UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

UNCTAD

MANUAL ON THE FORMULATION AND APPLICATION OF COMPETITION LAW

Edition 2004

UNITED NATIONS
New York and Geneva, 2004

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UNCTAD/DITC/CLP/2003/4

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CHAPTER I

COMPETITION LAW AND POLICY – AN OVERVIEW

In this chapter the following issues are discussed:

- *What is competition policy?*
- *Objectives and benefits of competition law*
- *Globalisation and the interaction between competition, trade and foreign direct investment policies*
    - *Trade liberalisation and competition law*
    - *Foreign direct investment and competition law*
- *Privatisation and deregulation – posing a new challenge for the competition authority?*
- *The structure of this manual.*

1.1 What is competition policy?

The term "competition policy" is sometimes used to describe the array of government policy measures that influence competition in domestic markets. On that broad definition, policies regarding tariff protection, deregulation and direct foreign investment, for example, would come within the ambit of competition policy.

In this manual, a narrower definition is used. Competition policy, as defined herein, is concerned with the design, effective implementation and enforcement of competition law, or anti-trust law, as it is usually termed in North America. Of course, a country has the option not to introduce or implement a competition law, and this may be the preferred competition policy for a government that feels it can achieve its social and economic objectives better by other means.

Competition law is intended to eliminate or curtail restrictive business practices, which hinder or prevent firms from competing freely with one another in domestic markets. The law recognises that, in some circumstances, the benefits to the community from a particular anti-competitive agreement or anti-competitive conduct will be greater than the detrimental effects that it causes. Accordingly, the competition authority and/or the Courts are empowered to allow the continuation of such restrictive practices where they can be justified on public interest grounds.

The restrictive practices that are prohibited by the competition law in most countries fall into three broad categories:

- Collusive arrangements, agreements or understandings between a number of firms to limit competition among themselves or deter other firms from entering the market,

- The abuse of market power by firms which are dominant in a market,

- Mergers, acquisitions or takeovers which will substantially lessen competition or prevent access to a market.

Some restrictive practices are so obviously detrimental to competition and so lacking in economic and social justification that they are prohibited outright. These are *per se* offences for which there is no defence once their existence has been proved. They include, price-fixing by a cartel, output quotas, collusive tendering, bid rigging and market sharing. (These practices are discussed in some detail in Chapter II).

In the case of other types of anti-competitive agreements and conducts, as well as in merger cases, the competition authority and the Courts usually adopt a so-called "rule of reason" approach. That is, the possible public benefits associated with a particular anti-competitive arrangement are taken into account, provided the parties to the arrangement provide the necessary evidence. The authority must then judge whether or not those benefits exceed the adverse effects of the restriction on competition.

1.2 The objectives and benefits of competition law

For many developing countries, competition law is a recent innovation. Whereas anti-trust legislation was introduced in Canada and the United States in 1889 and 1890 respectively, very few developing countries had passed comparable competition laws prior to 1980. Today, at least 80 developing economies and economies in transition have such legislation on the statute books, while several others are in the process of drafting a competition law suitable for their particular circumstances.

This upsurge in interest in competition law in developing and transition economies reflects the substantial changes that have been taking place in the political and economic environment. During the past two decades, many developing countries have instituted a programme of microeconomic reform, involving greater reliance on markets and less emphasis on central planning. Among the more important changes have been a lowering of tariff barriers, the removal of most quantitative import restrictions, the reduction of subsidies to domestic producers, the privatisation of government business enterprises, the easing of foreign exchange controls and the encouragement of foreign direct investment.

Underlying these reforms is a renewed confidence that market forces and the individual decisions of millions of consumers and privately owned businesses, can make a greater contribution to economic and social development than an inward looking centralised economic system. However, the potential benefits of a shift towards a more market-oriented economy will not be realised unless business firms are prevented from imposing restrictions on competition. Hence the need for a strong and effective competition law which will only permit anti-competitive agreements or conducts where these have demonstrable net public benefits.

Competition, or the active rivalry among business firms in seeking to meet market demands, delivers some important benefits to the economy. First, it puts pressure on firms to produce and distribute their products and services at the lowest possible cost. Secondly, it benefits consumers by ensuring that prices are kept down and are reduced in step with any cost reductions. Thirdly, it allows firms the opportunity to introduce new products or processes and enter new markets, thus contributing towards technological advance and higher quality goods and services. These are the static and dynamic efficiency gains that economists usually attribute to competition.

In almost all countries, which have a competition law, the stated objective of the legislation is to improve economic efficiency and thus contribute to economic development. It is also widely accepted that the law should aim to increase consumer welfare. This is an attainable objective, because the removal of obstacles to competition will tend to put downward pressure on the prices of intermediate and final goods and services.

