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The European school

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The development of a European school

The speed of technological development, globalisation and the rapid convergence of whole sectors of the economy have rendered the traditional, old-fashioned way of analysing markets in EC competition law obsolete. Already in the 1990s, Commissioner van Miert began to postulate the policy of drawing a solid picture of the markets in question and analysing factually what the real situation is. Legal certainty, the need to concentrate scare resources quickly on the most important issues and the will to shed bureaucracy were the buzzwords at the time. Commissioner Monti has developed this modernisation process further. According to Monti, the real impact of the competition rules on European society is determined by their efficient implementation. Just as companies adapt to competitive pressure, the Community system of protecting competition must adapt to the challenges facing it by becoming more efficient. The change in the policy of the Commission in favour of a greater role for economics in the analysis of competition issues is an important step in this direction. As the policymaker, the Commission has developed a school of thought for proper economic analysis, the 'European' school.

However, the complexity of basic antitrust economics should not be exaggerated. There is much common sense involved in economic analyses, mixed with sound economic methodologies. This means that the focus on economic insights should not be confused with the application of complex mathematical formulae and/or econometrical calculation models in competition assessments. The utilisation of those techniques is not the aim of the European school. Instead the modernisation process is a more pragmatic one, requiring competition economists to provide solid analyses and apply sound methodologies, for example in the definition of the relevant markets. In this chapter the new, more economics-based approach to vertical and cooperation agreements, as well as the economics of collective dominance, are discussed to illustrate the Commission's policy shift towards the 'European' school.

The European school and agreements under Article 81

In accordance with its more economics-based approach, the Commission favours a new architecture under Article 81. This new architecture includes a new de minimis Notice, two block exemptions and guidelines on horizontal agreements, one block exemption and guidelines on vertical agreements, and a new procedural Regulation in 2003. In particular, the application of Article 81(3) provides the vehicle for a comprehensive economic assessment.

New competition rules for distribution

In the past, the core problem with the Commission's approach to vertical restraints was its adherence to the doctrine of 'economic freedom'. This focused on restrictions on the parties' behaviour, limiting their ability to act in the market place. However, this approach had two major flaws. First, this reasoning can be applied to virtually any contract. Secondly, there is no principle in the economic freedom approach which provides a means of distinguishing between a benign and an anti-competitive restriction. Modern economic thinking rejects the notion that vertical restraints are per se anticompetitive. In particular, the impact on competition and efficiency of any vertical arrangements and distribution system depends very largely on the market context and the barriers to entry. Moreover, since different vertical restraints can have the same market effect, and the same vertical restraints can have different market effects (either pro- or anti-competitive), it is very difficult to say a priori either which types of restraint have an anti-competitive effect or what their overall impact on efficiencies is.

The new Block Exemption Regulation (BER), Regulation (EC) No. 2790/1999, covers supply and distribution agreements. The block exemption regulation for motor vehicle distribution and servicing agreements, which is set to expire in September 2002, is not affected by the new rules. However, it can be assumed that the Commission's more economics-oriented approach will provide the appropriate guidance for the new rules in these sectors too. Along with accompanying guidelines, the Commission has in the Block Exemption Regulation (BER) designed a key area of competition policy in a new style. The BER and the guidelines can be considered the first important step by the Commission in a comprehensive process of modernisation in line with European school thinking. In particular, the guidelines fully reflect the more economics-based approach of the Commission.

