

Prices and Competition: Resale Price Maintenance, Price Rigidity, Price-Fixing and Tying

Director's Letter Catherine Waddams



Articles in this newsletter present two examples of economic analysis: the effect of ending the Net Book Agreement, and the rigidity of Estate Agents fees; and two legal cases: on the dishonesty of price-fixing in *Norris vs USA*, and on tying in the European Court of First Instance ruling in *Microsoft*. The first two authors are PhD students at CCP, and the last two are colleagues who have been awarded their doctorates in the last six months; they are all an excellent example of the new academic talent, whose nurture is so central to the Centre's role. We congratulate Liza and Andreas, as well as Pinar Akman, on the recent award of their doctorates, and welcome them to the Centre's staff. Andreas and Pinar join the CCP doctorate alumni, and we are delighted that they remain with CCP as faculty members.

Another UEA graduand, Luke Garrod, who will also receive his doctorate at UEA in July, joined Liza as a Post Doctoral Fellow at CCP in March. He had spent the previous six months as a CCP research fellow working full-time examining evidence on the effect of remedies on consumers' activity in the markets for the Office of Fair Trading. The project was part of CCP's developing research on the rôle of consumers in markets, and Luke's co-authors on this paper [OFT 994] included Graham Loomes, as well as CCP founder members Morten Hviid and Catherine Waddams. The results were presented to a UEA conference on *Reconciling Normative and Behavioural Economics*, as part of a CCP-sponsored afternoon focusing on Competition Policy, as

well as at two well attended seminars at the OFT in March and April.

The theme of Consumer Empowerment was further developed in a project led by Michael Harker, undertaken for the Department for Business, Enterprise and Regulatory Reform. Both these projects have helped develop the Centre's thinking on the rôle of consumers in competition policy and to plan further research in this area. CCP's Autumn Newsletter will focus on our findings and research in this area.

As part of the ESRC Festival of Social Science in mid-March CCP members held an 'open surgery' for two days in Norwich City Centre, offering advice on switching energy supplier. Eighty people from the far corners of Norfolk (and beyond) sought our advice, many bringing carefully documented information on their bills, and the results of their own research on potential savings. We were impressed by the distance travelled, the care which had already been taken to explore alternatives, and the reassurance which these consumers sought before 'taking the plunge'. We will be in touch with them to explore their actions and experience after receiving our advice, and will include a fuller report in our autumn newsletter.

Other CCP contributions to policy debates on competition policy include discussions with the National Audit Office to inform their report on deregulation of the energy market [*'Protecting Consumers? Removing Retail Price Controls'*; HC 342]; evidence submitted to both the BERR Parliamentary Committee and the Ofgem inquiries into the Energy Market; the report for the OFT [OFT 981] on the effect of ending the Net Book Agreement (summarised in this issue by Matt Olczak); and Bruce Lyons' lead authorship of the Economic Advisory Group for Competition Policy Commentary on EC Rescue and Restructuring Aid Guidelines. We look forward to continuing our contribution to such debates, and to continuing them in-house with the distinguished contributors to our Annual Conference, whose theme this year is "Balancing Regulation and Competition".

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Newsletter

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Changes in Productivity from Ending Resale Price Maintenance on Books

(A report by Stephen Davies and Matt Olczak for the OFT)

Matt Olczak, Research Associate and PhD Student

Resale Price Maintenance (RPM) is the practice whereby upstream manufacturer(s) control the prices of their products when sold by downstream distributors. An example is the Net Book Agreement (NBA): from approximately 1900, publishers used the NBA to restrict the retail price of books in the UK, thus preventing retailers from selling a book under the publisher's chosen (net) price.

By the mid-1990s this practice had started to break down, in part due to significant changes occurring in the industry, and in 1997 it was formally ended by the Restrictive Practices Court. Thus by the mid-1990s a new era in which booksellers were free to choose their prices had begun.

Our research for the OFT¹ had two objectives:

- (i) using the abolition of the Net Book Agreement as a case study, to assess the impact of a competition policy intervention on productivity;
- (ii) to develop and assess a methodology which is appropriate not only for this particular case study but also more generally when assessing the impact of competition policy interventions.

The starting point for our methodology is the three key mechanisms through which competition can impact on productivity identified by the OFT (2007):²

- 1) **Within-Firm Effects:** competition (or the threat of entry) creates pressure to use resources more efficiently and reduce X-inefficiency and/or introduce product innovation.
- 2) **Between-Firm Effects/Market Sorting:** competition reallocates market share with the higher productivity firms gaining market share and/or new entrants replacing low productivity firms.
- 3) **Innovation:** competition leads to increased incentives for product and process innovation.