While there is a broad consensus among developed and developing countries about the principal objectives of competition law and policy, there are also some differences between countries in the statement of secondary objectives. Some developing economies emphasise that competition law has a role in limiting further increases in the concentration of economic power in the hands of a few large corporations.

Other countries see the need to have provisions in the legislation to protect the interests of small and medium-sized enterprises. Canada, for example, sees its competition law as a means of ensuring that "the small and medium-sized enterprises have an equitable opportunity to participate in the Canadian economy".

Finally, in Estonia and other economies in transition, the Competition Act sets out rules governing State Aid and government subsidies designed to ensure that such assistance is provided on a non-discriminatory basis and will not distort competition.

An effective competition law, properly implemented and enforced, is essential to the preservation of competition and the realisation of the benefits that can flow, to developing and developed countries alike, from the liberalisation of international trade and foreign investment. However, some limitations should be noted:

- Competition law does not usually seek to change the structure of a market (e.g. by an insistence that a large dominant enterprise be broken up into several competing enterprises). (However, United States law does contain provisions, which allow a Court to order such a break-up).
- An existing monopoly can continue to earn monopoly profits without necessarily

infringing the law. It commits an offence only when it takes advantage of its market power with the intention of limiting or preventing competition. (This issue is discussed in detail in Chapter III, The Abuse of Market Power).

- Competition law applies to anti-competitive agreements and conduct affecting domestic markets, not overseas markets. This means that export cartels organised by local producers will generally be exempt from the law.

- If competition legislation is to make its maximum contribution to a country's economic development and a more efficient allocation of the nation's resources, it is important that it applies universally to all domestic activities, including the activities of government-owned enterprises. If certain industries or activities are exempted for political or social reasons, this is likely to result in a misallocation of resources not dissimilar to that caused by high tariffs or large producer subsidies.

- Other economic policies affecting competition, such as trade and foreign investment policies, must have objectives, which are consistent with the aims of competition law. If they are contradictory, the anticipated gains from enhanced competition may not be realised. (for further discussion of this matter, see the section on Globalisation below).

1.3 Globalisation and the interaction between competition, trade and direct foreign investment policies

Trade liberalisation and competition law

Although globalisation has attracted some vocal critics in the last few years, it has brought significant economic and social benefits to many developing and transition economies. One element in the process of globalisation has been the liberalisation of international trade, including the reduction of tariff barriers, the elimination of most quantitative restrictions on imports and the ending of voluntary export restraints.

These measures towards freer trade have allowed some producers to expand their horizons to world markets, rather than relying exclusively on small domestic markets. By taking up new export opportunities, some domestic firms have been able to increase output and lower costs through economies of scale. Moreover, because strong competition is usually encountered in export markets, these firms have generally been under pressure to devise more efficient methods of production, better marketing techniques and quality improvements in their products. This has often meant lower prices and better quality goods, not only for foreign customers, but also for domestic consumers.

The lowering of trade barriers has also meant increased competition from imports for those local producers of tradable goods and services mainly dependent on the domestic market. The additional competitive pressure has obliged these firms also, to improve their productivity and keep down prices to consumers.

However, trade liberalisation has not come without causing some transitional problems. Some firms have failed as a result of stronger import competition. Some small and medium-sized domestic businesses have been sold to powerful transnational corporations, leading to higher levels of concentration in some markets in developing and transition economies. But looked at from a national perspective, this may be a modest price to pay for achieving a necessary improvement in the allocation of the country's resources. Generally the firms that have not survived have been the less efficient high cost producers, while the low-cost and innovative enterprises have been able to grow faster than they otherwise would.

Structural adjustment of this kind can have social implications as well as economic benefits. To address the social problems, the government may have to provide short-term transitional assistance, particularly for workers who have lost their jobs as a result of stronger import competition. But a combination of trade liberalisation and such transitional assistance is likely to bring greater long-run benefits to the country than retaining high barriers to international trade.

Competition policy comes into this picture because some firms, fearful of the consequences of trade liberalisation and stronger competition from imports may be inclined to protect their interests by introducing restrictive business practices. In some circumstances, such practices can limit international trade even more severely than the former high tariffs and just as severely as the non-tariff barriers, such as import quotas and voluntary export

restraints. Consider, for example the following practices:

- Domestic suppliers may enter into exclusive arrangements with their local distributors, which effectively deny importers access to some markets.
- Large retail chains may refuse to stock imported goods.
- An import cartel may be established to fix prices, so that imported goods cannot be sold more cheaply than the equivalent domestically produced items.

If an effective competition law is in place, such restrictive practices can be stopped. However, in countries where there is no competition law, the benefits of trade liberalisation could be lost through such anti-competitive conduct in the domestic market.