The ultimate aim of the guidelines is to identify agreements which raise no competition problems at all. If a competition problem is identified, the guidelines discuss whether there are suitable ways to remedy it. Section VI of the guidelines is a comprehensive tour through the new Commission's economic approach. It is the first time that the Commission has provided such a coherent, sophisticated insight into the conceptual basis of its economic competition thinking. In the section on the framework of the analysis (paragraphs 103-136), the negative and positive effects of vertical restraints are discussed first. In particular Paragraph 119 elaborates the general rules for the evaluation of vertical restraints. Although it must be kept in mind that every assessment is made on a case-by-case basis, the guidelines recommend applying some specific rules: the first recommendation is that competition concerns can only arise if there is insufficient inter-brand competition. This is the case if a certain degree of market power at the level of the supplier or the buyer or both exists. The guidelines refer to market power as the power to raise prices above the competitive level and, at least in the short term, to obtain supra-normal profits. This market power threshold is considerably lower than the dominance threshold applied in Article 82 cases. According to this definition, a substantial number of companies may dispose of market power. Where there are many firms competing in an unconcentrated market, it can be assumed that non-hardcore vertical restraints will not have appreciable negative effects. A market is deemed unconcentrated, according to the guidelines, when the HHI index (ie the sum of the squares of the individual market shares of all companies in the relevant market) is below 1000. This is a low figure in this context, and it can be assumed that a couple of markets would be deemed to be concentrated markets under the guidelines. Moreover, the guidelines indicate that vertical restraints that reduce inter-brand competition are generally more harmful than vertical restraints that reduce intra-brand competition. Additionally, exclusive dealing arrangements are generally viewed as worse for competition than non-exclusive arrangements. On the other hand, the guidelines indicate that vertical restraints agreed for non-branded goods and services are in general less harmful than restraints affecting the distribution of branded goods and services. Combinations of vertical restraints are viewed as aggravating their negative effects. However, certain combinations of vertical restraints are better for competition than such combinations in isolation. The issue of cumulative effects is discussed in a very detailed way too. The guidelines state that potential negative effects of vertical restraints are reinforced when several suppliers and their buyers organise their trade in a similar way. These so-called 'cumulative effects' may be a problem in a number of sectors.

The guidelines go on to describe the analytical methodology the Commission would apply in its case analysis. The methodology described in the guidelines is in line with the Market Structure Analysis (MSA) the Commission has developed in its merger proceedings. For assessments under Article 81(1), the Commission, in line with the European school approach, considers the following factors in its competition analysis: the market position of the supplier; market position of competitors; market position of the buyer; entry barriers; the maturity of the market; the volume of trade; the nature of the product; and other factors, depending on the circumstances of the case.

New competition rules for cooperation

In its comprehensive review process, the Commission adopted in 2000 revised block exemptions for specialisation agreements and research and development agreements, Regulations (EC) Nos. 2658/2000 and 2659/2000 respectively. These regulations are complemented by guidelines. The guidelines cover research and development (R&D), production, purchasing, marketing and standardisation and environmental agreements, and acknowledge that economics-based analyses are required to assess restrictions by effect. The more economic approach means that a balancing of the pro- and anti-competitive effects of agreements takes place. Horizontal cooperation, in particular between actual competitors, may cause competition problems. If parties to a cooperation agree for example to fix prices or output or to share markets, or if the cooperation enables the parties to maintain, obtain or increase their market power, competition problems may arise. On the other hand, horizontal cooperation can lead to substantial economic benefits. Companies need to respond to increasing competitive pressure. Globalisation, the speed of technological progress and the generally more dynamic nature of markets require new modes of cooperation. Cooperation can be a way to share risk, save costs, pool know-how and launch innovations faster. The basic aim of the new, more economics-based approach is to allow collaboration between competitors where it contributes to economic welfare without jeopardising competition. For small and medium-sized enterprises in particular, cooperation is an important means of adapting to the changing marketplace. Consumers may share these gains, provided that effective competition is maintained in the market.

The guidelines provide an analytical framework based on criteria that help to analyse the economic context of a cooperation agreement. The focus is on the assessment of the economic significance of the agreement. This means that even agreements which prima facie contain anti-competitive elements may contain significant pro-competitive elements which may outweigh the negatives ones. This approach concentrates on the effect of the agreements in the relevant markets.

