the economy. Similarly, the prevention of a merger which would result in efficiencies on the ground that it may save jobs in the short term may mean that the individual companies are unable to compete effectively on the market in the long run and a decision to allow an anti-competitive agreement between firms in an industry in historic decline may ensure the firm's survival for a time but may cause inefficiency. It may be better for nature to take its course. The most efficient will survive and the remaining resources can be used in new industries which will create future prosperity.

This is not to say that there should not be social, regional, employment, environmental, or other policies. It is a matter of whether, and to what extent, these may be or should be pursued as part of a *competition* policy and how far competition can be isolated from other policies. The question of what concerns competition law should encompass in addition to efficiency is ultimately a matter of political choice, and we return to it below when looking at the 'Chicago school' and at the current objectives of EC competition law.

[47] See the issue of refusal to supply by dominant forms and the 'essential facilities' doctrine, *infra* Chap. 7, and in respect of intellectual property rights, Chap. 10.

[48] See *infra* p. 27 ff.

[49] *Infra* n. 60.

[50] A good example of the tension between a popular distrust of large and powerful firms coupled with sentimentality towards small businesses on the one hand, and a popular liking for low prices and plenty of choice on the other, can be seen in the debate in the UK over supermarkets which culminated in the market investigation reference of the grocery sector by the OFT to the Competition Commission under s. 131 of the Enterprise Act 2002 in May 2006; see *The Grocery Market, the OFT's reasons for making a reference to the the Competition Commission*, OFT 845. Similarly, although a society may object to the ability of a large company with market power to make excessive profits at the expense of consumers, the shareholders in the monopolist may be institutions such as pension funds and assurance companies which are investing on behalf of the consumers in their role as workers or policy-holders.

4. US LAW

It is impossible to discuss competition law without some reference to US law because of the influence which American lawyers and economists, working with reference to the American system, have had on competition law thinking.

The USA was the first jurisdiction to adopt a proper 'modern' system of competition law.[51] The US Congress passed the Sherman Act in 1890.[52] It is still in force. Section 1[53] 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 hereby declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony . . .

Section 2 states:

> 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 several States, or with foreign nations, shall be deemed guilty of a felony . . .

None of the expressions used in the Sherman Act, such as 'in restraint of trade' or 'monopolize' were defined.

The most popular explanation for the passing of the Sherman Act is that it was to combat the power of the 'trusts'. It had become common for the owners of stocks held in competing companies to transfer those stocks to trustees who then controlled the activities of those competitors and consequently lessened competition between them (this is why it has become known as 'antitrust' law). The activities of the railroad companies gave rise to particular

[51] For a summary of the ways in which throughout the centuries the English Crown created monopolies and the spasmodic action taken against certain business practices, see M. Furse, *Competition Law of the UK and EC* (4th edn., Oxford University Press, 2004), 2–6; the UK courts developed a doctrine of restraint of trade at common law, but this never developed into a system of competition law: see *Chitty On Contracts* (29th edn., Sweet & Maxwell, 2006), Chap. 16.

[52] 'An Act to protect trade and commerce against unlawful restraints and monopolies', 15 USC, 2 July 1890. It was supplemented by later statutes, the Clayton Act (1914), the Federal Trade Commission Act (1914), the Robinson-Patman Act (1936), the Celler-Kefauver Act (1950) and the Hart-Scott-Rodino Antitrust Improvements Act 1976.

[53] See also *infra* Chap. 4.

concern. It is also claimed, however, that the Sherman Act was more of a protectionist measure passed in response to pressure by farmers, small businesses, or those desiring to stop the transfer of wealth from consumers to big business.[54] The Chicago school[55] view is that it was passed to preserve economic efficiency, but since the theories of allocative efficiency, deadweight loss, and Pareto-efficiency had not then been invented it cannot have been articulated in exactly this way.[56] The argument about the conception of US antitrust is not merely about history, but is important when considering what the objective of that law is now and in the 'struggle for the soul of antitrust'. It may seem to the neutral observer that in passing the Sherman Act Congress made a law without a discernible policy behind it and that the policy only emerged later. Richard Posner, a leading exponent of the Chicago school, says that the motives of the legislators of 1890 are irrelevant. We explain below the meaning of the expression 'populist' which appears in this extract.

R. A. Posner, *Antitrust Law* (2nd edn., University of Chicago Press, 2001), 24–6

Populists would like the interpretation of the antitrust laws to be guided neither by the common-law background nor by economics, but instead by the prominent vein of populist thought that runs through the legislative history of all the major federal antitrust statutes. But the motive and meaning of legislation are different things. No doubt most of the legislators whose votes were essential to the enactment of these statutes cared more about the distribution of income and wealth and welfare of small business and particular consumer groups than they did about allocative efficiency, especially since the economics profession itself had no enthusiasm for antitrust policy... But these legislators did not succeed in writing into the statutes standards that would have enabled judges to order these goals and translate them into coherent, administrable legal doctrine without doing serious and undesired damage to the economy. For guidance the courts perforce turned elsewhere. After a century and more of judicial enforcement of the antitrust statutes, there is a consensus that guidance must be sought in economics. There is no generally accepted principle of statutory interpretation that shows that the courts were wrong to go this route.

The law developed in a series of judicial decisions in the half-century following the Sherman Act in a rather ad hoc manner, and reflected the experiences of the American economy as it went through an industrial revolution, the Depression, and the New Deal.[57] In the 1940s and 1950s the 'workable competition' hypothesis[58] was influential.[59] In the 1950s the

[54] See E. T. Sullivan (ed.), *The Political Economy of the Sherman Act* (Oxford University Press, 1991) for a collection of essays written between 1959 and 1989 on the Sherman Act, published to mark the centenary of the Act. The articles display the wide divergence of views between some of the most eminent names in antitrust thinking, as well as historians and Department of Justice officials.

[55] For the Chicago school, see *infra* 23. For Robert Bork's Chicago view of the intention of Congress see R. H. Bork, *The Antitrust Paradox* (Basic Books, 1978, reprinted with a new Introduction and Epilogue, 1993), chap. 2.

[56] Alfred Marshall's *Principles of Economics* (Macmillan, 1890) was first published only in 1890 and Pareto published his theory in 1909. For a good account of the history of the US legislation, see E. Gellhorn., W. E. Kovacic, and S. Calkins, *Antitrust Law and Economics* (5th edn., West, 2004) 22–36.

[57] The New Deal was a federal policy begun under President Roosevelt in 1933 to aid those thrown out of employment in the Depression.

[58] See *infra* 33.

[59] See the Report of the Attorney General's National Committee to Study the Antitrust Laws (1955).

Structure → Conduct → Performance paradigm was developed by what is called the Harvard School, particularly by J. S. Bain. This led to a belief that markets were fragile and to an antitrust policy which intervened to protect small businesses against large firms (a policy which Posner describes as 'populist' because he sees it as based on 'a hostility towards wealth and power and a suspicion of capitalism but a suspicion that falls short of an endorsement of socialism').[60] From the 1950s onwards, however, another school of thinking emerged, the Chicago school, which did *not* believe that markets were fragile. Chicago school thinking had a profound impact on the development of antitrust enforcement in the USA and has influenced the thinking about competition law in Europe and around the world. Later, a school of 'post-Chicago' thinking emerged. The Harvard, Chicago and post-Chicago schools are described in the next sections.

There are three particular features of US antitrust law which should be noted as differing from EC law.[61] These need to be borne in mind when looking at US cases or reading American commentators. First, the US competition authorities, the Department of Justice Antitrust Division (DOJ) and the Federal Trade Commission (FTC), enforce the antitrust laws by bringing actions before the ordinary federal courts: they are primarily prosecutors rather than decision-makers (although the FTC does have administrative adjudication powers and both agencies shape the application of the law by the issuing of guidelines, making speeches, negotiating settlements and so on). The DOJ may bring criminal as well as civil proceedings for violations of the Sherman Act. The state governments (through their attorneys general) may also prosecute federal antitrust infringements and the states have their own state antitrust laws too. This is in contrast to the EC competition authority, the Commission, which enforces the rules by taking decisions binding on the firms concerned, acting as both prosecutor and judge.[62] Secondly, in the US the antitrust laws are the subject of a very significant amount of private litigation, again before the ordinary federal courts. This contrasts with the position in Europe where private litigation has hitherto been relatively rare.[63] The result of these two factors is that US law has been developed on a case by case basis by the courts, while in the EC it has been primarily developed by an administrative authority with the Court acting only to review the legality of the authority's actions. The third matter to note at the outset is that s. 2 of the Sherman Act forbids monopolization and attempts to monopolize. It is thus crucially different from the corresponding provision in EC law, Article 82, which forbids the 'abuse of a dominant position'. The significance of the difference in these provisions is explored further in Chapter 7.

[60] R. A. Posner, *Antitrust Law* (2nd edn., University of Chicago Press, 2001), 24. 'Populism' is a term that has been attached to various political movements in different countries (for example, late nineteenth-century Russia) but in general means the preferences of 'ordinary people'. It is characterized by the defence of the little man against powerful organizations, such as governments, large firms, and trade unions.

[61] There are more than three differences of course (e.g., s. 1 of the Sherman Act is structured differently from the EC counterpart, Article 81) but the three mentioned here are particularly crucial.

[62] There is an appeal by way of judicial review to the Court of First Instance (CFI) and from there on a point of law to the European Court of Justice (ECJ). Since 1 May 2004, under Council Regulation 1/2003 [2003] OJ L1/1, all the Member States of the EU must empower their national competition authority (NCA) to apply and enforce the EC competition rules. In many Member States the NCAs have powers similar to those of the EC Commission, whereas in others the NCA prosecutes before the courts.

[63] The 'modernization' of EC law, which came into effect on 1 May 2004, aims, *inter alia*, to encourage greater private enforcement, and the EC Commission is reviewing how private actions may be facilitated: see further *infra* Chaps. 2 and 15.

5. SCHOOLS OF COMPETITION ANALYSIS

A. THE STRUCTURE → CONDUCT → PERFORMANCE PARADIGM AND THE HARVARD SCHOOL

The S → C → P paradigm is that the structure of the market determines the firm's conduct and that conduct determines market performance, for example, profitability, efficiency, technical progress, and growth. The model thus sought to establish that certain industry structures lead to certain types of conduct which then lead to certain kinds of economic performance. In particular, highly concentrated industries cause conduct which leads to poor economic performance, especially reduced output and monopoly prices.

These views stemmed mainly from work done at Harvard University. The initial work was done in the 1930s, particularly by E. S. Mason,[64] and was developed by his pupil J. S. Bain in the 1950s.[65] The theory was developed through empirical studies of American industries (twenty manufacturing industries were studied in the early 1950s) rather than from theoretical models. The conclusion that market structure dictated performance caused a belief that competition law should be concerned with *structural* remedies rather than *behavioural* remedies. The focus of attention was, therefore, on concentrated industries. Bain considered that most industries were more concentrated than was necessary (economies of scale were not substantial in most industries); that barriers to entry were widespread and very high and so new firms were prevented from entering markets; and that the monopoly pricing associated with oligopolies began to occur at relatively low levels of concentration. These influential conclusions coincided with a general trend of US Congressional policies which sought to protect small businesses and which were suspicious of business expansion. This led in the 1960s to an extremely interventionist antitrust enforcement policy in the US.[66] Criticism of the Bainian analysis, led by the Chicago school (below), centred particularly on the fact that the conclusions drawn from the empirical studies were flawed;[67] that they wrongly found barriers to entry to be pervasive and wrongly found economies of scale to be rare. Consequently, the policy of condemning so many business practices as anti-competitive was misconceived. Despite the rise of the Chicago school, the S → C → P paradigm remains a basic tool of competition analysis. Although mainstream

[64] See E. S. Mason, *Economic Concentration and the Monopoly Problem* (Harvard University Press, 1957).

[65] See J. S. Bain, *Barriers to New Competition* (Harvard University Press, 1956) and *Industrial Organization* (2nd edn., Wiley, 1968).

[66] e.g., *Brown Shoe Co v. United States*, 370 US 294, 82 S.Ct 1502 (1962); *FTC v. Consolidated Foods Corp* 380 US 592, 85 S.Ct 1220 (1965); *FTC v. Proctor & Gamble Co*, 386 US 568, 87 S.Ct 1224 (1967); *United States v. Arnold, Schwinn & Co*, 388 US 365, 87 S.Ct 1856 (1967).

[67] *Inter alia*, in that they used accounting rates of return to calculate profits although they are unreliable indicators of monopoly profits; that they used cross-sectional data rather than data on a particular industry; that they were not a proper test unless based on long-run rather than short-run performance; and that the researchers did not always consider that the structural variables were not exogenous i.e. that the concentration was itself determined by the economic conditions of the industry. There is modern work with the S → C → P model (notably by John Sutton) which takes account in particular of this last, very serious concern: see further D. W. Carlton and J. M. Perloff, *Modern Industrial Organization* (4th edn., Pearson Addison Wesley, 2005), 246–74.

economists no longer believe that structure *dictates* performance, it accepts that structure is important to the ability of firms to behave anti-competitively. As Hovenkamp says:

> The S-C-P paradigm left certain marks that seem all but indelible—for example, the greatly increased attention to market definition, barriers to entry, and proof of market power that even the most convinced members of the Chicago School acknowledge to be important. Antitrust without structural analysis has become impossible, thanks largely to the S-C-P writers. To be sure, they may have gone too far in emphasizing structure over conduct, but that is a question of balance, not of basic legitimacy. Not even S-C-P's most vehement critics would roll the clock back completely.[68]

B. THE CHICAGO SCHOOL

'Chicago' is a school of monetarist and free-market economics, called after the University where many of its originators and adherents did their work.[69] Unlike the Harvard school the foundations of its competition analysis were rigorously theoretical rather than empirical. Even while the S → C → P paradigm was becoming established as the dominant ideology of the day Chicago scholars were loudly decrying it and developing an alternative model based on neo-classical price theory. Although the S → C → P model has never been entirely eclipsed, Chicago school economics produced a 'revolution' in competition thinking both in the US and (later) around the world.[70] Although, in its turn, it has been criticized and some of its most treasured shibboleths found not to withstand further analysis, its influence on competition law is profound. In the USA the ascendancy of Chicago during the 1970s and 1980s led to a change of direction in the application of antitrust law. [71]

The fundamental Chicago view[72] is that the pursuit of efficiency, by which is meant allocative efficiency[73] as defined by the market, should be the *sole* goal of competition law.[74] The school does not support sentimentality for small business or the corner store but places trust in the market. The identity of the winners or losers is irrelevant so long as efficiency is achieved. Indeed, since the writers consider that few barriers to entry exist, that industries frequently benefit from economies of scale, and that businesses are profit-maximizers, the Chicago school places much belief in the ability of the market to correct and achieve efficiency itself without interference from governments or competition laws.

Hovenkamp sets out the basic tenets of the Chicago school in the following extract from an article written in 1985. Although critical of some of the views, Hovenkamp nonetheless describes himself as a 'fellow traveler' [*sic*].

[68] H. Hovenkamp, *Federal Antitrust Policy: The Law of Competition and its Practice* (3rd edn., Thomson/West, 2005), 46.

[69] Milton Friedman was a leading figure of the Chicago school. The main proponents of its antitrust ideas include Stigler, Demsetz, Brozen, Posner, and Bork.

[70] See generally R. Posner, 'The Chicago School of Antitrust Analysis' 127 *Univ. Pa. LR.* 925 (1979).

[71] Chicago thinking was behind the entire 'Reaganomics' of the Reagan administration and Chicago School economics have had a profound and lasting influence on the economic policies of governments throughout the world.

[72] We can only describe here the views of Chicago school adherents generally. There are considerable divergences of view among them.