Foreign direct investment and competition law

The need for competition law is also evident when foreign direct investment is being liberalised and foreign exchange controls relaxed. If a large transnational corporation undertakes a new green field investment in a developing country, such as building a new factory, this may accelerate economic development in that country by transferring valuable technology, increasing competition and lowering costs and prices.

However, it is often the case that foreign direct investment takes the form of a transnational corporation (TNC) acquiring a domestic enterprise or establishing a joint venture with one. The result may not be pro-competitive. By making such an acquisition the TNC may gain a dominant position in the relevant market, enabling it to enjoy a high profit margin, and charge prices well above a competitive level.

Another scenario often encountered in developing and transition economies, is where the affiliates of two separate TNC have been established in competition with one another in a particular market, following the liberalisation of foreign direct investment in that country. Subsequently, the parent companies overseas decide to merge. With the affiliates no longer independent of one another, competition in the host country may be virtually eliminated and the prices of the product increased.

These adverse consequences of mergers and acquisitions by TNCs can be avoided if an effective competition law is in place in the host country. As mentioned earlier, one element typically found in competition law is a prohibition of any merger, acquisition or takeover likely to substantially lessen competition or prevent access to a market. This provision could be invoked to stop a TNC or an affiliate from engaging in an anti-competitive merger or acquisition in a domestic market.

It is sometimes argued that an economy which has implemented an effective competition law is in a better position to attract foreign direct investment than one which has not, This is because most transnational corporations are accustomed to the operation of such a law in their home countries and know how to deal with any concerns that the competition authority may raise. However, when considering the prospect of investing abroad in a developing economy without a well-established competition law, they face the uncertainty of not knowing if, and when, competition legislation will be introduced and, perhaps more importantly how it will be implemented.

There are, of course, other areas of uncertainty, which may tend to discourage foreign direct investment, notably political uncertainties, the slow pace of economic development, exchange rate movements, obstacles to international trade and government regulations. Nevertheless, when a TNC has to make a choice between two or three alternative locations for a particular investment and these are of approximately equal merit, the country that has an effective competition law may be favoured.

In this regard, it is worth noting that if a developing country does not have a competition law, a foreign direct investor in that country is exposed to a greater risk that it will have to:

- Pay higher prices for some locally produced inputs (e.g. monopoly prices set by a local cartel).
- Sell its products at lower prices on the domestic market, because some of its major customers have substantial market power as buyers (e.g.: a monopsony may be established by means of a joint-purchasing arrangement between major customers).

So far it has been suggested that effective competition legislation is likely to facilitate foreign direct investment and yet prevent TNCs from

making acquisitions, which would be damaging to competition in the domestic market of the host country. In order to ensure that a developing country gains the full benefit of foreign direct investment, government policy in that area must be consistent with the objectives of competition law. Sometimes, in order to attract a large-scale investment by a TNC, a national or local government may offer that corporation exclusive rights to supply its goods and services to the public authorities. It may even agree that no other firm will be given approval to enter the market in which the TNC is proposing to operate. Such inducements are evidently anti-competitive, but the adverse effects on competition may be outweighed in certain circumstances by the economic benefits that the foreign direct investment can bring.

It is important that the competition authority be consulted before investment incentives are offered to foreign corporations. Incentives which confer a monopoly position on the foreign direct investor should generally be avoided, but if they are granted it should be for a limited period only and be subject to a requirement of satisfactory performance, including reasonable prices.

To conclude this section, it is worth examining an argument sometimes put forward, especially by small open economies, that trade liberalisation and the deregulation of flows of foreign direct investment have made competition law unnecessary or irrelevant. According to this argument, free trade means that actual or potential competition from imports will keep down the prices of tradable goods on the domestic market to the lowest world levels. If domestic producers of non-tradable goods and services raise their prices and earn above – normal profits, this will only serve to attract (additional) foreign direct investment to the country, thus increasing output and again reducing prices to a competitive level.

A number of objections can be made to this argument. First, transport costs have to be taken into account. If transport costs are high for some tradable goods, import competition will be weak in those sectors and domestic producers acting collusively would be able to charge prices well in excess of costs. Competition law may be necessary to prevent such collusion occurring.

Secondly, some markets for non-tradable goods and services, such as a railway network or electricity transmission, are natural monopolies. An incumbent firm is secure from the threat of entry by a TNC because it would be too costly for the latter to duplicate the existing facilities. The contention that foreign direct investment will compete away any above – normal profits is seen not to be valid in these circumstances.

Thirdly, foreign direct investment is not always pro-competitive. As noted earlier, a TNC may obtain a dominant position in a developing country's market through the acquisition of a local enterprise, and then take advantage of its enhanced market power to drive other domestic competitors out of business. Alternatively, the TNC may use its dominant market power to ensure that it purchases supplies of certain inputs exclusively from the parent company or an affiliate, thus restricting competition in the market for those inputs. An effective competition law is needed to prevent such abuse of market power by a foreign direct investor.