Three types of agreement are described in the guidelines: (i) agreements that do not fall under Article 81(1); (ii) agreements that almost always fall under Article 81(1); and (iii) agreements that may fall under Article 81(1) if they lead to negative market effects. This means that the guidelines identify agreements in which the nature of the cooperation indicates from the outset that it is caught by Article 81(1). This affects primarily agreements that have as their object restricting competition by means of price fixing, output limitation or sharing of markets, customers or sources of supply. These so-called 'hard-core' restrictions are considered to be most harmful because they directly interfere with the outcome of the competitive process. It can consequently be presumed that these restrictions have negative market effects and do not result in any efficiency gains or benefits to consumers. They are therefore almost always prohibited.

On the other hand, there are also some horizontal agreements to which it is clear from the outset that Article 81(1) does not generally apply. These include agreements between non-competitors, agreements between competing companies that cannot independently carry out the project or activity which is the object of the cooperation, or cooperation concerning an activity which does not influence the relevant parameters of competition. These cooperation agreements will only come under Article 81(1) if they involve firms with significant market power and are likely to cause foreclosure problems vis-à-vis third parties.

All other agreements need to be examined in the light of two criteria – the nature of the agreement and market power/market structure – in order to decide whether they fall under Article 81(1). The nature of the agreement is determined by the area covered by and the objective of the agreement, the competitive relationship between the parties and the degree of coordination of activities. In the assessment of market power the following factors have to be considered: the parties' market shares, the level of concentration, the position of competitors, the stability of market shares, entry barriers and the countervailing power/supplier power. The guidelines propose a full Market Structure Analysis (MSA). In line with the more economics-based approach, the starting point for the analysis is the position of the parties. This determines whether or not they are likely to maintain, obtain or increase market power through the cooperation. To carry out this analysis, the relevant market(s) have first to be defined by using the Commission's methodology on market definition. Additionally the guidelines, by referring to the Herfindahl-Hirschman Index (HHI), take into account the market concentration, ie the market position and number of competitors.

The guidelines continue to discuss the Article 81(3) criteria. In particular, economic benefits and 'fair shares' for consumers are referred to. Concerning economic benefits, the guidelines mention static and dynamic efficiencies. It is up to the parties to demonstrate that efficiencies are likely to result from the cooperation and cannot be achieved by any less restrictive means. This means that efficiency claims must be substantiated by economic analysis provided by the parties. Future case law will provide further insight into the methodology used to calculate efficiencies. The guidelines explicitly state that speculative or general statements on cost savings are not sufficient. The only positive indication given at this point is that the Commission does not take into account cost savings arising from reduction of output, market sharing, or the mere exercise of market power.

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The European school and collective dominance

In the evolution of the EC case law on oligopolistic behaviour there are two questions with respect to the behaviour of firms which are of particular importance:

- Is it necessary, in order to be able to conclude that joint dominance exists, that the firms have established explicit links or other means of coordination between them?
- What kind of market behaviour is associated with joint dominance?

The existence of a collective dominant position may flow from the nature and terms of an agreement, from the way in which it is implemented and, consequently, from the economic links or factors which give rise to a connection between undertakings, which result from it. It follows from the *Gencor* and *Compagnie Maritime Belge* judgments that a Market Structure Analysis (MSA) needs to be performed in order to enable a finding that there is an oligopolistic or highly concentrated market whose structure alone may be conducive to coordinated effects on the relevant market. A detailed examination of whether the firms in the oligopoly have the power of collusive behaviour and to a significant extent are able to act independently of competitors, customers and final consumers must take place. A sectoral or case-by-case approach is favoured. This brings us to the second question mentioned above: what kind of market behaviour does joint dominance involve under EC law?