In the report we develop a methodology for distinguishing within- and between-firm effects on productivity.³ We approximate the counterfactual (what would have happened had NBA not been abolished) by examining (i) the industry's performance prior to abolition, and (ii) what happened over the post-abolition period in Germany - a roughly comparable country which retained RPM.

Our headline results for labour productivity, firstly for book retailing and then for publishing, are as follows.

Book Retailing

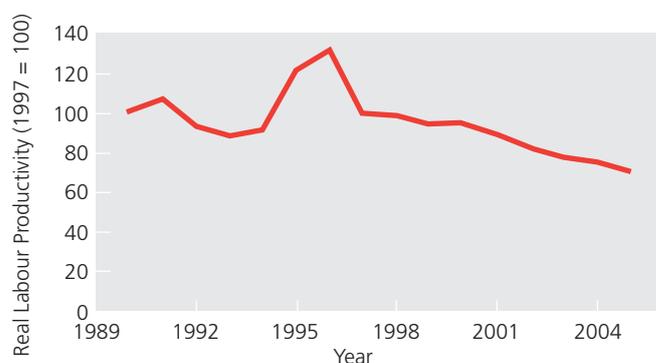
For book retailing two important conflicting effects on aggregate industry productivity post-NBA are identified:

- 1) As expected, the entry of the supermarkets and

internet sellers (now with a combined market share of more than 20%) has made a positive contribution to industry productivity via the between-firm effect. The exact magnitude of this effect is difficult to quantify in practice due to the absence of any hard and disaggregated estimates of their productivity in books alone (as opposed to for all products). However, on not unreasonable assumptions, this effect alone may have increased industry productivity by as much as a third in just five years (2001-5), but a more conservative estimate would be about 20%.⁴

2) There has been no long-run improvement in the within-firm productivity of the "bricks & mortar" (B&M) incumbent retailers. On the contrary, post-1997 they have suffered serious *negative within-firm* productivity changes (see Figure 1). This has had the effect of depressing aggregate productivity growth by between 10 and 16%.

Figure 1: Real Labour Productivity, UK B&M Retailers, 1990-2005



Combining the two effects, it is difficult to estimate the net outcome in aggregate industry productivity, because of the uncertainties about the true productivity of the new entrants, but the most likely outcome is that the two effects have very broadly offset each other.

These results prompt two key questions.

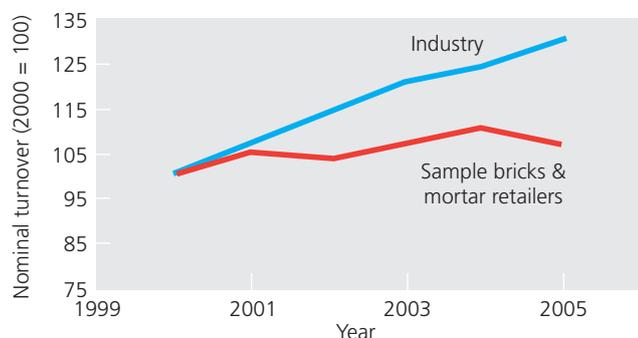
First, why have the B&M retailers failed to respond more positively, in terms of productivity, to competitive new entry?

At face value, the limited response of B&M retailers would appear to vindicate the supporters of retaining NBA, when they argued that abolition of NBA would seriously jeopardise the smaller independent retailers, who would be unable to survive in the face of discounting competitors. In fact, it is not just the independents, but also the much larger chains, such as Waterstone's, who have been apparently unable to counter the challenge of new entrants. However, close examination of the full picture post-1993 reveals more complexity (see Figure 1). In the years immediately after and before formal abolition, when the NBA was already beginning to collapse, the larger B&M retailers in fact posted quite impressive improvements in their within-firm productivity.⁵

The problems only really started to emerge as their

turnover subsequently began to fall as a consequence of the growth of the entrants. Figure 2 illustrates the impact of entry into the market on the turnover of incumbents.

Figure 2: *Total Nominal Turnover for a Sample of Selected UK B&M Retailers and the Book Industry Overall, 2000-2005*



This implies that it was a short-term inability to downsize and consolidate, in line with declining output, which was the cause of falling productivity. Certainly, the role of efficiency in the stated motives for the recent Waterstone's-Ottakar's merger point in this direction.⁶

Secondly, to what extent did the ending of RPM create the entry that has been observed?

What is clear is the impact that a wave of entry had on the market. It is impossible to assert causality with absolute confidence, and it is probably an overstatement to suggest that their entry would literally not have occurred without abolition. Rather, the real issue is whether their entry would have been so successful, and had such striking consequences for industry productivity, had RPM been retained.