[73] Chicago theory holds that the market itself punishes those who are productively inefficient. As the conditions for Pareto-efficiency can rarely be fulfilled, Chicago usually uses 'potential' Pareto-efficiency as the guide, which means a policy whereby the total gains of all those who gain should be greater than the total losses of all those who lose, see *supra* 13 ff.

[74] Some Chicago adherents would hold that allocative efficiency should be the sole goal of *all* government policies.

H. Hovenkamp, 'Antitrust Policy After Chicago' [1985] *Univ. Mich. LR* 213, 226–9

... the following discussion summarizes a few of the model's basic assumptions and principles that have been particularly important in Chicago School antitrust scholarship.

(1) Economic efficiency, the pursuit of which should be the exclusive goal of the antitrust laws, consists of two relevant parts: allocative efficiency and productive efficiency ... Occasionally practices that increase a firm's productive efficiency reduce the market's allocative efficiency. For example, construction of a large plant and acquisition of large market share may increase a firm's productive efficiency by enabling it to achieve economics of scale; however, these actions may simultaneously reduce allocative efficiency by facilitating monopoly pricing. A properly defined antitrust policy will attempt to maximize net efficiency gains ...

(2) Most markets are competitive, even if they contain a relatively small number of sellers. Furthermore, product differentiation tends to undermine competition far less than was formerly presumed. As a result, neither high market concentration nor product differentiation are the anti-competitive problems earlier oligopoly theorists believed them to be ...

(3) Monopoly, when it exists, tends to be self-correcting; that is, the monopolist's higher profits generally attract new entry into the monopolist's market, with the result that the monopolist's position is quickly eroded. About the best that the judicial process can do is hasten the correction process ...

(4) 'Natural' barriers to entry are more imagined than real. As a general rule investment will flow into any market where the rate of return is high. The one significant exception consists of barriers to entry that are not natural—that is, barriers that are created by government itself. In most markets the government would be best off if it left entry and exit unregulated ...

(5) Economies of scale are far more pervasive than economists once believed, largely because earlier economists looked only at intra-plant or production economics, and neglected economies of distribution. As a result, many more industries than were formerly thought may operate most economically only at fairly high concentration levels ...

(6) Business firms are profit-maximizers. That is, their managers generally make decisions that they anticipate will make the firm more profitable than any alternative decision would. The model would not be undermined, however, if it should turn out that many firms are not profit maximizers, but are motivated by some alternative goal, such as revenue maximization, sales maximization, or 'satisficing.' ...[75] The integrity of the market efficiency model requires only that a few firms be profit-maximizers. In that case, the profits and market shares of these firms will grow at the expense of other firms in the market ...

(7) Antitrust enforcement should be designed in such a way as to penalize conduct precisely to the point that it is inefficient, but to tolerate or encourage it when it is efficient ... During the Warren Court era,[76] antitrust enforcement was excessive, and often penalized efficient conduct ...

(8) The decision to make the neoclassical market efficiency model the exclusive guide for antitrust policy is nonpolitical.

[75] For 'satisficing' see *supra* n. 18.

[76] Earl Warren was Chief Justice of the Supreme Court 1953–68.

A clear statement of the view that 'efficiency is all' is set out in Robert Bork's celebrated polemic, *The Antitrust Paradox*.

R. H. Bork, *The Antitrust Paradox: A Policy at War with Itself* (Basic Books, 1978, reprinted with a new Introduction and Epilogue, 1993), 90–1

Antitrust is about the effects of business behavior on consumers. An understanding of the relationship of that behavior to consumer well-being can be gained only through basic economic theory. The economic models involved are essential to all antitrust analysis, but they are simple and require no previous acquaintance with economics to be comprehended. Indeed, since we can hardly expect legislators, judges, and lawyers to be sophisticated economists as well, it is only the fact that the simple ideas of economics are powerful and entirely adequate to this field that makes it conceivable for the law to frame and implement useful policy.

Consumer welfare is greatest when society's economic resources are allocated so that consumers are able to satisfy their wants as fully as technological constraints permit. Consumer welfare, in this sense, is merely another term for the wealth of the nation. Antitrust thus has a built-in preference for material prosperity, but it has nothing to say about the ways prosperity is distributed or used. Those are matters for other laws. Consumer welfare, as the term is used in antitrust, has no sumptuary or ethical component, but permits consumers to define by their expression of wants in the marketplace what things they regard as wealth. Antitrust litigation is not a process for deciding who should be rich or poor, nor can it decide how much wealth should be expended to reduce pollution or undertake to mitigate the anguish of the cross-country skier at the desecration wrought by snowmobiles. It can only increase collective wealth by requiring that many lawful products, whether skis or snowmobiles, be produced and sold under conditions most favorable to consumers.

The role of the antitrust laws, then, lies at that stage of the economic process in which production and distribution of goods and services are organized in accordance with the scale of values that consumers choose by their relative willingness to purchase. The law's mission is to preserve, improve, and reinforce the powerful economic mechanisms that compel businesses to respond to consumers. 'From a social point of view,' as Frank H. Knight puts it, 'this process may be viewed under two aspects, (a) the assignment or *allocation* of the available productive forces and materials among the various lines of industry, and (b) the effective *co-ordination* of the various means of production in each industry into such groupings as will produce the greatest result.' ...

These two factors may conveniently be called *allocative efficiency* and *productive efficiency* .... These two types of efficiency make up the overall efficiency that determines the level of our society's wealth, or consumer welfare. The whole task of antitrust can be summed up as the effort to improve allocative efficiency without impairing productive efficiency so greatly as to produce either no gain or a net loss in consumer welfare. That task must be guided by basic economic analysis, otherwise the law acts blindly upon forces it does not understand and produces results it does not intend.

Critics have argued that efficiency could not be the sole pursuit of competition law without becoming inconsistent with other government policies, such as those pursuing distributive goals.[77]

[77] The arguments are summed up in the Hovenkamp article an extract from which is set out *supra* 24.

Bork made a riposte to this in the Epilogue to his book reprinted in 1993:

R. H. Bork, *The Antitrust Paradox: A Policy at War with Itself* (Basic Books, 1978, reprinted with a new Introduction and Epilogue, 1993), 426–9

Of the two, the issue of the goals of antitrust seems to have fared somewhat better than the law's capacity to deal with economics. Fifteen years ago, the question of what goals antitrust serves, and hence what factors a judge may properly consider in deciding an antitrust case, had not been addressed in any systemic fashion. The answers given by courts and commentators were hardly more than slogans of a more or less appealing variety, depending on your taste for populist rhetoric. Though the preservation of competition was often cited as the aim of the law, there seemed no agreed definition of what, for the purposes of antitrust, competition is.

'Competition,' the courts assured us, meant the preservation or comfort of small businesses, the advancement of first amendment values, the preservation of political democracy, the preservation of local ownership, and so on ad infinitum. Judges could and did choose among the items they had invented and placed in this grab bag in order to legislate freely. Cornucopias have their attractions but, when it comes to finding and applying a policy to guide adjudication, horns of plenty make anything resembling a rule of law impossible.

The argument of this book, of course, is that competition must be understood as the maximization of consumer welfare or, if you prefer, economic efficiency. That requires economic reasoning because courts must balance, when they conflict, possible losses of efficiency in the allocation of resources with possible gains in the productive use of those resources. In a word, the goal is maximum economic efficiency to make us as wealthy as possible. The distribution of that wealth or the accomplishment of noneconomic goals are the proper subjects of other laws and not within the competence of judges deciding antitrust cases.

By and large, with some ambiguity at times, the more recent cases have adopted a consumer welfare model. Aside from some explicit statements to that effect, the best evidence for the proposition is that courts now customarily speak the language of economics rather than pop sociology and political philosophy. If the conversion from a multi-goal jurisprudence is not complete, it is nevertheless very substantial. Explicit opposition to the consumer welfare thesis comes less from judges than from the academics. The objections are generally of two kinds: denial that an exclusive consumer welfare focus is to be found in the various antitrust statutes; and insistence that such a policy is not desirable.

...

A different line of attack comes from those who observe, quite correctly, that people value things other than consumer welfare, and, therefore, quite incorrectly, that antitrust ought not be confined to advancing that goal. As non sequiturs go, that one is world class. There may be someone identified with the Chicago School who thinks all human activity can be analyzed in terms of economics and efficiency, but that is not true of most Chicagoans and certainly constitutes no part of my argument. No one body of law can protect everything that people value. If antitrust could, we would need no other statutes. If we trace the implications of the proposition, it results in judges deciding cases as if the Sherman Act said: 'A restraint of trade shall consist of any contract, combination, or conspiracy that fails to produce, in the eyes of the court, the optimum mix of consumer welfare and other good things that Americans want.' That is inevitably the result of bringing into judicial consideration an open-ended list of attractive-sounding goals to be weighed against consumer welfare.

Nor is there any force to the argument that the consumer welfare cannot be the exclusive mission of antitrust since that mission will be rendered less effective unless all other government policies pursue the same goal. Of course, antitrust will be less effective in promoting consumer welfare if government simultaneously subsidizes small business. A tariff policy designed to keep American companies viable will be less effective if government allows foreign competitors to set up manufacturing operations in the United States. That fact does not state a reason for a judge to alter the way he construes the tariff laws or other laws that apply to foreign companies' operations here. Many statutory policies conflict to some degree with other statutory policies. Whether or not they should do so, and to what degree, is a subject for legislation rather than adjudication.

In any event, no matter what policy goals or combination of goals one attributes to antitrust, the effectiveness of the law in forwarding those policies will be diminished by other public policies. That fact tells us nothing about how judges should go about deciding cases under the antitrust statutes.

Furthermore, in the following extract from the 2001 second edition of Posner's seminal book first published in 1976, he takes issue with the populist view that would seek still to use competition laws to promote goals other than efficiency.

R. A. Posner, *Antitrust Law* (2nd edn., University of Chicago Press, 2001), 24–5

Populists complain that monopolization transfers wealth from consumers to the stockholders of monopolistic firms, a redistribution that goes from the less to the more wealthy. The transfer, unlike the restriction in output that monopoly pricing entails, has no direct effect on efficiency, though some economists have long argued that, given diminishing marginal utility of income, a transfer of income from a wealthy to a poor person increases the utility of the poor person more than it reduces the utility of the wealthy person. The argument is plausible in extreme cases: a dollar surely confers more utility on an indigent person than on a billionaire. But applied to monopolies and cartels, it is undermined not only by the increasingly broad ownership of common stock, both directly and by virtue of pension-fund investments in the stock market, but also by the point made earlier that competition to become a monopolist will tend to transform the expected gains from the monopoly into social costs experienced as income by people not necessarily wealthier than the consumers of the monopoly's product. What is more, any windfall gains from monopolization will be enjoyed only by the first generation of the monopolist's shareholders, since anyone who buys their stock will pay a premium equal to the discounted present value of the expected monopoly profits, and so will earn only a normal, not a monopoly, return on his investment. In any event—and this is the most important point—the wealth-redistribution argument for antitrust has no implications for the content of antitrust policy. Whether the objection undergirding the policy is to the monopolist's distortion of output or to his profit, the measures required to meet the objection are the same.

A second populist concern is that monopoly, or more broadly any condition (such as concentration) that fosters cooperation among competing firms, will facilitate an industry's manipulation of the political process to obtain protective legislation aimed at increasing the industry's profits. Traditionally such protection took the form of controls over entry and price competition, coupled with exemption from the antitrust laws, that cartelized the industry much more effectively than could be done by private agreement. Once again, this is a concern that reinforces rather than contradicts the economic objection to monopoly. The legislation sought by an industry—a tariff, a tax on a substitute product, control of entry—will have economic effects similar to those of a private cartel agreement.

process, as well as directly through cartelization, thus implies no change in the character of an antitrust policy deduced from economic considerations. Nevertheless, it is not a solid argument. While monopoly or concentration reduces the costs of organizing effectively to manipulate the political process, it also reduces the demand for public assistance in suppressing competition. A firm that has a secure monopoly without public assistance or enjoys supracompetitive profits by reason of tacit collusion will have less incentive to expend resources on obtaining the aid of government in fending off competition than a highly competitive industry would have. The latter must incur higher costs of organizing to influence government, but it also has more to gain. The up-shot is that it's unclear as a matter of theory which type of industry, the monopolistic or the competitive, has more to gain from government intervention. This theoretical indeterminacy is mirrored in the empirical world, where we observe many unconcentrated industries—such as dairy farming, local broadcasting, taxi service, medicine, and law—enjoying governmental protection against competition.

A third populist argument has, in contrast, implications for antitrust policy that diverge sharply from those of the economic approach. The populist alternative to an antitrust policy designed to promote economic efficiency by limiting monopoly is a policy of restricting the freedom of action of large business firms in order to promote small business. The idea that there is some special virtue in small business compared to large is a persistent one, though the basis for the idea is obscure. While there may be a justifiable concern with the power of wealth to influence and perhaps deform the political process, the correlation between personal wealth and monopolization is weak. Among the wealthiest Americans today are trial lawyers, athletes, actors and actresses, other entertainers and media celebrities, and entrepreneurs few of whom owe their wealth to market power. Small businesses do not seem disadvantaged in lobbying relative to large, and large businesses are more likely to owe their size to economies of scale or scope, superior management, patents and copyrights, and other factors than even populists do not wish to bring under antitrust condemnation than to monopoly. Small businesses are not less likely than large to violate the antitrust laws or to seek and obtain protection from competition. Indeed, to the extent that small businesses tend to be found in small markets, they are as likely, even more likely, to collude to raise price above the competitive level....

Antitrust enforcement is not only an ineffectual, but a perverse, instrument for trying to promote the interests of small business as a whole. Antitrust objectives and the objectives of small business people are incompatible at a very fundamental level. The best overall antitrust policy from a small-business standpoint is no antitrust policy. By driving a wedge between the prices and the costs of the larger firms in the market (a market cannot be effectively cartelized unless the large firms in it participate in the cartel), monopoly enables the smaller firms to survive even if their costs are higher than those of the large firms. The only kind of antitrust policy that would benefit small business would be one that sought to prevent large firms from underpricing less efficient small firms by sharing their lower costs with consumers in the form of lower prices. Apart from raising in acute form the question whether society should promote small business at the expense of the consumer, such a policy would be unworkable because it would require comprehensive and continuing supervision of the prices of large firms. There are no effective shortcuts. For example, if mergers between large firms are forbidden because of concern that they will enable the firms resulting from such mergers to take advantage of economies of scale and thereby underprice smaller firms operating at a less efficient scale, one or more of the larger firms will simply expand until the efficient scale of operation is reached.

Perhaps the most contentious of all Chicago school claims is that the pursuit of efficiency as the sole goal of competition law is non-political. The essential argument is that since competition policy is dictated only by micro-economics it is ideology-free. The adoption of such a policy is,

however, in itself ideological. Chicago proclaims itself as neutral because it believes only in market forces. The idea that this is an apolitical stance is challenged by Fox and Sullivan in the following passages from an article in 1987.[78] In particular, the authors stress that the law should not only be economics. Rather, economics should be used as a tool to support the system which is aimed at supporting consumers and a dynamic system of competition law. The Chicagoans' view of economics itself reflects a vision of what society we should live in.