In several cases a collective dominant position has been characterised as a situation which enables the undertakings involved to adopt the same conduct on the market. In *Gencor*, the Court of First Instance speaks of the interdependence of firms which follows from the possibility of anticipating each other's behaviour and results in a strong incentive to align their conduct in the market, in particular in such a way as to maximise their joint profits by restricting production with a view to increasing prices. From this it seems clear that firms can behave individually and yet at the same time be part of a collectively dominant entity. Repeated interaction forces companies to take into account the future responses of the other firms when making price or supply decisions. Generally speaking, a coordinated equilibrium may result if the long-term gains of coordination are greater than the short-term gains of competitive behaviour. This concept is one that is broadly accepted in game theory.

'Tacit collusion' is the terminology most commonly used to describe oligopolistic situations in which supply is restricted and prices are above competitive levels; it is a non-cooperative way to coordinate behaviour in markets. Tacit collusion is an optimal oligopolistic behaviour in non-cooperative games in which each firm behaves in its own self-interest.[1] Tacit collusion needs some kind of enforcement mechanism to sustain the coordinated equilibrium. It usually involves a self-enforcing mechanism which results in companies coordinating their market behaviour without any explicit agreement. In this situation companies take decisions individually, unilaterally, independently and rationally. Because of the characteristics of the market, companies end up coordinating their market behaviour in an entirely non-cooperative fashion, ie without any kind of agreement.[2] The common factor in these situations is that firms 'stick together' at a supra-competitive price level and do not compete in an active way.

'Dynamic' economic theory offers an explanation of tacit collusion within oligopolies. Firms are supposed to base their decisions on what profits can be earned both in the short term and in the future.[3] Thus, the trade-off a firm is supposed to make is (a) whether it starts to compete actively at a precise moment with all the gains or losses associated with the decision now and in the future, and (b) what advantage the market would be able to offer in the case of joint dominance. This question touches upon the retaliation mechanism. In a market in which innovation does not play an important role, it is not difficult to match an initiative quickly. Such a market is therefore considered to be conducive to joint dominance, since it is in most cases also a mature market. Furthermore, an important factor is the amount of sunk costs. Additionally, the homogeneity of the products influences the degree to which it will be rational to respond.

Economic theory says that credible and timely retaliation is normally a necessary condition of both tacit coordination and explicit collusion. The assumption is that companies must be able to detect whether competitors are deviating from the coordinated behaviour and to respond with a credible and timely retaliatory measure which deters a company from deviating in the first place.

It is important to note that tacit collusion is not illegal. Therefore, in applying the concept of tacit coordination in a merger proceeding, the essential requirement is to distinguish tacit coordination from competitive behaviour. As to the distinction between tacit coordination and competitive behaviour, the specific difficulty is that companies in both situations behave rationally and independently. It is only because of the particular market characteristics that in some markets such rational and independent behaviour results in tacit coordination. Whether this is the outcome in a particular case is ultimately an empirical question which can only be answered on the basis of a detailed analysis of the characteristics of the market and the companies, the players' incentives to coordinate, the sustainability of the coordination and so on. Past competition history also matters as it may disclose information on companies' strategies. This more economics- based approach to collective dominance is continuously evolving in the Commission's merger proceedings.

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Conclusion

The characteristics of a mature, coherent and properly functioning system of competition law are that it blends the principles of the economic and legal systems, and is applied almost as a matter of course by businessmen, lawyers and judges. With the support of the more economics-based approach of the European school, the Commission is reaching towards that ambitious goal. The European school provides an analytical resource which is suppplementary to to the EC competition rules.

Notes

1 Tirole, J, *The Theory of Industrial Organisation* (MIT Press, 1988), p. 206, and JW Friedman, *Oligopoly Theory* (Cambridge University Press, 1983), p. 132.

2 Christensen, Peder/Rabassa, Valerie, 'The Airtours Decision: Is there a new Commission Approach to Collective Dominance?' in (2001) *ECLR*, p. 227-237

3 The basic theory stems from G Stigler, 'A Theory of Oligopoly', (1994) *Journal of Political Economy* 44.