Further insight on both these points can be gained by turning to our counterfactuals. We have seen that, compared to the pre-abolition UK years, B&M productivity surged ahead impressively immediately after 1993, only to fall back below the trend of productivity in the years before abolition. Moreover, in Germany, there was no discernible downturn in productivity growth post-1997. In that sense, the story appears to have been disappointing. However, comparing the UK post-abolition with Germany also sheds considerable light on our two questions. In Germany, as discussed, while there was also entry by internet sellers (less so supermarkets), their market penetration was much less pronounced, and this suggests that it is the low-price aspect of the internet sellers which has made them so effective in the UK.⁷ This would not have been possible with RPM retained. Similarly, it seems likely that productivity in German B&M has held up better than in the UK precisely because German retailers have not faced such a serious downturn in turnover. To the extent that this reasoning is correct, one might argue that the sluggish performance of UK productivity in the last ten years is misleading – the full long-term pay-off in terms of productivity is yet to

emerge. If so, we might expect to observe future increases in productivity, partly because of continuing between-firm effects, as the supermarkets and internet sellers advance further, and partly because remaining B&M retailers eventually achieve the increases in within-firm productivity that the Waterstones/Ottakar's merger hoped for.

Book Publishing

The picture is considerably simpler for the publishing sector, if only because it was not faced by the same scale of new entry, although, of course, the emergence of these firms downstream, with their increasing buyer power, may well have increased pressures on all publishers: increased within-firm efficiency became more essential given greater pressure on their margins.

Productivity gains were confined to largely within-firm, perhaps inevitably, given the absence of any major entry into the industry. Within-firm effects were observed, both pre- and post-NBA, although the comparisons on this against the counterfactuals are mixed. On the one hand, post-NBA abolition productivity growth was somewhat slower than pre-abolition. On the other hand, after 1997 the UK compares favourably with Germany over the same period. This implies that, had the NBA been maintained, productivity may even have been stagnant, as opposed to the moderate gains which actually occurred.

We are also able to shed some light on two issues which were commonly discussed in the original debate about the pros and cons of NBA. The first was that publishers might suffer from abolition because retail price cutting would lead to reduced numbers of titles and more demand uncertainty and reluctance by retailers to hold large inventories. If so, one might expect a negative impact on within-firm productivity amongst publishers. In fact, our results do not suggest that this happened. Second, it was argued that, to the extent that publishers were using NBA to facilitate collusion, its abolition would increase the intensity of competition between publishers. In this case, one might expect significant within-firm productivity gains post-abolition. On this, as we have already noted, there is scope for some disagreement on the facts, depending on which counterfactual one uses. On the basis of a comparison of the UK, pre- and post-abolition, the evidence suggests no such effect. But, using Germany as a counterfactual, there is some evidence in favour of this possibility.

¹ Report prepared for the OFT by Professor Stephen Davies, Matthew Olczak and Catherine Ball (all CCP) and Dr Christopher Wilson (University of Oxford). Full report:

http://www.offt.gov.uk/shared_offt/economic_research/offt981.pdf

² http://www.offt.gov.uk/shared_offt/economic_research/offt887.pdf

³ In addition our methodology captures at least some of the potential gains through innovation.

⁴ These estimates are drawn from Table 8.9, p69 in the full report.

⁵ The fact that these gains started to emerge even before formal abolition confirms what informed opinion has told us, namely that the change should not be identified too literally with the exact date of the formal abolition of the institution.

⁶ The efficiency defence, offered by the parties, suggested that there would be important efficiency gains from integrating Waterstone's superior stock management system into Ottakar's operations (Competition Commission, 2006, p13).

⁷ This fits with additional general evidence on the role low prices play in online retailing; see section 9.1 of the report.

The Paradox of Estate Agents' Prices

Catherine Ball, PhD Student

The 2004 study of the estate agency market by the Office of Fair trading (OFT)¹ highlighted an interesting paradox. The market seemed capable of sustaining 'rigid prices' whilst displaying none of the characteristics normally associated with a lack of price competition. Given that estate agents may not be competing strongly in price, the question is asked, in what dimension are they competing?

Rigid Pricing

Estate agents typically use a percentage point system for charging commission. Typical commission rates are 1%, 1.25%, 1.5%, 1.75% and 2% of the final selling price and this pattern is fairly stable across England and Wales. In addition, these percentage commission rates do not vary much either over time or across different value properties (see Table 1).