E. M. Fox and L. A. Sullivan, 'Antitrust—Retrospective and Prospective: Where Are We Coming From? Where Are we Going?' (1987) 62 *New York Univ LR* 936, 956–9

Economists have both praised and criticized mainstream antitrust law. Many economists, especially those with Chicago leanings, think that because antitrust is about markets, as is microeconomics, antitrust law should *be* economics. They react as though the law is out of kilter whenever it diverges from their particular economic insight; and they so react regardless of whether the law diverges because empirical processes have not validated factual assumptions, or because the law has identified social goals other than or in addition to allocative efficiency. Law is not economics. Nor were the antitrust laws adopted to squeeze the greatest possible efficiency out of business. Nonetheless, we would not want an antitrust system that hurts consumers rather than helps them. Most people agree that economics is a tool that can help keep the system on course to help consumers and to facilitate dynamic competition. Economic analysts have provided important insights into why business acts the way it does, and what the probable effect of a practice will be on the marketplace. Despite the consensus that economics can play a supporting role, the Chicago School, in the name of law and economics, has waged ideological warfare, assaulting antitrust itself. Commitment and belief fuel the debate on both sides. While others seem aware that the debate is about values, Chicagoans seem not to be. They often claim the imperative of science for their policy prescriptions. But on points of basic difference between Chicagoans on the one hand and realists or traditionalists on the other, the Chicago assertions are not provable. They are not matters of fact. They cannot be derived from economics. The basic difference between Chicagoans and traditionalists is a difference of vision about what kind of society we are and should strive to be...

...

The Chicago beliefs are compatible with only the most minimal law. In antitrust, the most minimal law, given the existence of the statutes, is law that proscribes only clear cartel agreements and mergers that would create a monopoly in a market that included all perceptible potential competition. Let us review the characteristics that underlie this minimalist approach to antitrust.

First, the Chicago School claims that it has the right prescription for efficiency. This is unprovable; some would say highly suspect, and others would say wrong. Economic experts have intense debates as to what scheme is likely to produce a more efficient or a more dynamic, inventive economy. Economics does not provide a conclusive answer. Within a wide range, the answer is indeterminate...

[78] One needs only to look at the USA in the 1980s. The economics of Chicago were those of the American Right. Robert Bork was President Reagan's nominee for the Supreme Court, but he was rejected by the Senate (although that had more to do with his conservative views on matters such as abortion than with his views on barriers to entry).

> Second, the Chicago School always opts for norms that presuppose that markets are robust and that firms, imbued with perfect knowledge and risk neutrality, move their resources quickly and easily to the most profitable opportunity. Data about how people actually behave belie these assumptions . . . Yet Chicagoans continue to press for legal rules that accept these assumptions as true . . . It is this mind-set that led Judge Posner to dissent in a recent case in which a prisoner was blinded in jail and sued prison authorities for neglect . . . A majority of the appellate court thought that appointment of counsel was improperly denied to the prisoner, but Judge Posner disagreed . . . Assuming the existence of a market for lawyers that would function like a Chicago model market, Judge Posner argued that if the prisoner's case was any good, a lawyer would have taken it on contingency. The fact that no lawyer did 'proved' that the prisoner's case lacked merit . . . [79]
>
> Third, the Chicago School defines competition in terms of efficiency; defines efficiency as the absence of inefficiency; defines inefficiency in terms of artificial output restraint; . . . and thus concludes that any activity that does not demonstrably limit output is efficient and therefore procompetitive. Thus, it 'proves' that almost all business activity is efficient—a neat trick.

Fox and Sullivan thus question the bases of many of the views on which the Chicago concept of efficiency is hung and hence challenge its utter faith in the ability of the market to correct itself. Criticisms have also been made in the Chicagoans' belief that barriers to entry are rare outside government regulation,[80] that potential competition polices the market as well as existing competitors because, in the absence of barriers to entry, monopolists will be challenged by new entrants if they reap monopoly profits, and that most markets are competitive. The Chicago model is criticized for being 'static' and concentrating too much on long-term effects rather than on short-term effects and of competition as a *process* Above all, it is argued that the neoclassical market efficiency model of Chicago is too simple to account for or predict business behaviour in the real world.

C. POST-CHICAGO

Whatever criticisms can be and have been made of the Chicago school, it undeniably changed competition law thinking profoundly. It placed rigorous economic analysis at the centre of competition law. After Chicago it is impossible to accept the S $\rightarrow$ C $\rightarrow$ P paradigm without qualification, or not to think of efficiency as a central concern. It shed new light on many matters.

More recently, however, there has been a synthesist of different strands of thought. Extreme Chicago ideas have been tempered by new insights. There is a general recognition that economics may give indications of what questions to ask, but does not always yield definitive answers, and certainly not answers which are necessarily value-free. What is called modern industrial organization theory or new industrial economics stresses the effect that the *strategic conduct* of firms can have in different market situations. It considers that firms may indulge in strategic entry deterrence, for example. So the belief that predatory pricing is rarely rational conduct, as Chicagoans said, is replaced with the idea that it can in some circumstances be adopted as a rational strategy to prevent new competitors entering the market.[81] Post-Chicago

[79] The case concerned was *Merritt* v. *Faulkner*, 697 F. 2d 761 (7th Cir). This story rather puts into the shade the classic Chicago school joke. A lawyer and a Chicago scholar walk along the pavement. The lawyer says 'Oh look, there's a £20 note lying on the pavement'. 'No', says the Chicago scholar, 'there can't be. If there was, someone would have picked it up'.

[80] See the discussion of barriers to entry *infra* 84 ff.

[81] See *infra* Chap. 7.

competition scholarship admits of more complexities than either the pure Harvard or Chicago approaches and 'helps observers understand why conduct thought benign in light of Chicago School teaching might in fact lessen competition'.[82] It also attempts to deal with the importance of dynamic competition.[83] Other ideas and theories which inform post-Chicago thinking include the following:

(i) Game Theory

Game theory is central to much modern industrial organization theory and stems from work done in the 1940's by von Neumann and Morgenstern.[84] It models the strategic interactions between firms—their conflict and cooperation—as 'games' in which each firm plans its own strategy, for example with regard to pricing or output, in the light of assumptions about the strategy which will be adopted by its competitors. Game theory is in particular an important tool in analysing the conduct of oligopolies and is dealt with further in that context in Chapter 14.

(ii) Contestable Markets

The theory of contestable markets[85] places the main emphasis on freedom of entry to, and exit from, a market. It attaches importance not to the structure of the market but to its contestability. So long as 'hit-and-run' entry by competitors is possible the behaviour of firms operating on the market will be constrained and they will perform efficiently and price competitively. The minimum conditions for a contestable market are instantaneous entry and costless exit and, crucially, the inability of the incumbent to respond to entry by another competitor by lowering its prices. This last point is vital because otherwise the incumbent firm can keep its prices at monopoly level and only lower them when it needs to respond to competition. In reality, again, the conditions for perfect contestability are not often found.[86] However, the term 'contestable market', meaning one with low barriers to entry and exit where the threat of entry does significantly constrain the incumbent, is used more loosely and is now often found in competition law discussion.[87]

(iii) Raising Rivals' Costs

Raising rivals' costs describes strategic behaviour of a firm which is designed to raise the costs of its rivals relative to its own.[88] It normally requires some degree of market power (or, for some strategies, political power or influence). It includes interfering with the production or selling methods of rivals, lobbying for or supporting government regulation which has a differential impact on the rivals' costs, raising the price of inputs, tying, raising switching costs (so that

[82] E. Gellhorn, W. Kovacic, S. Calkins, *Antitrust Law and Economics* (5th edn., West, 2004), 97.

[83] See *supra* 15.

[84] J. von Meumann and O. Morgenstern, *The Theory of Games and Economic Behaviour* (Princeton University Press, 1944).

[85] W. J. Baumol, J. Panzar, and R. Willig, *Contestable Markets and the Theory of Industry Structure* (Harcourt Brace Jovanovich, 1982); W. J. Baumol, 'Constestable Markets: An Uprising in the Theory of Industry Structure' (1982) 72 *Amer Economic Rev* 1.

[86] Sunk costs, for example, will be a hindering factor, see *infra* 88.

[87] S. Bishop and M. Walker, *The Economics of EC Competition Law* (2nd edn., Sweet & Maxwell, 2002), 3.33.

[88] T. G. Krattenmaker and S. C. Salop, 'Anticompetitive Exclusion; Raising Rivals' Costs to Achieve Power Over Price' 96 *Yale LJ* 209.

customers find it difficult or expensive to change to the rival's goods or services) and indulging in rapid product innovation in primary markets.[89] Some behaviour which raises rivals' costs may also increase welfare and whether competition law should sanction or allow it often depends on the particular circumstance of the case. In the following chapters of this book we will come across many examples of behaviour which can raise rivals' costs.[90]

(iv) Transaction Cost Economics

Transaction cost economics is based on the theory first developed by Ronald Coase in *The Nature of the Firm*.[91] Transaction costs are the costs a firm incurs by trading with other parties. Coase's argument was that a firm can choose to organize its activities by doing things itself (so internalising the costs) or by using other parties to do them (i.e. using the market). A firm producing widgets may therefore may have a choice between itself producing the inputs necessary for widget production and obtaining them from other parties. Similarly it may have a choice between doing its own distribution and using independent distributors. The first of these options in each case involves vertical integration while the second involves agreements with others. Which is chosen will depend on its comparative efficiency. The insight from transaction cost economics for competition law is that competition law should not be designed so as to force firms to take less efficient options for doctrinaire reasons of promoting more competitive markets.

> Transaction cost research has identified efficiency reasons for which firms use various forms of internal organization and has underscored the importance of contractual techniques in curbing opportunistic behavior that, if left unchecked, undermines business arrangements that increase efficiency. By showing that the main purpose of many forms of economic organization—for example, joint ventures, vertical integration, and restrictive distribution contracts—often is to reduce costs, transaction costs scholars have spurred a reevaluation of antitrust doctrines that have treated such arrangements with hostility.[92]

Therefore, in contrast to other ideas taken on board by post-Chicago thinking, such as the anti-competitive effects of strategic behaviour, transaction cost economics point to a less expansive application of competition rules.

(v) Conclusion

Post-Chicago analysis is more complex than either the original S→C→P paradigm or pure Chicago. It accepts the efficiency goal but recognizes the real-life complications in devising competition rules to achieve this. As far as application and enforcement are concerned, post-Chicago analysis makes greater demands on competition authorities and decision-makers because of the very wealth of models and theories that may fall to be considered.

[89] See D. W. Carlton and J. M. Perloff, *Modern Industrial Organization* (4th edn., Pearson Addison Wesley, 2005), 371–9.

[90] See in particular Chaps. 7 and 12.

[91] *Economica 4*, 386 (1937). See also the work of Oliver Williamson, particularly 'Transaction Cost Economics' in R. Schmalensee and R. D. Willig (eds.), 1 *Handbook of Industrial Organization* (1989) 135.

[92] E. Gellhorn, W. Kovacic, S. Calkins, *Antitrust Law and Economics* (5th edn., West, 2004), 101. See also R. J. Van den Bergh and P. D. Camesasca, *European Competition Law and Economics: A Comparative Perspective* (2nd edn., Sweet & Maxwell, 2006), 94–8; P. L. Joskow, 'The Role of Transaction Cost Economics in Antitrust and Public Utility Regulatory Policies' (1991) 7 JL Economic & Org 53.

D. OTHER SCHOOLS, THEORIES, AND CONCEPTS

The following should also be noted:

(i) Workable Competition

In the 1940's the theory of 'workable competition' was developed.[93] This was associated with the Harvard School and held that as perfect competition was usually impossible to attain competition policy should aim to produce the best competitive arrangement practically attainable. This too presented difficulties. The criteria by which workability can be assessed may be divided into structure, conduct and performance criteria but it may be hard to assess whether or not they have been satisfied in any particular industry; and if some are satisfied and some not, it may be hard to decide whether workability has been attained without making subjective value judgments.[94] Workable competition, in short, does not provide a very workable basis for developing a sound competition policy. The European Court of Justice (ECJ) referred to workable competition in 1976 in *Metro I*, equating it with 'the degree of competition necessary to ensure the observance of the basic requirements and the attainment of the objectives of the [EC] Treaty'.[95]

(ii) The Austrian School

The Austrian School embraces a theory of dynamic competition which goes beyond that advanced by Schumpeter.[96] As with Chicago, the Austrian School's conception of competition policy is just one facet of a wider school of economic theory,[97] one of whose most influential voices in the twentieth century was von Hayek.[98] Von Hayek believed in untrammelled free markets and the ability of potential competition to prevent the long-run exploitation of monopoly power. The implications of this were that competition laws should not interfere with the competitive process, not even by prohibiting cartels.[99]

(iii) Effective Competition

The concept of *effective competition* is found in EC competition law. The ECJ defines a dominant position for the purposes of Article 82[100] as involving an undertaking's power to 'prevent effective competition being maintained on the relevant market'[101] and under the EC Merger

[93] J. M. Clark, 'Towards a Concept of Workable Competition' (1940) 30 *American Economic Review* 241–56; see also S. Sosnick, 'A Critique of Concepts of Workable Competition' (1958) 72 *Quarterly Journal of Economics* 380–423.

[94] See further F. M. Scherer and D. Ross, *Industrial Market Structure and Economic Performance* (3rd edn., Houghton Mifflin, 1990) 52–5; R. J. Van den Bergh and P. D. Camesasca, *European Competition Law and Economics: A Comparative Perspective* (2nd edn., Sweet & Maxwell, 2006), 70–3.

[95] Case 26/76, *Metro* v. *Commission (No. 1)* [1977] ECR 1875, [1978] 2 CMLR 1, para. 20.

[96] See *supra* 15.

[97] Originating with Carl Menger, Professor of Economics at the University of Vienna, 1873–1903.

[98] Friedrich von Hayek held chairs from 1931 on at various universities: in London (the London School of Economics), Germany and Austria and, from 1950 to 1962, at the University of Chicago.

[99] See further R. J. Van den Bergh and P. D. Camesasca, *European Competition Law and Economics: A Comparative Perspective* (2nd edn., Sweet & Maxwell, 2006), 88.

[100] One of the two main competition law Articles. See *infra* Chaps. 5–7.

[101] Case 2/76, *United Brands* v. *Commission* [1978] ECR 207, [1978] 1 CMLR 429, para. 65; Case 85/76, *Hoffmann-La Roche & Co AG* v. *Commission* [1979] ECR 461, [1979] 3 CMLR 211, para. 38.

Regulation the grounds for the prohibition of a merger are that it would 'significantly impede effective competition'.[102] The Court of First Instance said in *GlaxoSmithKline* that 'the competition referred to in Article 3(1)(g) EC and Article 81 EC is taken to mean effective competition, that is to say, the degree of competition necessary to ensure that attainment of the objectives of the Treaty'.[103] Bishop and Walker suggest that 'effective competition' should be outcome-based.

S. Bishop and M. Walker, *The Economics of EC Competition Law* (2nd edn., Sweet & Maxwell, 2002), 16

2.10 ... The economic goal of EC competition law is the protection and promotion of effective competition. But this is a goal only because of the benefits that it delivers to European consumers. What matters therefore are the outcomes for consumers that competition in a particular market delivers—not the particular form that the competition process takes. Whether a market is characterized by effective competition or not therefore depends on the outcomes it produces.

This raises the question of what outcomes are produced by effective competition and how can they be distinguished from those produced by less than effective competition. The practical application of competition law ought to be interested less in outcomes that are desirable in some theoretical, abstract sense and more in outcomes that are feasible for regulatory intervention to achieve.... To draw this distinction requires consideration of the various economic models of competition and the implications each type of model has for consumer welfare.

6. ORDOLIBERALISM

Ordoliberalism is not a just school of competition or economic theory but an entire political and economic philosophy. However, it has important implications for competition policy and it is therefore convenient to mention it here before looking in the section below at its influence on the development of EC competition law.