Thus, the inescapable conclusion is that, even in a small open economy, a carefully designed and implemented competition law is essential to maintain competition. Globalisation, in the form of freer trade and increased foreign direct investment can often help to increase competition and contribute to more rapid economic development, but it needs to be complemented by strong and effective legislation to stop restrictive business practices and the abuse of market power.

1.4 Privatisation and deregulation: posing a new challenge for the competition authority?

In the last decade, many developing economies and economies in transition have privatised key industries and large individual enterprises formerly under public ownership. Privatisation has taken place in telecommunications, banking, ports, bus transportation, water supply, electricity generation and airports, for example.

One motive for privatisation has been to boost government revenues, while another, perhaps more important, has been to improve industry productivity and competitiveness. There is a widespread perception that the incentive to improve productive efficiency and provide better quality goods and services is stronger when management is responding to the profit motive than when it is subject to government direction.

In some industries, privatisation has not necessarily meant the end of regulation, for two main reasons. First, governments, for social reasons, have sought to protect the interests of

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certain groups of consumers who, prior to privatisation, were enjoying low prices as a result of cross-subsidisation from other consumers of the same service. For example, consumers living in rural or remote areas may not have had to pay the full cost of connection to the telephone network. Following privatisation, some governments have imposed a so-called “community service obligation” on the telephone service provider so that, in return for a small subsidy, the provider will continue to favour the remote consumer without increasing the charges to metropolitan users of the service.

Secondly, when the privatised industry is a natural monopoly, regulation has been necessary to ensure that the enterprise does not restrict output or raise prices in order to gain monopoly profits. In the supply of electricity, gas, and telecommunications services a natural monopoly exists at only one stage of the production/distribution chain. (i.e.: in those facilities that cannot be duplicated economically – electricity transmission lines, gas pipelines and the telephone line network. However, competition is feasible among firms engaged in the generation, wholesaling and retailing of electricity, and in the provision of telephone services to subscribers) It is therefore important to ensure that the private owner of the natural monopoly facility does not take advantage of its dominance of that stage to damage its competitors at other stages in the chain.

One way to overcome this problem is to make it a condition of the privatisation legislation that the natural monopoly owner shall not operate at other stages of the production/distribution chain. The other more light-handed approach would be to use the general competition law to prohibit that firm from abusing its market power.

A further issue to be resolved relates to the terms on which a firm competing at a later stage of the chain can gain access to the natural monopoly facility. For example, what fee should be paid by a telephone service provider, so that a call from one of its customers can be connected through the telephone network owned by the monopolist? How should the fee be determined and by whom? What role, if any, should be played by the competition authority in deciding these matters? Several of these questions will be discussed in more detail in Chapter X of this manual.

1.5 The structure of the manual

The next three chapters of this manual focus on the three main categories of restrictive business practice that are typically prohibited by the competition law. That is:

- Agreements, understandings and concerted action between two or more firms to limit or prevent competition (Chapter II),
- The abuse of market power by a single dominant firm (Chapter II),
- Mergers and acquisitions which are likely to substantially lessen competition (Chapter IV).

Chapter V discusses briefly, how and why authorisations and exemptions are granted by the competition authorities to allow certain anti-competitive practices to continue and some anti-competitive mergers to proceed. Chapters VI and VII deal with two issues of increasing interest to competition authorities and governments, particularly in developing countries, namely the interaction between competition law and intellectual property rights (Chapter VI) and how competition law impinges upon small and medium enterprises, including the informal sector of the economy (Chapter VII).

In the following chapter, Chapter VIII, the institutional arrangements for the effective implementation of the competition law are considered, including such matters as the composition of the competition authority, its independence from government and the transparency of its decision-making. Chapter IX discusses the sanctions and remedies that can be imposed once it has been proved that an infringement of the competition law has occurred.

The final chapter reverts to the questions raised above regarding access to the facilities owned by a natural monopoly and what part the competition authority should play in regulating the terms of access.

The principal topics to be discussed in each chapter are mentioned at the beginning of the chapter.

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CHAPTER II

RESTRICTIVE BUSINESS AGREEMENTS

In this chapter the following issues are discussed:

- *Horizontal and vertical agreements*
- *Obtaining evidence of agreements and concerted action*
- *Types of agreement*

Horizontal agreements
- *Collusive tendering*
- *Cartels*
- *Market sharing*

Vertical agreements
- *Resale price maintenance*
- *Exclusive dealing*
- *Tie-in arrangements*

- *Case studies of anti-competitive agreements*

2.1 Horizontal and vertical agreements

Competition law typically prohibits any agreement, arrangement or understanding between independent enterprises that has the purpose or effect of substantially lessening competition or limiting access to a market. This in – principle prohibition applies not only to written agreements but also to oral arrangements and concerted practices. Concerted practices include parallel behaviour by enterprises, which is not the result of the normal competitive process. For example, a simultaneous increase in the prices of particular services may be the result of informal contact between the producers.