Table 1:²

Price band	Average fees as a % of sale price	Average fees in total (£)
Less than £100,000	1.64	1,095
£100,000 or more but less than £200,000	1.40	2,032
£200,000 or more but less than £300,000	1.40	3,414
£300,000 or more	1.35	5,609
Total	1.45	2,525

This leads to a situation where the owners of higher value properties pay significantly more for the services of an estate agent than those with relatively lower value properties. The increase in absolute commission payments cannot be explained by differences in costs. Where there are significantly higher costs involved in selling a more expensive property, such as advertising in national as opposed to local newspapers, these costs are often separately billed to the house-seller and not included in the commission payment. If the market for estate agents' services was competitive we would expect to see absolute commission payments more closely related to the costs of selling.

Structure of the Market

In contrast to the lack of evidence for competition in pricing, the structure of the market suggests it should be competitive. In 2004, the OFT estimated there to be 11,000 estate agents operating in England and

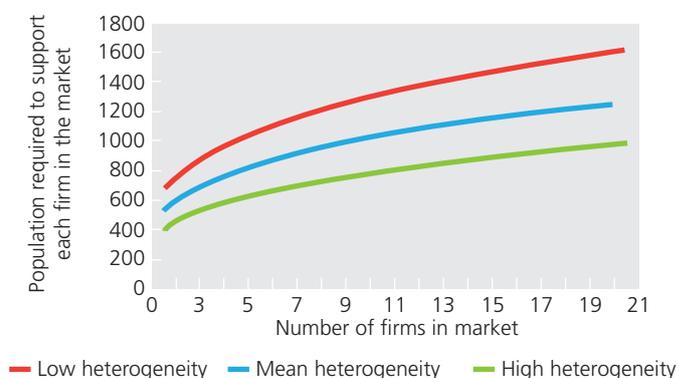
Wales. Most of these firms are independents and small chains with the largest seven firms owning only 20% of branches. It is not surprising that the market should be, at most, weakly concentrated. There are very few barriers to entry, either physical or intangible. With increased internet usage, it is possible to operate as an estate agent without maintaining a physical office. Staff turnover is high, enabling new entrants to recruit experienced staff. There is also no prevalent guild or trade association for estate agents. Therefore it would be expected that any excessive profits to be made in the industry would only encourage successful entry.

Thus there appears to be a paradox whereby the 'rigid pricing' we would normally expect to see in a tacitly-collusive market closed to new entry is evident in an unconcentrated market with free entry.

If Not Price Competition...

Given that estate agents may not be competing strongly in price, it is possible that they may be competing in some other dimension. In the UK there is evidence that estate agents 'soften' price competition by limiting the extent to which they compete directly. By choosing to differentiate their product slightly from that of their competitors they are able to prevent strong price competition. One form this differentiation takes is specialising in the type of property sold. In other words, estate agents will choose to carve the local housing market into submarkets comprising different types of properties: detached, semi-detached, terraced and flats/maisonettes, and choose to specialise in whichever of these areas is under-represented. Data collected on the number of estate agents in 1,947 different postcode districts in England and Wales shows that areas with lots of scope for this sort of differentiation, that is, areas with a significantly heterogeneous population of housing stock, will be able to profitably sustain a greater number of estate agents, all other factors held constant.

Figure 1:



The relationship between heterogeneity of the housing stock and the level of demand estate agents require to break even is decreasing in the degree of heterogeneity. The relationship is upward sloping due

to entry increasing competitive pressure and lowering margins requiring firms to achieve more demand in order to break even.

Figure 1 summarises this relationship. Areas containing lots of different types of housing in significant proportions (areas with high heterogeneity of housing stock) are able to sustain more estate agents at a given level of demand. This suggests that estate agents in these areas compete less strongly with each other in price.

Implications for Welfare

Estate agents are able to use specialisation to avoid strong price competition. It is difficult to analyse the effects on welfare without knowing the value that house buyers and sellers place on this specialisation. It is possible that specialisation increases the efficiency of the matching process between potential buyers and sellers and is therefore welfare-enhancing. The magnitude of this effect could counteract the negative effect of weak price competition.

The lack of price competition would be more of a concern if entry were to be restricted, for example through increased licensing requirements or regulation, as Figure 1 also shows that as the number of firms in an area increases, each firm's price-cost margins fall. New entry increases competitive pressure more slowly in areas with more scope for specialisation, but it does increase it and therefore regulation to verify quality that might impact on entry, such as licensing, should be considered with caution.

¹ Office of Fair Trading (2004), Full report available at:

http://www.offt.gov.uk/shared_offt/reports/consumer_protection/oft693.pdf. Estate agency market in England and Wales (OFT693).