Ordoliberalism was conceived in Germany in the 1930's and nurtured at the University of Freiburg during the Nazi era.[104] It became a key element of post-war thinking in Germany, envisaging a new relationship between law and the economic system and holding that competition is necessary for economic well-being and that economic freedom is necessary for political freedom.[105] It advocates an 'economic constitution' whereby competition and economic freedom are embedded into the law so that there is neither unconstrained private

[102] Council Regulation 139/2004 [2004] OJ L124/1, Art. 2(3). The previous Merger Regulation, Council Regulation 4064/89 [1990] OJ L257/13, also employed the concept of 'effective competition', see *infra* Chap. 12.

[103] Case T-168/01, *GlaxoSmithKline Services Unlimited v. Commission* [2006] ECR II-2969, [2006] 5 CMLR 1623, para. 109.

[104] Hence its alternative name of the 'Freiburg School'. The leading ordoliberal theorists were the economist Walter Eucken and the lawyers Franz Böhm and Hanns Grossmann-Doerth. See further D. Gerber, 'Constitutionalizing the Economy: German Neo-liberalism, Competition Law and the 'New Europe' (1994) 42 *American Journal of Comparative Law* 25.

[105] W. Möschel, 'Competition Policy from an Ordo Point of View' in A. Peacock and H. Willgerodt (eds.), *German Neo-Liberals and the Social Market Economics* (MacMillan, 1989), 142.

power nor discretionary governmental intervention in the economy. Competition law, it holds, should create and protect the conditions of competition. It follows from this that competition is a value in itself and not just a means by which purely economic objectives—such as efficiency—are to be achieved. An ordoliberal approach to competition policy leads to the protection of *competitors* and small and medium sized enterprises, regardless of the effects on efficiency, rather than the protection of *competition*, as it prizes the freedom of all citizens to be able to enter and compete on markets.

R. O'Donoghue and A. J. Padilla, *The Law and Economics of Article 82* (Oxford University Press, 2006), 9

Ordoliberal thinking on the goal of competition law was based on notions of "fairness" and that firms with market power should behave "as if" there was effective competition... This reflected a view that small and medium sized enterprises were important to consumer welfare and that they should receive some protection from the excesses of market power. Ordoliberal thought therefore considered that certain restrictions on dominant firm behaviour were necessary and appropriate. The basic notion was was that firms with economic power should not engage in conduct that unfairly limited rivals' access to markets or production. Of course, dominant firms had to be allowed the commercial freedom to compete on the merits. In this regard, ordoliberal thinking developed a notion of "performance-based competition" (*Leistungswettgewerb*). For example, non-predatory lower prices, better quality products, or better services were all considered as legitimate ways of excluding rival firms and should be permitted, whereas conduct that was not performance-based competition (e.g., below-cost prices) should be prohibited.

We see in later chapters of this book how ordoliberal thinking influenced the development of the law on Articles 81 and Article 82 of the EC Treaty.

7. EC COMPETITION LAW

A. GENERAL

The first 'European' competition rules were Articles 65 and 66 of the Treaty of Paris of 1951, which created the European Coal and Steel Community (ECSC).[106] The Treaty of Rome, which established the European Economic Community (EEC), and the competition rules set within it

[106] They were based on a draft prepared, at the behest of Jean Monnet, by the Harvard antitrust lawyer Robert Bowie, who was an adviser to John McCloy, the US High Commissioner for Germany and a close ally of Monnet. Monnet, a French economist and public official, Deputy Secretary-General of the League of Nations 1919–1923, is considered to be, with Robert Schuman, one of the founding fathers of the European Union. For an account of the history of the ECSC see D. Spiernburg and R. Poidevin, *The History of the High Authority of the European Coal and Steel Community: Supranationality in Operation* (Weidenfeld and Nicolson, 1994). The ECSC competition provisions were the pattern for the later EEC ones.

came into force in 1958.[107] However, the EEC competition rules were not enforced by the Community institutions until Regulation 17 was passed four years later.[108]

In a book published in 1998, Daniel Gerber, a comparative lawyer, argues that there is a rich tradition of thought in Europe about what we now call competition law, which has given European domestic competition laws, as well as EC law, a distinctive character of their own.

Gerber first of all summarizes what he calls the 'Competition Law Story' in Europe.

D. Gerber, *Law and Competition in Twentieth Century Europe: Protecting Prometheus* (Clarendon Press, 1998), 6–8

Europeans began to develop the idea of such a general law to protect competition almost a century ago. The idea took shape in the 1890s in Austria, where it was a product of Vienna's extraordinary creative intellectual life. Competition law proposals emerged in order to protect the competitive process from political and ideological onslaughts, and they relied heavily on bureaucratic application of a 'public interest' standard in doing so. One of these proposals gained significant political support, and a competition law was almost enacted—only to be barred by the disintegration of the Austrian legislative process.

Although political events blocked further development of competition law ideas in Austria, such ideas were intensely debated in both intellectual and political arenas in Germany during the decade that bracketed the turn of the century. These conflicts shaped a discourse from which Europe's early competition legislation drew much of its substance and without which its enactment is barely conceivable. Moreover, many elements of this discourse were to become fixtures of European competition law thought.

The first European 'competition law' was enacted in Germany in 1923 in response to the postwar inflation crisis. The system created to implement this legislation became an important factor of economic and legal life in Germany during the 1920s and established competition law as an operational reality rather than merely an idea. It was, however, too weak to withstand the pressures ranged against it, and it was eliminated during the 1930s.

German experience with this system was nevertheless influential in the spread of competition law ideas, and during the late 1920s competition law ideas were widely discussed throughout Europe. By the early 1930s, additional statutes along the lines of the German legislation had been enacted in several smaller European states. More importantly, these discussions and enactments generated a framework for thinking about the roles and characteristics of competition law that was to be used after the Second World War as the basis for competition legislation and that remains influential.

[107] On 1 January 1958 not only did the Treaty of Rome come into force but also, coincidentally, did a new German Competition Law system (the *Gesetz gegen Wettbewerbsbeschränkungen*). This was required by the American occupiers before they would return full sovereignty to the new German state. US officials considered that the concentrated and heavy cartelized nature of pre-war German industry had aided Hitler's rise to power and his military conquests and that US-style competition laws would help German democracy. Anti-cartelization statutes were first put into place in 1947. However, there was a domestic as well as an American impetus towards the adoption of a complete new system and Chancellor Adenauer's economics minister, Ludwig Erhard (who was himself Chancellor 1963–1966) pushed hard for it, although against strong opposition (which accounted for the delay until 1958). The GWB (which is still in place today) rapidly acquired an important role in Germany's economic and legal system. The institution primarily charged with enforcing it was (and is) the *Bundeskartellamt* (Federal Cartel Office).

[108] [1959–62] OJ Spec. Ed. 87. See *infra* Chap. 2.

After the end of the war, many European governments turned to competition law as a means of encouraging economic revival, undergirding recently re-won and still fragile freedoms and achieving political acceptance of post-war hardships. Virtually all of these competition law systems were based on the thought and experience of the interwar period. In most of them, however, competition law was imbedded in economic regulatory frameworks that impeded its effectiveness, and it was seldom supported by significant economic, political or intellectual resources. As a result, these systems remained a rather marginal component of general economic policy, and in this respect some have not fundamentally changed even today.

In postwar Germany, competition law took a different turn—one that was to play a key role in the process of European integration and to have extraordinary consequences for the course of postwar European history. This change of direction was prepared during the Nazi period by a group of neo-liberal thinkers who secretly and often at great personal risk developed ideas of how Germany should be reconstituted after the war. In their so-called 'ordoliberal' vision of society, economic freedom and competition were the sources not only of prosperity but also of political freedom. They represented the 'economic constitution' of society, and law, the ordoliberals said, had to protect and implement this constitution. In this view, therefore, competition law acquired a new importance because it was made a basic structure of the political system. It also acquired new characteristics: it was now to operate increasingly according to juridical principles and procedures rather than on the basis of administration discretion.

These ideas eventually fell on fertile soil in the years after the Second World War. Nourished by the desire for new social ideals and supported by the occupation authorities, neo-liberal reformers enacted a competition law in 1957 that achieved new prominence and a vastly greater economic and political role. Despite often intense opposition from 'big industry', competition law has become a 'pillar' of the 'social market economy', and as such it has played a key role in some of the postwar Europe's most impressive economic and political successes.

Gerber thus locates the spirit of European competition law in the ideas of *fin-de-siècle* Austria and in the German concept of ordoliberalism.[109] In fact, he goes further back, to nineteenth-century liberalism's conception of law as being necessary to create freedom by constraining power. In Europe, competition law is to be seen as part of an 'economic constitution' which embraces social justice and is part of the political system.[110] The UK, however, has in the recent past at least shared the American economic philosophy. One commentator has identified a dichotomy between what he calls 'neo-American' capitalism—individualistic, unregulated, based on short-term profits, and with a minimal social component—and 'Rhine model' capitalism—collective achievement, public consensus, social welfare.[111] Gerber considers that English legal culture led to distinctive features in the UK competition law model, which moved it away from the general 'European model' he identifies. Nevertheless the UK's use of administrative controls produced similarities which are important from the perspective of European integration 'because they have provided a common experiential base that has eased

[109] See *supra* 34. See further D. Gerber, 'Constitutionalizing the Economy: German Neo-liberalism, Competition Law and the 'New Europe' (1994) 42 *American Journal of Comparative Law* 25.

[110] For a recent example of the concern of many Member States for the 'social' aspect in competition policy, see the insertion into the Treaty of Article 16 (ex Art. 7) reiterating the value of 'services of general economic interest' in the Community. See further *infra* Chap. 8 and the Addendum, *infra* 1399.

[111] M. Albert, *Capitalism Against Capitalism* (Whurr Publishers Ltd, 1993).

mutual understanding and co-operation within EU institutions and forged important links between Member State governments and officials'.[112]

B. THE OBJECTIVES OF THE EUROPEAN COMMUNITY AND EC COMPETITION POLICY

(i) The Objectives of the European Community

An examination of the *raison d'être* of the European Community and European Union is beyond the scope of a book on competition law. As Craig and de Bùrca state, '[t]here are and always have been many different and contested views about the original aims and *raison d'être* of the EC and EU among its political actors, populace, and commentators. A complex range of historical, political, and economic forces and contingencies contributed to creating the entity which exists today'.[113] A brief discussion of the aims and objectives of the Community is, however, essential to understand the context within which the competition rules are set and the impact that these aims and objectives may have on the interpretation and application of those rules.

The Preamble to the Treaty of Rome[114] states that the Member States recognize, *inter alia*, 'that the removal of existing obstacles calls for concerted action in order to guarantee steady expansion, balanced trade and fair competition'. The objectives of the Treaty are set out in Article 2. The original Article 2 stated:

> The Community shall have as its task, by establishing a common market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relations between the states belonging to it.

Article 2 has subsequently been amended, and since the Treaty of Amsterdam came into force on 1 May 1999 states:

> The Community shall have as its task, by establishing a common market and an economic and monetary union and by implementing the common policies or activities referred to in Articles 3 and 4, to promote throughout the Community a harmonious, balanced and sustained development of economic activities, a high level of employment and of social protection, equality between men and women, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance, a high level of protection and improvement of the quality of the environment, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States.

The Community therefore has a number of wide-ranging and aspirational goals which have expanded during the life of the EC and which it seeks to achieve through economic integration. The creation of the common market is not therefore an end in itself, but a means (along with the establishment of economic and monetary union (EMU) and the implementation of common policies or activities) of achieving the promotion of the matters listed in Article 2. The 'common market', often used colloquially as a synonym for the Community, means an area where direct

[112] D. Gerber, *Law and Competition in Twentieth Century Europe: Protecting Prometheus* (Clarendon Press, 1998), 207.

[113] P. Craig and G. de Bùrca, *EU Law: Text, Cases and Materials* (3rd edn., Oxford University Press, 2003), 4.

[114] The adoption of this Treaty and its amendments are discussed *infra* Chap. 2.

and indirect barriers to trade between Member States are removed and a common import and export policy adopted toward the outside world as far as commercial transactions are concerned. In *Metro v. Commission*,[115] the Court of Justice said in 1976 that the objectives of the Treaty included the creation of a single market achieving conditions similar to those of a domestic market. The single market is the 'internal' aspect of the common market, and is now defined in Article 14(2):[116]

> The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty.

The economic integration of the Member States has been taken further by progress towards EMU. The third and final stage of EMU entailed the adoption of a single currency, the Euro (€).[117] The single internal market, however, remains the core concept on which economic integration is founded.

Article 3 of the Treaty sets out the 'activities' of the Community necessary for the purposes set out in Article 2. This has also expanded since 1958, reflecting the additions to Article 2. The present Article 3 states:

> 1. For the purposes set out in Article 2, the activities of the Community shall include, as provided in this Treaty and in accordance with the timetable set out therein:
>
> (a) the prohibition, as between Member States, of customs duties and quantitative restrictions on the import and export of goods, and of all other measures having equivalent effect;
>
> (b) a common commercial policy;
>
> (c) an internal market characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital;
>
> (d) measures concerning the entry and movement of persons as provided for in Title IV;
>
> (e) a common policy in the sphere of agriculture and fisheries;
>
> (f) a common policy in the sphere of transport;
>
> (g) a system ensuring that competition in the internal market is not distorted;
>
> (h) the approximation of the laws of Member States to the extent required for the functioning of the common market;
>
> (i) the promotion of co-ordination between employment policies of the Member States with a view to enhancing their effectiveness by developing a co-ordinated strategy for employment;
>
> (j) a policy in the social sphere comprising a European Social Fund;
>
> (k) the strengthening of economic and social cohesion;
>
> (l) a policy in the sphere of the environment;
>
> (m) the strengthening of the competitiveness of Community industry;

[115] Case 26/76, *Metro v. Commission (No. 1)* [1977] ECR 1875, [1978] 2 CMLR 1, para. 20.

[116] Previously Article 7a. The concept of the 'internal market' was first formally enshrined in the Treaty by the Single European Act 1986 (SEA), which provided for its completion by the end of 1992.

[117] The adoption of the Euro began on 1 January 1999 and culminated in the introduction of the new coins and banknotes on 1 January 2002 and the withdrawal of national currencies at the end of February 2002. For the way in which the 'ECU' referred to in the Treaty became the 'Euro' without an amendment to the Treaty, see S. Weatherill and P. Beaumont, *EU Law* (3rd edn., Penguin, 1999), 776. Not all Member States have adopted the single currency. On 1 January 2007 the Member States in the eurozone were Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland and Slovenia. Of the pre-2004 Member States, Denmark, Sweden and the UK remain outside it. Cyprus and Malta will join on 1 January 2008.

(n) the promotion of research and technological development;

(o) encouragement for the establishment and development of trans-European networks;

(p) a contribution to the attainment of a high level of health protection;

(q) a contribution to education and training of quality and to the flowering of the cultures of the Member States;

(r) a policy in the sphere of development co-operation;

(s) the association of the overseas countries and territories in order to increase trade and promote jointly economic and social development;

(t) a contribution to the strengthening of consumer protection;

(u) measures in the spheres of energy, civil protection and tourism.

The Community's activities are thus broad, encompassing the pursuit of a large number of policies and activities, including in Article 3(1)(g), 'a system ensuring that competition in the internal market is not distorted'.[118]

Further, Article 4(1), inserted into the Treaty by the TEU in 1993,[119] assumes that economic policies in the Community will be based on an open market economy with free competition:

For the purposes set out in Article 2, the activities of the Member States and the Community shall include, as provided in this Treaty and in accordance with the timetable set out therein, the adoption of an economic policy which is based on the close co-ordination of Member States' economic policies, on the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition.

This is taken up in Article 157(1) which deals with the Community's industrial policy,[120] and says that Community action shall be 'in accordance with a system of open and competitive markets'.