In this chapter, for simplicity of exposition, any collective agreement, arrangement, understanding, or concerted action that may have anti-competitive effects is referred to as "an agreement".

The prohibition of anti-competitive agreements covers a wide range of restrictive business practices. Among the most serious breaches of the law are the fixing of prices or output by a cartel, collusive tendering, and market sharing. These are regarded as *per se* offences. That is, the existence of the practice itself is sufficient evidence of a breach of the law. Past experience indicates that such practices substantially lessen competition but do not provide any incentive to improve efficiency.

On the other hand, numerous commercial agreements between suppliers and distributors, franchisers and franchisees, and the members of trade and professional associations do contribute to an improvement in economic efficiency, even though some also have anti-competitive effects. The competition laws in most countries allow enterprises or associations involved in such agreements to apply for authorisation or exemption from them. The competition authority must then weigh up the anticipated gain in efficiency from each particular agreement against any adverse effects on competition. This balancing of benefits against costs is often referred as the "rule of reason" approach in anti-trust cases. If the courts or the competition authority find that an agreement is likely to result in a net public benefit, it can of course remain in place.

It is customary to distinguish between horizontal and vertical agreements. Horizontal agreements are between independent enterprises competing or potentially competing in the same market. Vertical agreements are between independent enterprises at different stages of the production/distribution process – for example between a manufacturing enterprise and its

distributors or between a manufacturer and some of its raw material suppliers.

Horizontal agreements, especially those relating to prices, discounts, output, or the sharing of markets often restrict competition directly or limit access to markets. They may give rise to a number of *per se* offences, as will be explained in more detail later in this chapter. The great majority of vertical agreements involve exclusive dealing, which, depending on the circumstances of each case, may be capable of authorisation or exemption under competition law. However, resale price maintenance, by which a producer gains the agreement of distributors or retailers not to sell the product below a specified minimum price, is prohibited outright in a number of jurisdictions.

2.2 Obtaining evidence of a restrictive agreement or concerted action

How does one detect the existence of a restrictive agreement, such as a price-fixing cartel, which is clearly injurious to competition? This is seldom easy, even in those developed countries, which have a relatively long history of enforcing competition laws. The first problem is that the parties to the most detrimental agreements will want to keep them secret, both to avoid the penalties that the law provides and to prevent customers becoming aware that they are being overcharged. Experience indicates that such agreements are seldom committed to writing.

Secondly, market prices may sometimes vary in a way consistent with either strong competition in the market or the actions of a price-fixing cartel. In a competitive market, businesses are obliged to immediately match price cuts offered by their rivals if they are to survive. But the member firms in a cartel may also make equal price reductions simultaneously if, for example, they have a collective agreement to do so in order to prevent other firms from entering the market.

Thirdly, to prove the existence of an anti-competitive agreement it is necessary to establish that the parties to the agreement were co-operating with one another or were taking concerted action. As noted above, concerted action may take place without any formal contact between the firms concerned, often making it necessary to infer such conduct from market behaviour alone.

Despite these difficulties, anti-competitive agreements can be detected and where necessary brought to an end, by employing one or more of the following means:

- Evidence from customers,
- Evidence from whistleblowers,
- Evidence from new entrants or potential competitors,
- Documentary evidence of an agreement,
- Inferences from market behaviour.

Evidence from customers

Collusive tendering is one restrictive practice which will be obvious to the purchasing officers in large corporations or government departments. In its simplest form, collusive tendering involves an agreement among a number of suppliers that they will submit identical bids in response to an invitation to tender.

A slightly more sophisticated approach is an agreement which provides for each supplier in turn to submit the lowest tender price over a series of tenders. Not only will purchasing officers become aware of such practices, but the tenders submitted will themselves provide written evidence that an anti-competitive agreement exists.

Evidence from whistleblowers

In order to obtain reliable evidence about secret cartels involved in price-fixing or output restrictions, it is often necessary to have the testimony of a senior staff member from a firm within the cartel. To obtain such information and facilitate prosecution of the offenders, several countries, including the United States and the United Kingdom, have recently promulgated plans to offer greater leniency to whistleblowers willing and able to disclose details of the cartel's operations. Further information on this subject may be found in Chapter X Sanctions and Remedies.