² *Ibid.* p44.

That Unsettling Feeling: Secret Price-Fixing is Not in Itself Dishonest? *Norris v USA*¹

Andreas Stephan, Lecturer in Law

On 12 March 2008, the House of Lords ruled that secret price-fixing is not itself dishonest (and does not constitute the common law crime of *conspiracy to defraud*²), unless it is accompanied by 'aggravating features such as fraud, misrepresentation, violence, intimidation or inducement of a breach of contract' (para.17). The decision could have important implications for the criminal cartel offence, which shares the same two part objective/subjective standard of dishonesty, as set out in *R v Ghosh*. Under s.188 of

the Enterprise Act 2002, it is a criminal offence to 'dishonestly agree' to implement hard-core cartel practices. The crucial question is whether the *Norris* reading of dishonesty applies to conduct occurring after the 2002 Act came into force.

The case concerned a former CEO of Morgan Crucible, Ian Norris, who was indicted by a US court in October 2003 for involvement in the price-fixing of carbon products which took place between late 1989 and May 2000. The US Department of Justice Antitrust Division subsequently commenced extradition proceedings under the controversial Extradition Act 2003. Section 137 of the Act requires 'dual criminality', but as the alleged crime was committed before June 2003, this requirement was not satisfied by the cartel offence. Instead, the US government argued that price-fixing constituted the crime of conspiracy to defraud at the material time.

In a separate case, the Serious Fraud Office had also begun criminal proceedings for conspiracy to defraud against nine individuals and five companies. They are alleged to have fixed prices in sales to the NHS of the blood thinning drug *warfarin* between 1996 and 2000. However, these prosecutions appear likely to cease in light of the ruling in *Norris*.

Distinction between Self-Interest and Harm

In their decision, the Law Lords made reference to a number of civil cases from the 19th and 20th centuries, which clearly did not treat price-fixing as criminal or dishonest in itself, and which had never been overruled. These decisions reflect an historical tolerance of anti-competitive practices by English law. In *Adelaide Steamship* (1913) it was held that 'no contract was ever an offence at common law merely because it was in restraint of trade'.³ Moreover, in *Jones v North* (1875), Sir James Bacon V-C ruled that there was no dishonesty in the act of bid-rigging, describing it as 'very honest'.⁴

At the heart of this case law lies a flawed and antiquated distinction between restraints of trade as a means of furthering one's own interests, and dishonestly prejudicing another's rights (or property): *'While commercial parties could not lawfully act with the wrongful and malicious object of injuring another party, they were free to promote their own business as they thought fit, "however severe and egotistical" such means might be, even though this might inflict loss to others.'* (para.17)

In the preceding Divisional Court ruling in *Norris*,⁵ Auld LJ had accepted the US counsel's contention that such agreements were regarded very differently in the more recent past, and that dishonesty should be determined on a case-by-case basis according to the standards of the time. In rejecting this argument, the Lords pointed to the exclusively civil treatment of price-fixing in legislation preceding the Enterprise Act 2002. The British government specifically rejected

criminalisation in 1955 when it was recommended by the Cairns Committee Report. Reference was also made to the wording of the Enterprise Bill (in 'creat[ing]' an offence) and to the relevant parliamentary debates.

Auld LJ had also taken the view that dishonesty could largely be inferred from the defendant's efforts to keep the cartel secretive (paras.67-8). In light of the historical treatment of price-fixing outlined above, the Lords rejected this contention. They pointed out that secrecy alone could not satisfy the (objective) dishonesty standard; it is the act which causes loss that must be treated as dishonest, and price-fixing was not considered so in the past (para.60).

Extradition and Retrospective Criminality

There is no doubt that considerable confusion would have been created, had the House of Lords upheld the Divisional Court's finding of a common law crime of price-fixing. A common law offence would have carried a maximum penalty of ten years' imprisonment (it is only five under the statutory offence); it would have applied to undertakings as well as individuals; and would potentially have applied to vertical agreements.

However, the more politically-charged implications involve extradition and retrospective criminality. First, it would have fuelled criticism over the UK's loose and one-sided extradition arrangements with the US. Second, it would have allowed the US to initiate extradition proceedings, pursuant of a number of UK nationals involved in price-fixing during the 1990s. This might have caused substantial embarrassment for the government; the minister responsible for the Enterprise Bill had given assurances in Parliament that there was no prospect of Anthony Tennant⁶ being extradited because, '...the matter is not defined as criminality at this point' (speaking in April 2002). Such a ruling may also have created a de facto cartel offence in many common law jurisdictions around the world, which still make reference to English cases when interpreting principles in common law.