The abandoned Constitutional Treaty would have said that the EU offered its citizens '... a single market where competition is free and undistorted'. The June 2007 Council meeting, however, agreed that the EC wll be subsumed into the EU and a revised Treaty on European Union will refer to establishing an internal market but without the reference to free and undistorted competition. Article 3(1)(g) will disappear from the EC Treaty, which will be renamed the 'Treaty on the Functioning of the Union'. However, a Protocol on competition will be annexed to the new Treaties. EC competition law will become EU competition law. For details, see the Addendum.[121]

However, even if the over-arching objective of the competition rules is to advance the (present) aims of the EC as set out in Article 2 of the EC Treaty, that still leaves open the question of how exactly they are to do this. In other words, in the light of the discussion in the sections above, what are the goals which the application of EC competition law is designed to achieve in order to further the Community's mission?

[118] Until the TEU amendments in 1993 this provision was Article 3(f) and read: 'the institution of a system ensuring that competition in the common market is not distorted'. It was reworded by the TEU and became Article 3(g), and was again renumbered by the Treaty of Amsterdam to become the present Article 3(1)(g).

[119] As Article 3a under the previous numbering.

[120] 'Industrial policy' describes the very wide raft of policies to do with creating employment and investment opportunites and enhancing competitiveness (not necessarily the same as enhancing competition) and the output of industry.

[121] See *infra* 1399.

(ii) The Development of the Objectives of EC Competition Policy

As Bork wrote in relation to US law: 'Antitrust policy cannot be made rational until we are able to give a firm answer to one question: What is the point of the law—what are its goals?'.[122]

We said above[123] that EC law appears to be striving for 'effective competition'. We therefore need to ask, in the light of the preceding discussion, what effective competition entails. As noted above, competition policy has been included in the list of Community activities set out in Article 3 since the inception of the Community in 1958. It was embedded in the Treaty right from the start as a set of wider policy goals oriented towards the objective of European economic integration. It was necessary in order to underpin the internal market aspect of the common market because there was no point in dismantling, by means of the free movement provisions, State measures which divided the Community territorially and compartmentalized the market if private undertakings could erect and maintain barriers to trade between Member States by carving up markets between them and indulging in anti-competitive practices. Economic integration is therefore promoted both by free movement and by competition.[124] In general it is true to say that the free movement provisions apply to State measures and the competition provisions to those of private actors. However, this statement masks a number of complexities. First, in some cases the free movement provisions can bind private parties, in particular where 'collective' private action is concerned in the area of free movement of persons and services.[125] Secondly, some situations raise both free movement and competition issues. A good example of this is *Bosman*,[126] where the ECJ decided the case on free movement grounds and declined to deal with the (very interesting) competition arguments.[127] Thirdly, it is possible to impugn some State measures on competition grounds. Indeed, the application of the competition rules to State action has become a very significant aspect of competition law in the EU.[128]

The Community Courts have repeatedly stressed the fundamental nature of the competition rules. As the ECJ said in *Eco Suisse*:

However, according to Article [3(1)(g)] EC..., Article [81] of the Treaty constitutes a fundamental provision which is essential for the accomplishment of the tasks entrusted to the Community and, in particular, for the functioning of the internal market. [129]

[122] R. Bork, *The Antitrust Paradox: A Policy at War With Itself* (Basic Books, 1978, reprinted with a new Introduction and Epilogue, 1993), 50.

[123] *Supra* 34.

[124] See J. Baquero Cruz, *Between Competition and Free Movement: The Economic Constitutional Law of the European Community* (Hart Publishing, 2002).

[125] See Case 36/74, *Walrave & Koch* v. *Association Union Cycliste Internationale* [1974] ECR 1405 and Case 415/93, *Union Royal Belge des Sociétés de Football Association ASBL & others* v. *Jean-Marc Bosman* [1995] ECR I-4921, [1996] 1 CMLR 645 (both cases concerning the rules of sporting organizations).

[126] *Ibid. Bosman* is described in Chalmers, Hadjiemmanuil, Monti and Tomkins, *European Union Law* (Cambridge University Press, 2006), 708 as being '[o]utside the small world of Community lawyers, arguably the most famous cases in the history of Community law ...'.

[127] The case dealt with the rights of professional football players to move between clubs when out of contract, and changed the transfer system. See also Case C-303/99, *Wouters* v. *Algemene Raad van de Nederlandse Orde van Advocaten* [2002] ECR I-1577, [2002] 4 CMLR 913, on the rules of the Dutch Bar, discussed *infra* Chap. 3.

[128] See *infra* 54 and Chap. 8.

[129] Case C-126/97, *Eco Swiss China Time Ltd* v. *Benetton International NV* [1999] ECR I-3055, [2000] 5 CMLR 816, para 36. Article 81 is one of the two main substantive competition articles. See also Case C-453/99, *Courage Ltd* v. *Crehan* [2001] ECR I-6297, [2001] 5 CMLR 28, para. 20; Case T-168/01, *GlaxoSmithKlineServices Unlimited* v. *Commission*, 27 September 2006, para. 118 ('indispensable for the achievement of the missions entrusted to the Community').

The role of competition policy as an instrument of single market integration is absolutely crucial to an understanding of EC competition law. It differentiates EC law from any system of domestic competition law, whether in the Member States, the USA, or elsewhere. EC competition law has been seen as serving two masters, the 'competition' one and (even more demanding) the imperative of single market integration. This second goal has sometimes dictated the entire development of the law, particularly, as we shall see, in respect of vertical restraints.[130] A good example of the use of the competition rules in advancing the single market was the adoption of the new block exemption Regulation on motor vehicle distribution in 2002.[131] The Regulation allows the dealers and manufacturers less leeway than the previous Regulation[132] because the Commission was concerned that they were still acting to maintain price differentials in different Member States. The Competition Commissioner, Mario Monti, said of the new Regulation:[133]

> ... The Commission also needs to play its role as an initiator of change where markets do not function satisfactorily in the light of the Treaty objectives. The adoption in July of new exemption regulation for motor vehicle distribution can serve as a concrete example. It is high time we had a genuine single market in cars, for the benefit of consumers but also in the interests of the competitiveness of European industry. A review had clearly shown that the market integration pursued by old regulation applicable to the sector had not been achieved to the extent hoped for, and that consumers were receiving their share of the benefits deriving from the exempted restrictions. Thus, a new system has been put in place to give a fresh boost to market integration, so that consumers can benefit from better prices, wider choice and improved services.[134]

As recently as 2000, the Commission's Annual Report on Competition Policy talked of the two objectives of competition policy:

Commission's XXIXth Report on Competition Policy (1999), Introduction, paras 2–3.

The first objective of competition policy is the maintenance of competitive markets. Competition policy serves as an instrument to encourage industrial efficiency, the optimal allocation of resources, technical progress and the flexibility to adjust to a changing environment. In order for the Community to be competitive on worldwide markets, it needs a competitive home market......

The second is the single market objective. An internal market is an essential condition for the development of an efficient and competitive industry. As the Community has progressively broken down government erected trade barriers between Member States, companies operating in what they had regarded as "their" national markets were and are for the first time exposed to competitors able to compete on a level playing field.... Moreover, the objectives of competition policy have been integrated into into the Commission's new strategy for the European single market adopted on 24 November.[135] The aim is to prevent anti-competitive practices from undermining the single market's achievements.

[130] *Infra*, Chap. 9.

[131] Commission Regulation 1400/2000 [2002] OJ L203/30, [2002] 5 CMLR 777.

[132] Regulation 1475/95 [1995] OJ L145/25.

[133] Commission's *XXXIInd Report on Competition Policy* (Brussels, 2003), foreword, p. 5.

[134] Note also the swingeing fines imposed by the Commission on motor manufacturers found to have infringed the competition rules by attempting to prevent the parallel import of their cars between Member States, e.g., *Volkswagen* [1998] OJ L124/60, [1998] 5 CMLR 33 (€102 million, reduced by the CFI on appeal, Case T-62/98, *Volkswagen AG v. Commission* [2000] ECR II-2707, [2000] 5 CMLR 853 to €90 million, appeal to the ECJ dismissed, Case C-338/00P, *Volkswagen AG v. Commission* [2003] ECR I-9189, [2004] 4 CMLR 351).

However, in 1999 the White Paper on Modernization in 1999 the Commission said that the focus of competition policy had changed:[136]

> At the beginning the focus of [the Commission's] activity was on establishing rules on restrictive practices interfering directly with the goal of market integration... The Commission has now come to concentrate more on ensuring effective competition by detecting and stopping cross-border cartels and maintaining competitive market structures.

As we will see below, the Commission has now formulated the objectives of competition law in a way which conceptualizes competition and market integration as serving a common end, rather than seeing competition as a means of advancing the single market.[137]

There was considerable German and ordoliberal influence on the drafting of the EC competition provisions (particularly noticeable in respect of Article 82 which is worded so as to prohibit 'the abuse... of a dominant position' and gives specific examples of such abuse, including the charging of excessive prices[138]) and we have already seen that the development of EC competition law has been greatly influenced by ordoliberal ideas. Ordoliberalism, it will be recalled, prizes individual economic freedom and is hostile to monopoly not because of its effects on efficiency but because it embodies private economic power. The result of this is that EC law has often been interpreted and applied to protect the competitors themselves rather than the competitive process, to favour small or medium-sized enterprises, to keep markets open and to achieve' fairness'. Moreover, as well as serving to uphold the single market, competition policy has been called in aid to support or advance other Community policies such as liberalization.[139] We see in the subsequent chapters of this book how these purposes have sometimes conflicted, and how different ones have been favoured at different times and in different contexts. The question of to what extent, if at all, the EC competition rules should take on board socio-political issues such as the environment or employment has been, and remains, deeply controversial.

[135] This is a reference to the Commission's communication of 24 November 1999 (COM(1999)642, endorsed by the Helsinki Council, Bull. 12–1999), setting out the strategic objectives of the internal market for the next five years (2000–04), which were to improve the citizens' quality of life, enhance the efficiency of the EU's product and capital markets, improve the business environment and exploit the achievements of the internal market in a changing world.

[136] Commission White Paper on modernization of the rules implementing Articles 81 and 82 of the EC Treaty [1999] OJ C132/1, [1999] 5 CMLR 208, Executive Summary, pt. 8.

[137] See *infra* 51.

[138] The concept of a 'dominant position' is also central to EC merger regulation, see Council Regulation 139/2004 [2004] OJ L24/1 and *infra* Chap. 12, which shows the EC's fear of 'unilateral or collective acquisition of market power likely to undermine market mechanisms' (D. Gerard, 'Merger Control Policy: How to Give Meaningful Considerations to Efficiency Claims?' (2003) 40 CMLRev 1367, 1380).

[139] For example, in the liberalisation of the air transport and telecommunications markets: see further *infra* Chap. 7 and Chap. 8.

(iii) The 'Modernization' of EC Competition Law and the Consumer Welfare Standard

During the 1990's the Commission began to move towards a realignment of the goals of competition law in line with the modern economic thinking on competition described above.[140] The term 'modernization' is often used specifically to refer to the great reform of the enforcement of EC competition law which took place in 2004.[141] However, the modernization of EC competition law goes much wider and deeper than that, and encompasses also the gradual revolution in the interpretation and application of the substantive law which had taken place in the previous decade,[142] as well as developments subsequent to 2004.[143] The result of all this is to place the welfare of the consumer squarely at the heart of EC competition law discourse.

In fact, the word 'consumer(s)' appears twice in the text of the competition articles themselves. First, it is provided in Article 81(3) that a restrictive agreement may escape prohibition if it contributes to improving the production or distribution of goods or promoting technical or economic progress while, *inter alia*, 'allowing consumers a fair share of the resulting benefit'. Secondly, Article 82, which prohibits any abuse by undertakings of a dominant position, contains a (non-exhaustive) list of examples of abuses. The second of these (Article 82(b)) is 'limiting production, markets or technical development to the prejudice of consumers' (and the ECJ referred to Article 82(c) and (d) as being aimed at practices which cause damage to consumers in *Continental Can* in 1974[144]). In addition, consumers feature in the Merger Regulation (ECMR), Article 2(1)(b) of which says that in appraising a merger the Commission shall take into account, *inter alia*, '... the interests of the intermediate and ultimate consumers, and the development of technical and economic progress provided that it is to consumers' advantage and does form an obstacle to competition'.[145]

[140] *Supra* 13 ff.

[141] Council Regulation 1/2003 [2003] OJ L1/1 and the accompanying secondary legislation and Notices; see *infra* 119.

[142] This could be discerned first of all in the more 'economic' approach taken to some aspects the assessment of mergers under the regime which came into operation in 1990 (pursuant to the original European Merger Regulation, Council Regulation 4064/89 [1990] OJ L 257/13, now Regulation 139/2004 [2004] OJ L24/1, see *infra* Chap. 12); the first solid manifestation of it in the antitrust field was the adoption by the Commission of a Notice on the definition of the relevant market in 1997 (Commission Notice on the definition of the relevant market for the purposes of Community competition law [1997] OJ C372/51); then there was the Green Paper on vertical restraints (COM 96) 721 final) paving the way for the reform of the Commission's much-criticized policy towards vertical restraints in 1999 (Commission Regulation 2790/99 [1999] OJ L336/21 and the Commission Notice, Guidelines on vertical restrains [2000]OJ C291/1, see *infra* Chap.9), the 1999 White Paper on the modernization of enforcement and procedure (Commission White Paper on modernization of the rules implementing Articles 81 and 82 of the EC Treaty [1999] OJ C132/1), and new Guidelines and block exemptions on horizontal cooperation agreements in 2000 (Guidelines on the applicability of Article 81 of the EC Treaty to horizontal cooperation agreements [2001] OJ C3/2; Commission Regulation 2658/2000 on specialization agreements [2000] OJ L304/3; Commission Regulation 2659/2000 on categories of research and development agreements [2000] OJ L304/7).

[143] Such as the Commission review of Article 82, launched by the DG Comp Discussion Paper on the application of Article 82 of the Treaty to exclusionary abuses, Brussels, December 2005, and the Draft Guidelines on the assessment of non-horizontal mergers, 13 February 2007.

[144] Case 6/72, *Europemballage & Continental Can* v. *EV Commission* [1973] ECR 215, [1973] CMLR 199. para. 26, in which the ECJ made the important point that the provisions were aimed at practices which injured them indirectly as well as directly.

[145] Council Regulation 139/2004 [2004] OJ L24/1 (the ECMR). Exactly the same provision appeared in the original Merger Regulation, 4064/89 [1990] OJ L257/13. Note also that Recital 29 of Regulation 139/2004 refers to a merger's potential efficiencies counteracting the effects on competition and 'in particular the potential harm to consumers' (there was no similar recital in 4064/89).