Evidence from new entrants and potential competitors

Businesses which have recently entered a market or are considering doing so, are likely to complain to the competition authority if they suspect that their entry is being hindered by an anti-competitive agreement among some of the established firms in that market. For example, a group of manufacturers may have agreed to provide

an additional loyalty discount to selected retailers if they do not deal with the new entrant. Evidence of such an agreement is likely to be obtainable from the entrant and the retailers concerned.

Documentary evidence of an agreement

In most countries, the competition authority, if it believes there has been a contravention of the law, has the power to inspect relevant documents and require individuals to furnish information. A person cannot refuse to provide the necessary documents or information on the ground that the material might incriminate him/her. This obligation to provide relevant information applies to any suspected infringement of the law, including a suspected abuse of monopoly power, an anti-competitive merger, or a restrictive business agreement.

In the case of a restrictive business agreement it is important that the full details of the agreement and the parties to it are known, so that its economic effects can be properly analysed before the matter goes before the Court. The credibility of the competition authority will be endangered if evidence about the agreement and its effect on competition is inadequate or incomplete.

Inferences from market behaviour

As mentioned previously, a simultaneous price reduction by a large number of the firms in a market may not always be indicative of a price-fixing agreement or concerted action. However, if firms accounting for a large share of the market frequently raise their prices simultaneously, without the justification of higher costs, this provides a much stronger indication of a collusive agreement.

What inference can be drawn if the firms in a particular market enjoy persistently high profit margins (relative to costs)? This certainly is an indication that barriers to entry are high, but it is conceivable that barriers are high because of the superior efficiency and brand reputation of the incumbent firms or their control of the sources of cheap raw material supplies. If none of these factors are responsible it must be considered likely that a cartel is operating, perhaps offering loyalty discounts to existing customers in order to deny a potential entrant firm access to the market. This inference would have to be tested by collecting direct evidence of the kind alluded to above.

2.3 Types of restrictive business agreement

Table 2.1 below lists some of the more important types of restrictive business agreement that are prohibited by competition legislation. They are classified as either horizontal or vertical and then according to whether they are *per se* offences or not. It will be recalled from the earlier discussion that *per se* offences are prohibited outright. Those types of agreement included in the table beside the heading 'rule of reason' will usually be assessed by the courts or the competition authority to see whether in the particular circumstances of each case:

- The effect on competition is minimal, or is actually favourable, or

- The agreement is likely to result in efficiency gains, such that the benefits to the public from having the agreement outweigh the detriments caused by the lessening of competition that it brings about.

If neither of these outcomes is likely, action should be taken to terminate the agreement.

Table 2.1 Types of anti-competitive agreement

	Horizontal	Vertical
Per Se Offence	Collusive tendering Price-fixing Output quotas Market sharing Concerted refusal to deal	Resale price maintenance
Rule of Reason	Advertising restrictions Joint purchasing Joint marketing Information agreements	Exclusive dealing Tie-in sales Full-line forcing (Resale price maintenance)

Before proceeding to a brief discussion of some of the types of agreement identified in the table, three points deserve comment. First, an agreement that is beneficial in one situation may be illegal in another. For example, an agreement among a group of small firms to pool their orders when purchasing from a large and dominant supplier may enhance competition in the market. Yet a similar joint purchasing agreement between the only two large firms in a particular market, would create a monopsony and probably result in a substantial lessening of competition.

Secondly, some types of restrictive business agreement are regarded as *per se* offences in some countries but not in others. For example, in most countries resale price maintenance is prohibited *per se.* But, in Australia, as a result of a recent amendment to the Trade Practices Act, the practice may now be authorised in those cases where the competition authority is satisfied that this would result in a net public benefit.

Thirdly, some collusive agreements encountered in practice are quite complex, consisting of two or more types of the agreements shown in Table 2.1. This is particularly evident in the case of international cartels. For example, in the recent animal vitamins case, described in Case Study 2.1 below, it was revealed that the producers concerned had been engaged in fixing the wholesale prices of their products as well as sharing the global market between them.

Horizontal agreements

Collusive tendering

Collusive tendering is regarded as one of the most blatant and unjustifiable types of anti-competitive practice. It is deliberately designed to prevent the participating firms from competing on price and offers no incentive to firms to increase their efficiency.

In its simplest form, collusive tendering involves an agreement between independent enterprises to submit identical bids for one or more jobs. From the viewpoint of the tenderers, this can be a risky method of trying to restrict competition. This is because, if the bids are sealed, it is obvious to the firm inviting the tenders that there must have been collusion (in breach of the law). Secondly, this type of arrangement tends to encourage cheating by

Case Study 2.1 Price fixing and market sharing in animal vitamins

Three of the world's largest vitamin suppliers, F. Hoffmann-La Roche, BASF and Rhone-Poulenc Animal Nutrition and their global affiliates entered into price-fixing and market sharing arrangements for vitamins A and E in various parts of the world.