One wonders whether the Norris extradition could have been blocked on grounds of fairness and certainty, without undertaking such a troubling dissection of dishonesty. Guiding principles exist in law that no one should be punished unless it was clear and certain that the conduct was forbidden, before it was carried out (*R v Rimmington* [2006] 1 AC 459, 33), and that it is for Parliament and not the judiciary to decide which conduct should attract criminal penalties (*R v Jones* [2007] 1 AC 136, 29); these are supported by human rights rulings (e.g. *Hashman v UK* (1999) 30 EHRR 241 38). The Lords made reference to these cases, but they were not central to their ruling.

Dishonesty and the Criminal Cartel Offence

The contention that has been created by *Norris* is whether the act of secret price-fixing became dishonest when Parliament created the statutory cartel offence, or if dishonesty still requires some additional 'aggravated conduct'.⁷ If the latter proves to be the case, then the bar for securing a conviction under the criminal offence is raised substantially. It is hoped that the Lords' reading of dishonesty is treated as contextually distinct; applying only to conspiracy to defraud, and cartel conduct preceding June 2003. However, much will still depend on the jury's objective judgment as to 'ordinary standards of reasonable and honest people'. Some guidance of contemporary attitudes to price-fixing is given by a public survey conducted for CCP.⁸ This suggests that 6 in every 10 Britons consider price-fixing to be dishonest, but only a quarter *strongly* hold that belief. Only 1 in 10 feel imprisonment is an appropriate penalty, and most do not equate price-fixing as equivalent to theft or fraud in terms of how objectionable it is.

In *Norris*, the Lords noted no evidence of a shift in public perceptions prior to the Enterprise Act. It is clear from the Penrose Report⁹ that the dishonesty element was included, in part, so as to signal the seriousness of the offence. However, the hardening of attitudes, as well as the deterrence of cartels, may be more likely to result from securing a decent number of convictions. This is less likely to occur in light of *Norris* and the relatively soft public perceptions of price-fixing suggested by the survey. The first charges under the offence (concerning the Marine Hose market) have not resulted from a hard-fought prosecution, but rather have been induced by a US plea bargain. The use of such settlements in the US, coupled with a cartel offence of strict liability (no standard of dishonesty required), has resulted in a high number of prison sentences for cartel offences.

Information dissemination is important in educating people about the harmful effects of price-fixing, and convincing them that strong sanctions are justified. Frustratingly, the media coverage of the *Norris* case largely focused on the extradition issues and on Ian Norris' health problems. He was portrayed as a vulnerable victim of overzealous US law enforcement. The enormously damaging effects of the cartel he is alleged to have been involved in, as well as the serious allegations that he obstructed an investigation into the infringement, were largely overlooked.

¹ [2008] UKHL 16.

² Conspiracy to defraud is a broad English Common Law offence which arises when an agreement involves the use of dishonest means and prejudices, or carries a risk of prejudicing another.

³ [1913] AC 781, 797.

⁴ [1875] LR 19 Eq 426, 429.

⁵ [2007] EWHC 71.

⁶ Alleged to have been involved in the price-fixing of Auction House commissions.

⁷ J Joshua, 'Norris: A stalking horse for the cartel offence?' (2008) *Competition Law Insight* 7 2 (11).

⁸ A Stephan 'Survey of Public Attitudes to Price-Fixing and Cartel Enforcement in Britain' (2007) CCP Working Paper 07-12.

⁹ [2002] UKCLR 97.

The European Court of First Instance confirms in *Microsoft* that it is not ready to embrace a more economics-based approach to Article 82 EC

Liza Lovdahl Gormsen, Post Doctoral Fellow

Introduction

The debate on the modernisation of Article 82 of the EC Treaty¹ has been ongoing for many years.² One of the primary reasons for initiating the review was a greater appreciation of microeconomic theory on the part of the policymakers and the need to ensure that the rules under Article 82 are sufficiently responsive to sound economics. While it is not the Community Courts' job to develop competition policy,³ they have the power to change their application of Article 82. The European Court of First Instance (CFI) did not take this opportunity in *Microsoft*.⁴ This confirms that reform of Article 82 is not going to happen immediately.

The Microsoft Marathon

On 17 September 2007, the CFI essentially upheld the Commission's decision in *Microsoft*.⁵ This marks the end of a saga starting in December 1998 with a complaint against Microsoft from the American software company Sun Microsystems.⁶ The case was not appealed to the European Court of Justice (ECJ).