As the modernization process progressed, the speeches and publications of the Commission proclaimed the belief that the competition rules should promote efficiency and consumer welfare. This was particularly so after the appointment of an economist, Mario Monti, as Commissioner responsible for competition in 1999. Furthermore, this theme appeared in 'soft law' documents emanating from the Commission.[146] The Commission Guidelines on vertical restraints, adopted in middle of 2000, state that '[T]he protection of competition is the primary objective of EC competition policy, as this enhances consumer welfare and creates an efficient allocation of resources'.[147] Monti elaborated on this later in 2000 when he described the EC approach in this way:

> Enshrined in the Treaty.... [is] 'an open market economy with free competition'. Since its adoption more than 40 years ago, the Treaty acknowledges the fundamental role of the market and of competition in guaranteeing consumer welfare, encouraging the optimal allocation of resources and granting to economic agents the appropriate incentives to pursue productive efficiency, quality and innovation. Personally I believe that this principle of an open market economy does not imply an attitude of unconditional faith with respect to the operation of market mechanisms. On the contrary, it requires a serious commitment—as well as self-restraint—by public powers, aimed at preserving those mechanisms.[148]

Furthermore, in a speech in July 2001, he said:[149]

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

The fact that he said that the protection of consumer welfare was *the* goal rather than *a* goal was acclaimed by the then Deputy Assistant Attorney General of the US DOJ Antitrust Division who said that '[w]e in the United States applaud Commissioner Monti's bold leadership in embracing the consumer welfare model of competition policy'.[150]

The approach enunciated by Monti above, and reflected in the Verticals Guidelines, is one whereby competition laws protect the competitive structure and dynamic of the market: 'they protect openness of access to markets, and the right of market actors not to be fenced out by dominant firm strategies that are not based on competitive merits'.[151] Such an approach is likely to lead in some cases to a different outcome than that which is reached by a system concerned with efficiency seen exclusively in terms of whether or not output is limited, as is arguably currently the position in US law.[152] The importance accorded in the EC to the competitive

[146] Moreover, in a case in 1998 Advocate General Jacobs reminded the Court that 'the primary purpose of Article [82] is to prevent distortion of competition-and in particular to safeguard the interests of consumers-rather than to protect the position of particular competitors', Case C-7/97, *Oscar Bronner GmbH & Co KG* v. *Mediaprint* [1998] ECR I-7791, [1999] 4 CMLR 112, para. 58 of his Opinion, discussed *infra* Chap. 7.

[147] [2000] OJ C291/1 (the 'Verticals Guidelines), para 7.

[148] M. Monti, 'European Competition Policy for the 21st Century' in B. Hawk (ed.) [2000] *Fordham Corp L Inst*, chap. 15, (and available on the Commission's web site http://www.europa.eu.int/comm/competition/speeches/.

[149] 'The Future for Competition Policy in the European Union', Merchants Taylor's Hall, London, 9 July 2001, available on the Commission web site, http://www.europa.eu.int/comm/competition/speeches/index_speeches_by_the_commissioner.html.

[150] William J. Kolasky 'North Atlantic Competition Policy: Converging Towards What?', Address given at the BIICL 2nd Annual International and Comparative Law Conference, London, 17 May 2002, available on the DOJ web site, http://www.usdoj.gov/atr/public/speeches/speech_kolasky.htm.

[151] E. Fox, 'What is Harm to Competition? Exclusionary Practices and Anti-competitive Effect' (2002) 70 ALJ 371, 392.

[152] See *ibid.*, 380–91 and further *infra*, Chap. 7.

process is shown by the wording of the competition provisions themselves, as explained in the Commission's 2004 Guidelines on Article 81(3).[153] The Guidelines contain a statement of the objectives of Article 81 phrased differently to the statement in the Verticals Guidelines, but still talking of protecting competition as a means of enhancing consumer welfare:[154]

The objective of Article 81 is to protect competition on the market as a means of enhancing consumer welfare and of ensuring an efficient allocation of resources. Competition and market integration serve these ends since the creation and preservation of an open single market promotes an efficient allocation of resources throughout the Community for the benefit of consumers.

The Guidelines go on to deal with the question of the conditions which have to be fulfilled before agreements which are restrictive of competition may escape the prohibition against such agreements by the operation of Article 81(3).[155] The final condition under Article 81(3) is that the agreement must not 'afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the products concerned'. The Commission's conclusion on this in the Guidelines is that in the end protecting competition trumps other considerations:

Ultimately the protection of rivalry and the competitive process is given priority over potentially pro-competitive efficiency gains which could result from restrictive agreements. The last condition of Article 81(3) recognises the fact that rivalry between undertakings is an essential driver of economic efficiency, including dynamic efficiencies in the shape of innovation. In other words, the ultimate aim of Article 81 is to protect the competitive process.[156]

Neelie Kroes, who took up office as Competition Commissioner in autumn 2004, continued to proclaim the goal of protecting competition as a means of ensuring efficiency and consumer welfare. For example, in a speech in London in September 2005 she said:[157]

Consumer welfare is now well established as the standard the Commission applies when assessing mergers and infringements of the Treaty rules on cartels and monopolies. Our aim is simple: to protect competition in the market as a means of enhancing consumer welfare and ensuring an efficient allocation of resources. An effects-based approach, grounded in solid economics, ensures that citizens enjoy the benefits of a competitive, dynamic market economy.

Further, her speech to the BEUC[158] in November 2006 was actually entitled 'Consumer Welfare is the Standard of Anti-trust Enforcement'.[159]

[153] [2004] OJ C101/97.

[154] *Ibid.*, para. 13.

[155] See *infra* Chap. 4.

[156] Guidelines on the application of Article 81(3) of the Treaty, para. 105.

[157] European Consumer and Competition Day, London, 15 September 2005, http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/05/512&format=HTML&aged=0&language=EN&guiLanguage=en. The Commission's 'Competition Day' held twice yearly since 2000 became a 'Competition and Consumer Day' in September 2005 when it was held in London, and both the Competition Commissioner, Neelie Kroes and the Chairman of the OFT, John Vickers stressed that (in Vickers' words) '...consumer and competition policies must work together in tandem if not as one': see also http://www.oft.gov.uk/NR/rdonlyres/1FA03036-F07D-42BE-858E-0B1194855CB0/0/sp0705.pdf.

[158] Bureau Européen des Unions de Consommateurs (the European Consumers' Organisation).

[159] Brussels, 16 November 2006, available at http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/06/691&format=HTML&aged=0&language=EN&guiLanguage=en ('The consumer is at the heart of competition enforcement. We want markets to work better, not for an abstract notion of "free competition", but because better functioning markets provide consumers with better goods and better services, at better prices').

The imprimatur of the CFI has been given to the welfare of consumers as the objective of the competition rules. Although in 1976 the ECJ had referred to 'workable competition'[160] the Community Courts had not previously made pronouncements on the precise economic objectives of the rules. In the summer of 2006, however, the CFI gave two judgments[161] in which it identified the 'well-being' or 'welfare' of consumers as the objective. The first was *Österreichische Postsparkasse* in which the CFI said:

It should be pointed out in this respect that the ultimate purpose of the rules that seek to ensure that competition is not distorted in the internal market is to increase the well-being of consumers. That purpose can be seen in particular from the wording of Article 81 EC. Whilst the prohibition laid down in Article 81(1) EC may be declared inapplicable in the case of cartels which contribute to improving the production or distribution of the goods in question or to promoting technical or economic progress, that possibility, for which provision is made in Article 81(3) EC, is inter alia subject to the condition that a fair share of the resulting benefit is allowed for users of those products. Competition law and competition policy therefore have an undeniable impact on the specific economic interests of final customers who purchase goods or services.[162]

This was followed by the judgment in *GlaxoSmithKline* where the CFI said:[163]

However, as the objective of the Community competition rules is to prevent undertakings, by restricting competition between themselves or with third parties, from reducing the welfare of the final consumer of the products in question...

In *GlaxoSmithKline* this formulation of the objective of the rules was crucial to the one of the findings in the case, as it prevented an agreement from falling within the prohibition of anti-competitive agreements in Article 81(1). Although the object of the agreement was to restrict parallel trade that could not, on the facts of the case, be equated with the object of reducing the welfare of the final consumer.[164]

Two further interesting points should be noted. First, there is the meaning of 'consumers'. The word 'consumers' in Article 81(3) has long been interpreted in EC law as encompassing all indirect and direct users, and not just private (natural person) end-users, which is the popular conception of a 'consumer'.[165] However, *GlaxoSmithKline* (and to a lesser extent *Österreichische Postsparkasse*) considers the competition rules to be aimed at the welfare of the *final* consumer. This may be no more than a reflection of the facts in those cases. Nevertheless, there is undoubtedly a current rhetoric, illustrated by the Commissioner's speeches, that emphasises the benefits that the Commission's enforcement of the competition rules has for individuals. Moreover, the 2006 Leniency Notice (which sets out the rewards offered to cartel members who reveal the cartel to the Commission) justifies the leniency policy on the grounds that '[t]he interests of consumers *and citizens* in ensuring that secret cartels are detected and punished outweigh the

[160] Case 26/76, *Metro v. Commission (No. 1)* [1977] ECR 1875, [1978] 2 CMLR 1, para. 20, see *supra* 33.

[161] The judgments were given by different Chambers, with one judge in common. For the Court of First Instance, see Chap. 2.

[162] Cases T-213/01 and T-214/01, *Österreichische Postsparkasse AG v. Commission* and *Bank für Arbeit und Wirtschaft AG v. Commission* [2006] ECR II-1601, para. 115.

[163] Case T-168/01, *GlaxoSmithKlineServices Unlimited v. Commission*, 27 September 2006, para. 118.

[164] See further *infra*, Chap. 3.

[165] See Case T-29/92, *SPO v. Commission* [1996] ECR II-289; Merger Regulation, 139/2004, Art. 2(1)(b) (intermediate and ultimate consumers); Guidelines on the application of Article 81(3) [2004] OJ C101/97, para. 84 (...direct or indirect users...including producers that use the products as an input...In other words...customers of the parties to the agreement and subsequent purchasers).

interest in fining those undertakings that enable the Commission to detect and prohibit such practices'[166] (emphasis added). This suggests that European citizens have an interest in the enforcement of the competition rules that goes beyond their role as consumers.

Secondly, there is the question of what the 'welfare of the consumer' or 'consumer welfare' actually means. Because of the way that competition law works—in *prohibiting* agreements, abuses or mergers because of their anti-competitive effects—it will normally be the case that the competition authority will initially be concerned with identifying any consumer *detriment* that may arise from the conduct or transaction under review. The question may then arise as to whether this detriment is offset by any resulting consumer *benefit*. This is seen clearly in the operation of Article 81(3) of the EC Treaty, mentioned above.[167] What amounts to consumer detriment has never been precisely defined,[168] but appears to consist of higher prices, reduced output, less choice or lower quality of goods or services, or diminished innovation, while consumer *benefit* consists of the reverse (lower prices, greater output, greater choice, higher quality, more innovation).[169] EC law has not yet expressly equated 'consumer welfare' with 'consumer surplus' in the economic sense described earlier.[170] Certainly, the standard or objective of EC competition law does not appear to be 'total welfare'. It will be recalled from above[171] that the economic concept of total welfare is the sum of consumer surplus and producer surplus and that it does not encompass value judgments about how the surplus should be distributed. However, EC law demands in Article 81(3) that a 'fair share' of the efficiency gains resulting from anti-competitive agreements must be passed on to consumers if such agreements are not to be prohibited and, according to the Commission, the efficiency gains from anti-competitive mergers must likewise be passed on.[172] In other words, EC competition law is concerned not with the welfare effects on the whole economy but with the impact on consumers. The efficient allocation of resources must work to the benefit of consumers, or at the very least not make them worse off.

The pursuit of the objective of consumer welfare rather than, for example, the aims of competition policy identified by ordoliberalism, can have a decisive influence on the interpretation and application of the law. The last part of the EC competition rules to be subjected to 'modernization' is Article 82, the provision prohibiting the abuse of a dominant position.[173]

[166] Commission Notice on immunity from fines and reduction of fines in cartel cases [2006] OJ C298/17, para. 3.

[167] And see Chap. 4. It is also seen in the 'efficiency defence' in merger control, (*infra* Chap. 12) and in the suggested 'efficiency defence' in respect of Article 82 (see DG Comp Discussion Paper on the application of Article 82 of the Treaty to exclusionary abuses, Brussels, December 2005, paras. 84–92, *infra* Chap. 7). In Case C-95/04 P, *British Airways plc* v. *Commission*, 15 March 2007, para. 86, the ECJ said that it had to be determined whether the disadvantage to competition might be counterbalanced, or outweighed, by efficiency advantages which also benefited the consumer.

[168] See P. Marsden and P. Whelan, ' "Consumer Detriment and its Application in EC and UK Competition Law' [2006] ECLR 569.

[169] See e.g. Guidelines on the application of Article 81(3) [2004] OJ C101/97, particularly paras. 16, 21, 25; Guidelines on the assessment of horizontal mergers [2004] OJ C31/3, paras. 8, 80–1; DG Comp Discussion Paper on the application of Article 82 of the Treaty to exclusionary abuses, Brussels, December 2005, para. 4; Draft Guidelines on the assessment of non-horizontal mergers, 13 February 2007, paras. 71–72.

[170] *Supra* 3 ff.

[171] *Supra* 13.

[172] Commission Guidelines on Horizontal Mergers [2004] OJ C31/5, paras. 77 and 79 (see further *infra* Chap. 12); also, Discussion Paper on Article 82, paras. 84–90.

[173] The modernization of Article 82 was initiated by DG Comp's Discussion Paper on the application of Article 82 to exclusionary abuses, December 2005.

The question of whether competition law should protect competitors or competition is particularly relevant in respect of Article 82 and we will see in Chapters 5, 6, and 7 how the debate about the 'reform' of Article 82 necessitated a wide-ranging debate about the purposes of competition law. Older ideas linger on: the Advocate General's Opinion in *British Airways*, delivered in February 2006 described Article 82 as not being 'only or primarily designed to protect the immediate interests of individual competitors or consumers 'but to protect the structure of the market and thus competition as such (as an institution)... '.[174] The ECJ's judgment in that case, which took a very 'conservative' line towards the application of Article 82, did not gainsay that statement.[175]

(iv) Socio-Political or 'Non-efficiency' Factors and the Relationship of Competition with Other Community Policies

As already intimated, there has been a long controversy over how far, if at all, 'non-competition' issues should be taken into account in EC competition law. It will be seen in the subsequent chapters of this book that on numerous occasions in the past cases and decisions have taken account of socio-political factors,[176] particularly those embodied in other Community policies, but that contradictory messages on this have been sent out by the Community Courts and the Commission.

The adoption by the EC of the goal of promoting consumer welfare through allocative efficiency makes it difficult to simultaneously promote other objectives. Indeed, the whole philosophy of the modern 'economic' approach to competition policy is that it should be concerned only with efficiency. The EU and its Member States must obviously pursue other policies too, but these, it is argued, should not affect the ways in which the competition rules are interpreted and applied. Moreover, the 2004 reforms, which decentralized the enforcement of EC competition law to the national competition authorities of the Member States[177] and gave encouragement to the private enforcement of the competition rules in the national courts, made the exclusion of non-efficiency considerations attractive on expediency grounds. It is one thing for the Commission to balance competition against other Community policies, but quite another for national courts and authorities to do so.[178]

The problem with EC competition policy is that it can never stand alone in splendid isolation because, as seen above[179] it is stated in the EC Treaty to be one of a number of activities

[174] Opinion of Kokott A-G in Case C-95/04 P, *British Airways* v. *Commission*, delivered 23 February 2006, para. 86.

[175] Case C-95/04 P, *British Airways* v. *Commission*, 15 March 2007.

[176] See in particular the application of Article 81(3), *infra* Chap. 4.

[177] Council Regulation 1/2003 [2003] OJ L1/1; Commission Notice on cooperation with in the network of competition authorities [2004] OJ C101/43.

[178] In the Commission White Paper on modernization of the rules implementing Articles 81 and 82 of the EC Treaty [1999] OJ C132/1, the Commission first proposed decentralization and turned its face against using Article 81(3) to take into account socio-political factors: see *infra* Chap. 4. Member States do pursue objectives which do not fit with the efficiency approach. In 2006 Member State governments interfered with merger transactions in the energy sector in order to protect national companies from 'foreign' take-overs, thus incurring the wrath of the Commission which considered the actions contrary to the European Merger Regulation (ECMR) Regulation 139/2004 [2004] OJ L24/22. On 18 October 2006 the Commission opened infringement proceedings under Art 226 EC against Spain in respect of the conditions the Spanish energy regulator had imposed on the takeover of the Spanish energy company Endesa by the German company E.ON: see Press Release IP/06/1426, and further, Chap. 12.