Senior executives of the companies or some regional affiliates agreed to fix regional wholesale prices and to allocate market shares to individual countries, including Australia and Mexico. The Australian respondents, for example, met and communicated by telephone to make and give effect to price fixing and market sharing arrangements for vitamins A and E and pre-mix containing those vitamins.

The respondent companies agreed that the conduct was covert and clandestine and was engaged in with full knowledge that it was illegal per se under competition law.

The companies involved were the three largest suppliers of animal vitamins in Australia, as well as in other countries. They controlled about 90 per cent of the Australian market for the supply of animal vitamins A and E leaving customers with few alternative sources of supply, especially as the same companies were the predominant manufacturers of these products globally.

The value of sales affected by the collusive arrangements was significant, even in a single country like Australia. The arrangement set the floor price for all sales of the products mentioned above.

This arrangement was brought before the Federal Court in Australia by the Australian Competition and Consumer Commission (ACCC). The respondents (i.e. the Australian affiliated companies) admitted their involvement in the illegal conduct, recognised the serious nature of the offences they had committed and agreed to the penalties imposed by the Court.

In March 2001, the Federal Court imposed penalties totalling $A 26 million on the three companies concerned – the highest aggregate penalty record ed in Australia up to that time.

one or more of the tenderers. In the belief that all of the other firms will submit identical bids at the agreed level, each individual firm can hope to gain extra business by submitting a lower bid. Eventually, cheating of this kind is likely to cause the disintegration of the cartel.

Other more sophisticated forms of collusive tendering may be used to avoid these problems. In particular, the tenderers may agree among themselves on which of them will submit the lowest bid, and which will only bid for the business of certain customers. They may also agree to have a rotation system to ensure that each firm in turn is a successful bidder. Further they may agree to lower their bids by a certain percentage in order to keep a vigorous and efficient competitor out of the market. To maintain the cohesion of the group and prevent cheating, the tenderers will often devise a system for compensating unsuccessful bidders from the profits earned by the successful bidder.

Whichever of these forms of collusive tendering is used, it will be recognised as a *per se* offence under competition law. In some countries, severe penalties can be imposed for this practice. In Kenya, for example, collusive tendering is a criminal offence punishable by up to three years' imprisonment.

Price-fixing

A collective agreement to fix prices is also unlikely to yield any public benefits either by way of greater efficiency in the production of goods and services or improvements in product quality. Yet such an agreement will generally lessen competition and diminish the incentive for the firms involved to introduce new and superior products. It is not surprising therefore that price-fixing is typically regarded as a *per se* offence.

However there are two exceptions to this general rule. First, in some jurisdictions, a list of recommended prices issued by a trade association to its small business members would not be regarded as an infringement of competition law, provided that the prices are only recommended and individual enterprises are free to charge what they like for the goods or services in question. Prosecutions have been launched against trade and professional associations in cases where it was considered that the recommendations were really aimed at achieving uniformity in pricing.

Secondly, cartels which only seek to fix the export prices for certain commodities are typically exempted from the competition law. This is not because they are necessarily beneficial to the public (e. g. such price-fixing may invite retaliation or trade sanctions from the importing countries) but because competition law is generally concerned with the effects of anti-competitive practices on the domestic market alone.

The prohibition that normally applies to price-fixing, extends to the fixing of discounts, rebates and the exchange of price information. It also applies to situations where buyers collude in order to determine the maximum prices that they are prepared to pay for primary and intermediate products.

Output quotas

It is not uncommon for cartels to fix an output quota for each participating firm, as an alternative to fixing the prices at which the good can be sold. The effect of this practice is to prevent the more efficient and the more vigorous firms from expanding their share of output at the expense of those that are less efficient or less vigorous. The upshot is a lessening of competition and, in all likelihood, higher prices to consumers than would have been charged in the absence of the agreement.

Output quotas, such as those administered and monitored by the Organization of Oil Exporting Countries (OPEC) are difficult to enforce because some producers may want to increase output above the allocated amount. In order to maintain cohesion in the cartel, those participants selling above their quota may be required to make payments into a pool which is used to compensate those who have produced less than their quota.

It should be noted that a cartel of this kind is also likely to be vulnerable to competition from non-member firms who can increase their output to take advantage of any price increase that the cartel is able to engineer.

As indicated in the Table above, a collective agreement to set output quotas for the individual participants in a cartel is usually regarded as a *per se* infringement of the competition law.

Market sharing

Market sharing agreements also undermine the competitive process by limiting the scope for the more efficient producers within the group to sell beyond their present geographical territories or to take on customers whom they have not previously

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supplied. This type of restriction is therefore likely to make it more difficult for such firms to lower their unit costs of production through the exploitation of economies of scale. An example of an illegal anti-competitive market sharing agreement is provided in Case Study 2.2 below.