The CFI upheld the Commission's finding that Microsoft had breached Article 82 by refusing to supply interoperability information to competing providers of work group server operating systems; and by tying its Windows Media Player (WMP) with its Windows PC operating system. The CFI confirmed the EUR497 million fine imposed on Microsoft and the remedies requiring the provision of interoperability information and the unbundling of WMP. However, the CFI concluded that the appointment of a monitoring trustee to supervise Microsoft's compliance with the decision was unlawful. The Commission's investigatory and enforcement powers cannot be delegated. Thus, the Commission could not require Microsoft to pay the costs of the monitoring trustee.

Refusal to Supply Interoperability Information

The Commission's decision found that Microsoft was abusing its dominant position 'by refusing to supply Sun and other undertakings with the specifications for the protocols used by Windows work group servers in order to provide file, print and group and user

administration services to Windows work group networks, and allow these undertakings to implement such specifications for the purpose of developing and distributing interoperable work group server operating system products.'⁷

On appeal, Microsoft claimed that the conditions for imposing compulsory licensing on a dominant company were not therefore met. The Court did not agree with these arguments. Instead, it confirmed the Commission's decision on the basis of the test set out in *IMS Health*.⁸ In this case, the ECJ held that three cumulative conditions must be satisfied for a finding of abuse. First, the refusal prevents the emergence of a new product for which there is a potential consumer demand; second, the refusal is unjustified; and third, it excludes any competition on a secondary market.⁹

Tying of WMP

The Commission's analysis of tying started by outlining four requirements necessary for tying to violate Article 82: (i) the tying and tied goods are two separate products; (ii) the undertaking concerned is dominant in the tying product market; (iii) the undertaking concerned does not give customers a choice to obtain the tying product without the tied product; and (iv) tying forecloses competition.¹⁰ The Commission found that Microsoft's conduct fulfilled all the conditions for tying in Article 82(2)(d).¹¹ This was upheld by the CFI.

In relation to the fourth requirement of foreclosure, Microsoft argued that the Commission had applied a new and speculative foreclosure theory to establish the existence of a foreclosure effect resulting from the tying of Windows and WMP. It was inconsistent with the Commission's own decision in *AOL/Time Warner*.¹²

In its decision, the Commission acknowledged that tying WMP to Windows could not automatically be assumed to foreclose competition, so a closer examination of effects was necessary.¹³ It recognised that a detailed analysis of effects required examination of whether the efficiencies arising from tying WMP to Windows outweighed any possible anti-competitive effects from tying WMP.¹⁴ This is an appreciated development compared to the approach taken in *Tetra Pak II* and *Hilti*.¹⁵ In these cases, an abuse was found by virtue of depriving consumers the choice of buying the tied product from other suppliers without examining the effects of the tying and how it would harm consumer welfare. Established Article 82 jurisprudence supports Microsoft's argument about a new foreclosure theory as foreclosure is usually assumed without a closer examination of effects. However, the CFI dismissed this argument as unfounded and based on a selective and inaccurate reading of the Commission's decision.

A More Economics-Based Approach

The foreclosure argument goes to the heart of the great intellectual confusion over the proper standard of liability governing allegedly exclusionary conduct in practice and case law under Article 82. To alleviate the confusion, then Competition Commissioner, Mario Monti, announced in June 2003 that the Commission had started an internal review of its policy on Article 82. One of the primary reasons for initiating the review was a greater appreciation of micro-economic theory on the part of the policy-makers and the need to ensure that the rules under Article 82 are sufficiently responsive to sound economics. As a part of the review, DG Competition published its *Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses* in December 2005 (Discussion Paper).¹⁶ Although it has no legal status and is therefore not binding, it reveals DG Competition's thinking on the issue.

The Discussion Paper proposes a two-step analysis for assessing whether a particular conduct is exclusionary. The specific conduct in question (1) must be capable of foreclosing the market, but (2) will only be considered abusive where it can be established that the conduct has a market-distorting foreclosure effect. The second limb is a new development compared to established jurisprudence. The latter easily finds an abuse where there is foreclosure instead of examining whether foreclosure has any anti-competitive effects. In July 2005, the economic advisory group on competition policy to the Commission (EAGCP) suggested a more economics-based approach to Article 82.¹⁷ According to the EAGCP, a more economics-based approach is a careful examination of how competition works in each particular market in order to evaluate how specific company strategies affect consumer welfare.¹⁸ In the light of this understanding, the Commission's decision in *Microsoft* seems to have adopted a more economics-based approach by exploring ways in which tying would cause harm to consumer welfare. The Commission said that by pre-installing WMP into Windows, third party content providers would concentrate on producing formats interoperable with WMP. This would give Microsoft a competitive advantage that had nothing to do with the quality of WMP.¹⁹

Policy Implications

Unlike the Commission's attempt in the decision to adopt a more economics-based approach, the CFI judgment is disappointing in this regard. It does not contain any new principles of law, but rather involved the application of the established jurisprudence to the particular situation in *Microsoft*. The Court relied on some of the more formalistic case law under Article 82

such as *Hoffmann-La Roche*, *British Airways* and *Michelin II*.²⁰ It reiterated – at least in the tying part of the case – that Article 82 does not require a detailed analysis of effects or a demonstration of consumer harm.