[179] *Supra* 38 ff.

undertaken to achieve the objectives of the European project. The fact that the realm of EU activities is ever-widening complicates matters. The EC Treaty now contains a number of 'flanking'[180] provisions that provide that certain policies or objectives must be taken into consideration, or taken regard of, when other Community policies or activities are being pursued—the environment,[181] employment,[182] cultural aspects,[183] human health protection,[184] consumer protection,[185] economic and social cohesion,[186] and development co-operation.[187] There is no expressed hierarchy of these, except that the integration of environmental protection requirements into other Community policies and activities is stipulated in Article 6, in the 'Principles' section in Part One of the Treaty. It can be argued that it is possible to construct a hierarchy based on the legal nature of the provisions concerned, with for example, directly effective Treaty provisions taking precedence over secondary legislation,[188] and it should be noted that, as we have already seen, the ECJ has described the competition provisions as being 'fundamental' provisions.[189]

There are two possible ways in which non-efficiency issues and other Community policies can be taken into account.[190] A matter may be excluded from the scope of competition law altogether; or the matter may be covered by the competition rules but other considerations may affect their application. Examples of the former are the ECJ's exclusion of collective bargaining agreements between employer and employees on the ground that such arrangements fall within the ambit of social policy,[191] and cases finding that an entity is not an 'undertaking' and

[180] Or policy-linking or policy integration.

[181] Article 6 EC; the specific provisions on environment policy are in Articles 174–176. On the Commission's DG Comp (Competition Directorate General)'s website there is a page 'European Competition Policy and the Environment' which says 'Community law provides that environmental considerations must be integrated into all other Community policies. This includes European competition policy. In their turn both the national legislator and the industry have to respect competition law in putting in place environmental initiatives. Neither should they establish forms of collaboration, rules or practices that would constitute unjustified obstacles to competition'. See further, *infra* Chap. 4 and Chap. 13.

[182] Article 127(2) EC ('The objective of a high level of employment shall be taken into consideration in the formulation and implementation of Community policies and activities').

[183] Article 151(4) EC ('The Community shall take cultural aspects into account in its action under other provisions of this Treaty . . .').

[184] Article 152(1) EC ('A high level of human health protection shall be ensured in the definition and implementation of all Community policies and activities').

[185] Article 153(2) EC ('Consumer protection requirements shall be taken into account in defining and implementing other Community policies and activities').

[186] Article 159 EC (Member States to conduct their economic policies to attain the objectives in Article 158, which provides for the Community to develop and pursue actions leading to strengthening of economic and social cohesion).

[187] Article 178 EC (Community to take account of the development cooperation objectives in Article 177 in implementing policies which are likely to affect developing countries).

[188] See J. Baquero Cruz, *Between Competition and Free Movement: The Economic Constitutional Law of the European Community* (Hart Publishing, 2002), 63–5; Odudu, O, *The Boundaries of EC Competition Law* (Oxford University Press, 2006), 169–70.

[189] Case C-126/97, *Eco Swiss China Time Ltd* v. *Benetton International NV* [1999] ECR I-3055, [2000] 5 CMLR 816, para. 36; Case C-453/99, *Courage Ltd* v. *Crehan* [2001] ECR I-6297, [2001] 5 CMLR 28, para. 20; J. Baquero Cruz, *op cit.* n. 188, 71.

[190] See generally Odudu, *op. cit.* n. 188, 159–174.

[191] Case C-67/96, *Albany International BV* v. *Stichting Bedrijfspensioenfonds Textielindustrie* [1999] ECR I-6025, [2000] 4 CMLR 446: see *infra* Chap. 3.

its agreements or conduct therefore not subject to the competition rules.[192] This manoeuvre preserves the purity of the 'only consumer welfare objective' approach to competition law by making competition law inapplicable, but is questionable.[193] Once within the scope of competition law, there is the possibility of taking account of non-efficiency considerations through the application of Article 81(3), or through what is categorized as an 'abuse of a dominant position' under Article 82. The present position is that Article 81(3) should not be used in this way,[194] and the approach to Article 82 is also being reformed in a direction that would exclude non-efficiency considerations (such as ordoliberal-inspired ones).[195] However, despite this general trend of restricting competition law to efficiency questions there continue to be instances where other considerations intrude. One difficult case is *Wouters*[196] in which the ECJ in 2002 held that the rules of the Dutch Bar did not infringe the prohibition against restrictive agreements because the rules pursued public interest objectives.[197]

As far as the objective of single market integration is concerned, it is noted above that the Commission now conceptualizes this and competition as serving the same ends. Those ends are consumer welfare and an efficient allocation of resources. If we look again at the statement of the objective of Article 81 set out in paragraph 13 of the Article 81(3) Guidelines[198] we see that that competition and market integration serve these ends as 'the creation and preservation of an open single market promotes an efficient allocation of resources throughout the Community for the benefit of consumers'. In this way competition policy is released from its role as the handmaid of market integration and the raison d'être of the single market identified as consumer welfare. No longer, as in the past, are there two separate objectives of competition policy.[199] Competition and single market integration converge as means to the same ends.[200]

There has also been a long-standing problem over the relationship between competition policy and the Community's industrial policy. In 2004 the Commission issued a Communication, *A pro-active competition policy for a competitive Europe*,[201] which set competition at

[192] For example, Case C-205/03 P, *Federación Nacional de Empresas de Instrumentación Científica, Médica, Técnica y Dental (FENIN)* v. *Commission*, 11 July 2006 (ECJ), affirming Case T-319/99 *FENIN* v. *Commission* [2003] ECR II-357, [2003] 5 CMLR 34); Cases C-264, 306, 354 & 355/01, *AOK Bundesverband and others* v. *Ichtyol-Gesellschaft Cordes and others* [2004] ECR I-2493: see further *infra* Chap. 3 and Chap. 8.

[193] There are also matters excluded from the competition rules by the Treaty itself: agriculture (Art. 36 EC and Council Regulation 26/62, [1959–62] OJ Spec.Ed. 129); national security (Art. 296 EC; for the application of this in the context of mergers, see *infra* Chap. 12); nuclear energy (inasmuch as it is covered by the Euratom Treaty, Art. 305(2) EC). For the position of undertakings entrusted with services of general economic interest see Art. 86(2) EC, discussed *infra* Chap. 8.

[194] *Infra* Chap. 4.

[195] *Infra* Chaps 5 and 7.

[196] Case C-309/99, *Wouters* v. *Algemene Raad van der Nederlandse Orde van Advocaten* [2002] ECR I-1577, [2002] 4 CMLR 913.

[197] Cf. Case C-519/04 P, *Meca-Medina and Majcen* v. *Commission*, 18 July 2006, [2006] 5 CMLR 1023, *infra* 111.

[198] *Supra*, 46.

[199] As said, for example, in the quotation from the Commission's XXIXth Report on Competition Policy set out *supra* 42.

[200] For the development of this convergence see C. D. Ehlermann, 'The Contribution of EC competition policy to the Single Market' (1992) 29 *CML Rev* 257; K. Mortelmans, 'Towards Convergence of the Rules on Free Movement and Competition' (2001) 38 *CML Rev* 613; R. O'Loughlin, 'EC Competition Rules and Free Movement Rules: An Examination of the Parallels and their furtherance by the ECJ *Wouters* Decision' [2003] ECLR 62; J. Baquero Cruz, *op. cit.* n. 188, *supra*. This does not mean, however, the single market does not have a *political* function as well.

[201] COM (2004) 293 final.

the heart of industrial policy rather than in opposition to it. The Commission said that '[T]he goal of a pro-active competition policy is to support the competitive process in the internal market and to induce firms to engage in competitive and dynamically efficiency-enhancing behavior'. The Commissioner elaborated on this in a speech in September 2006:

> This afternoon I would like us to try to rethink industrial policy! I think it makes no sense to speak of industrial policy and competition policy as distinct one from the other, let alone as antagonistic policies. I would rather define industrial policy as one which frames the structural conditions necessary to ensure economic success in a globalising economy. And I therefore have no qualms in saying that competition policy forms—or should form—a central plank in any industrial policy.[202]

This explanation of the relationship between competition policy and industrial policy has to be seen in the context of the Lisbon Strategy[203] whereby the EU has set itself the strategic goal of becoming the most competitive and dynamic knowledge-based economy in the world by 2010, capable of sustainable economic growth and more and better jobs and greater social cohesion. The 2004 Communication said of competition and the Lisbon Strategy:

> Competition policy is one of a number of Community policies impacting upon the economic performance of Europe. It is a key element of a coherent and integrated policy to foster the competitiveness of Europe's industries and to attain the goals of the Lisbon strategy.

The trumpeting of competition policy as advancing the Lisbon agenda highlights how the argument goes round in a (virtuous) circle: the application of competition law serves the 'economic' goal of consumer welfare/efficiency and does not take account of 'socio-political' concerns; the goal of consumer welfare/efficiency is to ensure that 'citizens enjoy the benefits of a competitive, dynamic economy';[204] and that economy will deliver to them 'sustainable growth with more and better jobs and greater social cohesion'[205]—surely a socio-political goal *par excellence*. As the Director General of DG Comp has said:[206]

> Competition is not an end in itself, but an instrument designed to achieve a certain public interest object, consumer welfare. At the same time, competition policy can contribute to other objectives: in the EU context, for example, it can work towards the success of the strategy for growth and jobs, and form part of the public debate about the role of state intervention and regulation in industry.

C. THE LIMITS OF COMPETITION, PUBLIC SERVICES, AND REGULATION

(i) The Limits of Competition

At the beginning of this Chapter we said that even in a free market economy some areas may not be left to unbridled competition. In other words, there are 'limits to competition'. The provision of

[202] Neelie Kroes, *Industrial policy and competition law & policy*, speech at Fordham University School of Law, 14 September 2006.

[203] Originally declared at the Lisbon European Council in March 2000 and relaunched in February 2005 in the Communication of the Commission to the Spring European Council, *Working together for growth and jobs: A new start for the Lisbon Strategy* COM (2005) 24, 2 February 2005.

[204] See Neelie Kroes, London, 15 September 2005, n. 157, *supra*.

[205] *Ibid.*

[206] P. Lowe, (2006) 2 *EC Competition Policy Newsletter* 1.

some goods or services may be considered essential but unsuited to the rigours of the market and to the application of competition laws. Also, the liberal professions have historically operated closed shops replete with restrictive practices, claiming that this modus operandi is in the public interest.[207] The biggest area of contention relates to what can be called the 'public services'. There is much controversy inside Member States about how public services should be run, what should be privatized, and what should be a monopoly immune from competition and, not surprisingly, these are equally controversial matters at EC level. In EC law, some bodies are held to be outside the competition rules altogether, while in other cases the competition rules apply to them only to some extent or with dispensations. The question of what should be covered by the competition laws is a major issue and arises in a number of contexts throughout this book.[208]

(ii) Competition and Regulation

The last quarter of the twentieth century saw a revolution in the way in which public services were owned and run. Throughout Europe many State-owned monopolies were wholly or partly privatized and put into the private sector.[209] The opening up of sectors previously monopolized by State enterprises legally protected from competition is known as liberalization. However, such moves can lead, at least in the short term, to private monopolies replacing public ones. This does not necessarily benefit consumers. There are particular problems where the provision of services in a sector depends on the use of a network (such as railway lines) which cannot feasibly be duplicated. Moreover, these undertakings are often providing services which are essential and have to be provided 'universally' (the supply of water, sewage and basic postal and telephone services for example). One solution to these problems is to subject the liberalized sectors to 'regulation'. Regulation 'consists of public interventions which affect the operation of markets through command and control'[210] and typically involves setting up a body which implements controls on prices and quality, creates as far as possible conditions for competition to exist and then polices them, and oversees the social obligations of the undertaking such as the obligation to provide universal service.[211]

One difference between regulation and competition law is that regulation acts *ex ante* (in advance) whereas competition law may act *ex post* (reacting to conduct which is taking place or has taken place).[212] So, where prices are concerned, a regulator will set out in advance what the

[207] The EC Commission undertook a major review of competition law and the liberal professions in 2003, and reports were published in February 2004 (COM (2004) 83 final) and September 2005 (COM (2005) 451 final), available on the Commission's web site. A resolution of the European Parliament of 12 October 2006 supported the Commission's moves towards removing overly restrictive regulation in the professions. See also, e.g. Case C-309/99, *Wouters v. Algemene Raad van de Nederlandse Orde van Advocaten* [2002] ECR I-1577, [2002] 4 CMLR 913.

[208] But see in particular *infra* Chap. 3 and Chap. 8. The question of sport is dealt with in Chap. 2.

[209] Private rather than public ownership is a major plank of the 'neoliberal' ideology which at present drives globalized capitalism.

[210] T. Prosser, *Law and the Regulators* (Oxford University Press, 1997), 4.

[211] *Ibid.*, 5–6. Obviously this is a generality. The functions of the regulators differ between sectors and different states organize regulation differently. The regulators in the UK include OFWAT (water), OFGEM (energy), the Rail Regulator and, pursuant to the Communications Act 2003, OFCOM.

[212] Monopoly control is generally *ex post*, and so, in the current regime under Regulation 1/2003, is the control of anti-competitive agreements (although there is the possibility of interim measures or injunctions). Merger control is *ex ante* (the EC merger regime requires prior notification of mergers with a 'Community dimension', see Chap. 12). For the differences between competition and regulation, see further R. O'Donoghue and A. J. Padilla, *The Law and Economics of Article 82* (Hart Publishing, 2006), 1.4.5.

undertaking may charge while a competition authority will step in only if and when it appears that an undertaking's pricing infringes the competition rules. Regulation is far more *dirigiste* than competition law. Competition laws can apply to regulated sectors alongside regulatory regimes and numerous instances of where this has occurred in the EU will be seen in this book. Indeed, the Commission favours the application of competition law rather than regulation wherever possible.[213]

In the EC the European Commission has pursued a programme of liberalization and attempted to open up the transport, postal services, gas, electricity, and telecommunications markets. The telecommunications market is the most striking and ambitious example of this liberalization. It has been pursued both through Directives adopted under the special procedure laid down in Article 86(3) of the EC Treaty[214] and through Council harmonization Directives under Article 95 (which provides for measures necessary for the establishment of the internal market). The latter culminated in a package of measures adopted in 2002, the linchpin of which is the Framework Directive for electronic communications.[215] There are no EC regulators in the sense that we are discussing here[216] but the regulators in the Member States may have duties imposed upon them by EC law to implement Community policy. For example, the Framework Directive 'lays down tasks of national regulatory authorities and establishes a set of procedures to ensure the harmonised application of the regulatory framework throughout the Community'.[217] Perhaps the most significant point to note about the Framework is that only electronic communications markets where 'ordinary' competition law is not sufficient to remedy persistent market failures are to made subject to regulation. The Commission may ultimately veto the decision of a national regulatory authority to subject a particular market to *ex ante* regulation if it thinks it unnecessary. The regulated sectors are not specifically dealt with in this book but are discussed where relevant.[218]

D. THE NEW ECONOMY

We have seen that the regulation of telecommunications is now subsumed in the regulation of the electronic communications sector as a whole. This is because the telecommunications, media, and information technology sectors have converged to such an extent that they have to be regulated as a whole.[219] The electronic communications sector is part of what is termed the 'New Economy', an expression which also encompasses high technology industries such as Internet based businesses (for example B2B marketplaces),[220] computer software and

[213] In the UK the sector regulators have concurrent powers with the Office of Fair Trading to apply the Competition Act 1998 and the Enterprise Act 2002 in their sectors. See generally *Butterworths Competition Law* (Butterworths, Looseleaf), Div. IX.