The CFI's judgment confirms the continuing divide between the law and the policy underpinning Article 82. It is a reminder that if the Commission's enforcement policy is to become more economics-based, the impetus cannot be expected to come from the Community Courts immediately. The Commission is not precluded from regarding a more economics-based approach simply because the CFI endorsed the old form-based approach. However, it is crucial that the Commission gets support from the community Courts. While the Commission has prosecutorial discretion, it has to be executed within the framework of Community case law as highlighted by Advocate General Kokott in her Opinion in *British Airways*.²¹

Whether the Discussion Paper will be turned into Guidelines on Article 82 is still unknown.²² Perhaps the Commission was awaiting the CFI's judgment in *Microsoft*. In that case, the Commission was waiting in vain. Despite the CFI's reluctance to overrule earlier case law and support the Commission in its effort to modernise Article 82, the Commission welcomed the judgment. Following the judgment, Competition Commissioner Neelie Kroes called it a 'landmark' decision,²³ perhaps because the judgment gives the Commission comfort in its enforcement of other Article 82 investigations such as its investigations into Intel and Rambus as well as possible further actions against Microsoft.²⁴

¹ Article 82 EC prohibits an abuse of a dominant position.

² It reached the public domain at the 8th annual conference of the European University Institute in Fiesole in June 2003.

³ The Commission is responsible for orientation of competition policy, see Case C-234/89, *Stergios Delimitis v. Henninger Bräu AG* [hereinafter *Henninger Bräu*], 1991 E.C.R. I-935.

⁴ Case T-201/04 *Microsoft Corp. v Commission*, judgment of 17 September 2007.

⁵ *Ibid.*

⁶ Commission Opens Proceedings against Microsoft's Alleged Discriminatory Licensing and Refusal to Supply Software Information, IP/00/906 of 3 August 2000.

⁷ *Microsoft COMP/C-3/37.792*, decision of 24 March 2004, recital 546.

⁸ Case C-418/01 *IMS Health GmbH & Co OHG v NDC Health GmbH & Co KG* [2002] ECR I-3401.

⁹ *Ibid.*, paragraph 38.

¹⁰ *Microsoft* decision, recital 794.

¹¹ *Ibid.*, recital 795.

¹² OJ [2001] L268/28.

¹³ *Microsoft* decision, recital 841.

¹⁴ *Ibid.*, recital 955.

¹⁵ Case C-333/94 *Tetra Pak International SA v Commission* [1996] ECR I-5951; Case C-53/92 *Hilti AG v Commission* [1994] ECR I-667.

¹⁶ *Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses* (December, 2005). Available at: <http://www.europa.eu.int/comm/competition/antitrust/others/discpaper2005.pdf>

¹⁷ EAGCP Report *An Economic Approach to Article 82 EC* (July 2005). Available at:

http://europa.eu.int/comm/competition/publications/studies/eagcp_july_21_05.pdf

¹⁸ *Ibid.*, page 2.

¹⁹ *Microsoft* decision, recital 891.

²⁰ Case 85/76 *Hoffmann-La Roche AG v Commission* [1979] ECR 461; Case T-203/01 *Manufacture Française des Pneumatiques Michelin v Commission*; Case C-95/04P *British Airways plc v Commission*.

²¹ Advocate General Kokott's Opinion in C-95/04P *British Airways plc v Commission* delivered on 23 February 2006, paragraph 28.

²² Commission Discussion Paper on Abuse of Dominance - Frequently Asked Questions, MEMO/05/486 of 19 December 2005. See also Liza Lovdahl Gormsen 'Will there be Article 82 Guidelines and what are the Implications?' Global Competition Policy (April, 2008).

²³ Commission welcomes CFI ruling upholding Commission's decision on Microsoft's abuse of dominant market position, IP/07/359 of 17 September 2007.

²⁴ Commission initiates formal investigations against Microsoft in two cases of suspected abuse of dominant market position, MEMO/08/19 of 14 January 2008.