[214] See *infra* Chap. 8.

[215] Directive on a common regulatory framework for electronic communications networks and services [2002] OJ L108/33. The Directive applies to all electronic communications, as explained in the following section.

[216] The expression 'regulator' is often used loosely to mean competition authority.

[217] Framework Directive, n. 215 *supra*, Art. 1.

[218] For example, some of the Notices in the telecommunications/electronic communications sector, as discussed in Chaps. 5 and 7.

[219] See European Commission, 'Towards an Information Society Approach', Green Paper on the convergence of the telecommunications, media and information technology sectors, and the implication for regulation, COM(97) 623 final (Brussels, 1997).

[220] Software systems whereby parties transact business online through a central node.

hardware, biotechnology and aerospace. The characteristics of these markets include very rapid technological change, the creation and exploitation of intellectual property rights, the need for complementary products to work together, and a high degree of technical complexity. In some markets such as electronic communications 'network externalities' (the service becomes more valuable to customers the more people who use it—mobile phones which can send and receive photos are no fun if your friends do not have one too) are an important feature. New economy industries pose particular problems for competition laws. For example, competition between undertakings is not so much on price as on innovation; the usual ways of defining markets may not work well;[221] and competition may not be *in* markets but *for* markets (markets may 'tip' towards one firm whose products become the standard, rendering the firm dominant—Microsoft is the obvious instance[222]—and competition will be aimed at replacing the dominant firm). Regulation can be applied to some markets, as in the case of electronic communications, to deal with some of the issues but there is much debate about the extent to which 'ordinary' competition law can be satisfactorily applied to the new economy.[223] The argument is that the application of competition rules should be revised to allow for the dynamic competition in these markets. Faull and Nikpay (a book written by a team of past and present officials of the EC Commission's Competition Directorate-General) concludes that in general such adjustment is unnecessary.[224]

> In conclusion, there seems to be no important conflict between innovation and competition policy aimed at product market competition and there seems to be no fundamental flaw in competition policy. Competition policy, by defending competition and open markets, will in general have a positive impact on both static and dynamic efficiency. Companies under competition pressure will be less complacent and will have more incentive to innovate and gain market share. Product market competition and a strict competition policy generally work as an effective stick to promote innovative effort.[225]

In the later chapters of this book we will see many examples of cases and merger decisions involving new economy markets.

[221] For market definition tests, see *infra* 60 ff.

[222] Note also the battle in the early 1980s between the Betamax and VHS video formats, which was won by VHS to the total extinction of Betamax.

[223] See, e.g., J. Temple Lang 'European Community Antitrust Law—Innovation Markets and High Technology Industries' [1996] *Fordham Corp L Inst*, 519; C. Veljanovski, 'EC Antitrust in the New Economy: Is the European Commission's View of the Network Economy Right?' [2001] *ECLR* 115; C. Ahlborn, D. S. Evans, and A. J. Padilla, 'Competition Policy in the New Economy: Is European Competition Law up to the Challenge?' [2001] *ECLR* 156; M. Monti, 'Defining the Boundaries, Competition Policy in High Tech Sectors', speech at UBS Warburg Conference, Barcelona, 11 September 2001; D. S. Evans and R. Schmalensee, 'Some Economic Aspects of Antitrust Analysis in Dynamically Competitive Industries', NBER Working Paper 8268, May 2001; R. Lind and P. Muysert, 'Innovation and Competition Policy: Challenges for the New Millenium', [2003] *ECLR* 87.

[224] J. Faull and A. Nikpay (eds.), *The EC Law of Competition* (2nd edn., Oxford University Press, 2007, 1.123–1.129 (L. Peeperkorn and V. Verouden). The book is expressed to be the authors' personal opinions, rather than the official position, but is obviously of particular interest because of the connection with DG Comp.

[225] Faull and Nikpay, para. 1.129. This conclusion is reached after an analysis of, and in reliance on, the arguments of Evans and Schmalensee, *supra* n. 223. See also *Wanadoo*, COMP/38.233, [2005] 5 CMLR 120, upheld on appeal, Case T-340/03, *France Télécom SA v. Commission*, 30 January 2007.

8. COMPETITION LAW AND THE INTERNATIONAL CONTEXT

The effects of anti-competitive practices and the exercise of monopoly power can be felt in States far away from that in which the undertaking concerned is located. Indeed, many undertakings in todays globalized economy are truly 'multinational' in the sense that they have a presence throughout the world. One of the most important issues in competition law at present is the international application and enforcement of competition laws and there are (exciting) developments in international cooperation in competition matters. The international aspects of competition law arise in many places in this book, and are discussed as a whole in Chapter 16.

9. THE TECHNIQUES AND TOOLS OF COMPETITION LAW

A difficult question that must be faced by all authorities is how competition law should pursue its goals. The discussion above suggests that appropriate competition rules should be framed:

(i) to deal with the prejudicial consequences of market power ;

(ii) to deal with oligopolistic markets;

(iii) to prevent mergers which lead to a concentration in market power;

(iv) to prevent restrictive agreements between competitors (horizontal agreements);

and

(v) to prevent restrictive vertical agreements which have anti-competitive consequences.

How such rules are interpreted and applied will also be crucial to the pursuit of those goals.

It is possible to adopt a system of competition law which takes a formalistic prohibitory approach based on the assumption that certain types of conduct are harmful. This was the position taken in the UK's restrictive trade practices legislation,[226] which has now been repealed and replaced by the Competition Act 1998. The legislation proscribed certain types of agreements between certain types of party concerning the matters listed in the Act. The Act did not admit the possibility of looking at the effect of agreements to see if they did in fact restrict competition. The matter was broadly denuded—deliberately—of economic content and the law reduced to a number of formal propositions. Judges did not, therefore, have to rule on economic matters.[227] The perverse result was a system which caught many harmless and even pro-competitive agreements but, conversely, allowed some which were seriously anti-competitive.[228]

[226] In its final form, the Restrictive Trade Practices Act (RTPA) 1976.

[227] The original Restrictive Trade Practices Act was enacted in 1956 and the judiciary did not wish to have to decide such matters.

[228] The best account of the Restrictive Trade Practices Acts was set out in the 3rd edition of R. Whish, *Competition Law* (Butterworths, 1993), chap. 5, 123, which stated that 'the formalism and technical conundra have multiplied and the present law is extremely complex and riddled with anomalies and unanswered questions'.

EC competition law does not take this type of extreme formalistic approach. It is essentially an 'effects-based' law. The provisions are drafted in broad terms. Thus Article 81 of the EC Treaty broadly aims to prevent 'restrictive' agreements (iv and v above); Article 82 broadly aims to prevent abuses of market power, in the terms of Article 82 a 'dominant position' (i above); and the Merger Regulation is intended to preclude mergers which would significantly impede effective competition, in particular by the creation or strengthening of a dominant position (ii and iii above).[229] Ironically, despite the economic base, the EC competition authorities have often been criticized for failing to take a sufficiently economically rigorous approach to the application of competition law and for having instead adopted a formalistic view. They, too, have sometimes operated on the assumption that certain things should be prohibited as a matter of course because they are bound to have an anti-competitive effect. More recently, the European Commission, which enforces the EC competition rules,[230] has displayed a greater determination to use rigorous economic analysis in its decision making. This was epitomized by the creation of the new post of Chief Competition Economist in 2003.[231]

Economic analysis is not, however, a panacea for all problems. It does not necessarily tell the competition authority what the outcome of any given agreement or conduct will be. It has already been seen that economists disagree over many things and economics do not provide the answer to every question. The applicability of a particular law may turn on the question whether or not a particular firm has market power. There may, however, be disagreement about what market that firm operates on (are pink widgets really substitutes for yellow widgets?) and about whether barriers to entry exist[232] to prevent other undertakings entering that market and challenging that firm's strong position. The economic view that monopoly is inefficient presents, therefore, only a starting-point to the application of the law in any particular case. Similarly, there may be disagreement about whether or not a particular agreement is or is not restrictive. A distribution agreement which decreases competition between A and B may in fact increase competition between X and Y. Thus a distribution agreement, for example, in which X grants A the sole right to distribute its brand of goods, to the exclusion of B, may encourage A to market the goods actively so that X's product competes vigorously on the market with Y's.[233] Furthermore, even if there is agreement that competition law should achieve consumer welfare, there can be disagreement about how allocative, productive and dynamic efficiencies should be weighed against one another, what are the welfare implications of certain practices or whether the protection of *competitors* in the short term is necessary to protect *competition*, and thus consumer welfare, in the longer term. We see these debates played out in the cases discussed in this book, especially those in Chapter 7 (abuse of a dominant position) and Chapter 12 (mergers). It is important to realize that over-enforcement of the competition rules (prohibiting agreements, conduct or mergers where there is no likely or actual harm to the market, so-called Type 1 errors, or 'false positives') is as harmful—some say *more* harmful—than under-enforcement (failing to prohibit where there is such harm, so-called Type 2 errors, or 'false negatives').[234]

[229] These Articles are described in greater detail *infra* in Chap. 2 and are discussed fully in subsequent chapters. The control of oligopolistic markets, outside the merger context, is problematic, although Article 82 can be employed in some situations: see *infra* Chap. 11.

[230] See *infra* Chap. 2.

[231] See *supra* Chap. 2.

[232] See *infra* 84 ff.

[233] For the approach of EC law to this scenario see *infra* Chaps. 3, 4, and 9.

[234] The way the terminology 'Type 1' and 'Type 2' errors is used is not standardized. Some writers use them the labels the other way round. However, this is how the terminology is used in this book.

It was seen in section 5 that there are fashions in economic theory and schools of antitrust analysis, and that today's orthodoxy may be overtaken by new ideas. Nevertheless, given that competition policy is concerned with economic structures, conduct, and effects, it must be correct that its application should be as economically literate as possible. Faull and Nikpay explains the advantages and limitations of economic analysis in competition cases:

J. Faull and A. Nikpay (eds.), *The EC Law of Competition* (2nd edn., Oxford University Press, 2007), 4

1.02 The growing acceptance and importance of economics in competition policy raises questions regarding the usefulness of economics, both for devising competition rules and for deciding on competition cases. A word of caution is appropriate in this respect. Economic thinking and economic models have proved not to be perfect guides.

1.03 Economic theories and models are built on and around assumptions. This approach has the benefit of making explicit the various elements relied upon in arriving at a particular conclusion or insight. At the same time, these assumptions by definition do not cover (all) real world situations. In addition, when the assumptions are changed the outcomes of the models may look very different. It is for these reasons that the application of economic theories may not always be able to give a clear and definitive answer, for example as to what will happen in a market when companies merge, or when companies try to collude or engage in specific types of conduct.

1.04 The best that the application of economic principles can do in general is to provide a coherent framework of analysis, to provide relevant lines of reasoning, to identify the main issues to be checked in the context of certain theories of competitive harm, and possibly to exclude certain outcomes. In other words, it helps to tell the most plausible story. In individual cases it will be necessary first to find the concepts and the model that best fit the actual market conditions of the case and then to proceed with the analysis of the actual or possible competition consequences. Economic insights can also be useful in the formulation of policy rules, indicating under what conditions anti-competitive outcomes are very unlikely, very likely, or rather likely, and helping to devise safe harbours.

In Section 10 we introduce some of the basic economic concepts used in antitrust analysis.

10. MARKET POWER, MARKET DEFINITION, AND BARRIERS TO ENTRY

A. MARKET POWER

It is clear from the discussion above that the key concern of competition law is with firms which can profitably raise prices above marginal cost.[235] This is what is meant by market power. It is firms which, individually or collectively, have market power that are able to restrict output, increase prices above the competitive level, and earn monopoly profits. They can raise prices without losing so many sales that the rise rise is unprofitable. Concomitantly, they can influence

[235] And see D. W. Carlton and J. M. Perloff, *Modern Industrial Organization* (4th edn., Pearson Addison Wesley, 2005), 642.

the variety or quality of goods or services, innovation, and the other parameters of competition.[236] Most firms have some market power in the short term,[237] but it is market power which endures for a significant period of time that matters. The exercise of such market power leads, as we have seen, to an inefficient result for society as a whole. In this section we introduce the concepts of market definition and barriers to entry which are central to the assessment of market power in EC competition law and to the discussion throughout this book.

In 1981 a seminal paper by William Landes and Richard Posner triggered a debate about the assessment of market power, and the point at which the degree of market power warrants antitrust proceedings, which continues today.[238] Landes and Posner advocated the use of the Lerner index to assess market power.[239] This expresses the concept of market power 'as the setting of price in excess of marginal cost by measuring the proportional deviation of price at the firm's profit- maximising output from the firm's marginal costs at that output'.[240]

There are two ways of measuring a firm's market power, 'direct' and 'indirect'. The 'direct' method involves estimating the market power by using econometric methods, particularly the residual demand curve (the demand curve facing a single firm[241]). However, this requires data which is often not available and even if it is the estimation of market power in this way may prove problematic.[242] The 'indirect' method involves a structural approach. First the 'relevant market' is defined and secondly the power on that market of the undertaking under review is assessed using market share and 'barriers to entry' analysis. *Barriers to entry* are vital to the determination of market power by this method since it is these which enable a firm already in the market to earn monopoly profits without attracting other firms to enter that market. The definition, identification, and significance of barriers to entry is one of the most controversial matters in antitrust economics. This issue is discussed below.[243] The 'indirect' method is the one commonly used by competition authorities throughout the world. It is used by the EC Commission. Moreover, it has the imprimatur of the ECJ.[244]

Under the 'indirect' method, therefore, the determination of the relevant market (or 'antitrust market'[245]) is of crucial importance. This raises the important question of how a market is identified and defined. This issue is discussed below.[246]

[236] DG Comp Discussion Paper on the application of Article 82 of the Treaty to exclusionary abuses, Brussels, December 2005 (hereafter 'Discussion Paper on Article 82') para. 24.

[237] As customers and competitors will need time to react to the price increase.

[238] W. M. Landes and R. A. Posner, 'Market Power in Antitrust Cases' (1981) 94 *Harvard L Rev* 937. See the discussion in J. Vickers, 'Market Power in Competition Cases' (2006) 2 *European Competition Journal* 3.

[239] A. P. Lerner, 'The Concept of Monopoly and the Measurement of Monopoly Power' (1934) *Rev. Economic Studies*, 157.

[240] RJ Van den Bergh and P.D.Camesasca, *European Competition Law and Economics: A Comparative Perspective* (2nd edn., Sweet & Maxwell, 2006), 110, who give the simplest formulation as L= (P-MC)/P. See also J. Vickers, 'Market Power in Competition Cases' (2006) 2 *European Competition Journal* 3, 4–6.

[241] Called 'residual' as it is demand not met by other firms in the market: see Carlton and Perloff *op. cit.*, n. 235, 66–9.

[242] M. Motta, *Competition Policy* (Cambridge University Press, 2004), 116–17; Vickers, *op cit.* n. 240, 7. See, however, J. B. Baker and T. F. Bresnahan, 'Estimating the Residual Demand Curve Facing a Single Firm' (1988) 6 *International Journal of Industrial Organization*, 283.

[243] See *Infra* 84 and Chap. 6.

[244] Case 6/72, *Europemballage Corp and Continental Can Co Inc v. Commission* [1973] ECR 215, [1973] CMLR 199, para. 32 and subsequent case law: see *infra* 61 and Chap. 6.

[245] Including markets in merger cases, although, as noted *supra* 3, the Commission now uses 'antitrust' to denote areas of competition law other than mergers.

[246] See also, in particular, the discussion *infra* in Chap. 6.