Case Study 2.2 Market allocation by producers of seamless steel tubes

On 8 December 1999, the European Commission imposed fines totalling EUR 99 million on eight producers of seamless steel tubes: British Steel Limited (United Kingdom), Dalmine SpA (Italy), Mannesmannrohren-Werke AG (Germany), Vallouree SA (France), Kawasaki Steel Corporation, NKK Corporation, Nippon Steel Corporation and Sumitomo Metal Industries (Japan). These firms are among the largest producers of seamless tubes in the world. Until 1995, these firms had agreed to keep to their respective domestic markets when supplying certain seamless tubes used in oil and gas prospecting and transportation. The cartel restricted competition in the common market by the requirement that the domestic markets of the different producers be respected in this way.

Concerted refusal to supply or purchase

Restrictive agreements of this kind are sometimes described as boycotts. The participating firms collude with a view to stopping or limiting their sales to particular customers or alternatively stopping or limiting their purchases from particular suppliers. The boycott may not actually be put into effect, but the threat to do so may induce the 'potential victim(s)' to take the course of action prescribed. For example, a distributor may be told that its supplies of certain goods will be withheld unless it agrees to adhere to the resale prices recommended by the manufacturers concerned.

Such action would evidently inhibit price competition among the distributors and would do little if anything towards an improvement in economic efficiency. Accordingly, concerted refusals to supply or purchase are often regarded as *per se* offences in a number of countries.

However, in some circumstances there may appear to be justification for a concerted refusal to deal. For example, a trade association might advise its members not to supply a particular customer who is known to be a poor credit risk. Similarly, a professional association may have rules which deny membership of the association, and thereby the right to practice in the profession, to persons without certain specific qualifications.

There is room for debate about the appropriate action that should be taken in these two cases. In the trade association example, the advice is unlikely to be of concern to the competition authority provided it is not binding on the members. Each member is then free to determine whether it will withhold supplies or not. In the case of professional association rules, one needs to know what risks and dangers the public might be exposed to, if unqualified persons were allowed to practise. This would have to be weighed against the lessening of competition that is caused by the exclusion of certain potential entrants from the market.

Given that, in certain circumstances, a refusal to deal may be justifiable, it may be better if the competition legislation allows for the possibility of authorising such practices rather than prohibiting them outright.

Advertising restrictions

Advertising can often be an effective means of competition, making consumers better informed about the characteristics of different goods and services and different brands while stimulating the demand for products and services which are new to the market. However, competing suppliers sometimes agree not to advertise their goods or services or to limit the amount or the style of the advertising that they undertake. Two examples are provided by barristers, who typically agree not to advertise their fees to the public, and by solicitors who traditionally have eschewed most forms of display advertising.

Such anti-competitive agreements have not always been subject to close scrutiny by the competition authority in the past, since professional rules have hitherto been exempt from competition legislation in a number of countries (e.g. Australia and the United Kingdom). That situation is now changing, and advertising restrictions applying to the professions or other businesses will have to be justified if they are to be allowed to continue.

Joint purchasing and joint marketing

As explained in Chapter VII (Competition Policy and the Small Business Sector), agreements by a group of small firms to purchase or sell goods and services jointly may sometimes have a favourable effect on competition in the market, as well as on the competitiveness of the small firms themselves. In fact, in Germany, the Act against Restraints on Competition has been amended to allow a special exemption for joint purchasing arrangements by small businesses or their trade associations, provided individual firms are able to purchase independently should they wish to do so. The Federal Cartel Office would only intervene in the rare cases in which such an arrangement had a substantial adverse effect on competition.

Joint purchasing and marketing agreements among the leading firms in an industry are much more likely to be anti-competitive. In some cases they could be a partial substitute for a merger, which might lead to a single enterprise dominating the market. Although such joint arrangements may restrict competition to some degree, they may also enable the participating firms to increase their efficiency, perhaps through the economies of scale in purchasing and marketing. Whether there will be a net public benefit from the arrangement will be a matter for the competition authority to decide in the light of the particular circumstances in each case.

Vertical agreements

Vertical restrictive agreements are made between firms at different stages of the production/ distribution process (e.g. between a manufacturer and a wholesaler or a manufacturer and a retailer). Since the firms are not in direct competition with one another but are operating in different markets, there is less likelihood that an agreement between them will substantially lessen competition. Manufacturers and their distributors have a complementary relationship to one another – sometimes described as a principal-agent relationship. Handled properly it can contribute to greater economic efficiency with little adverse effect on competition. For that reason competition authorities are generally less concerned with vertical restraints than with horizontal constraints. Nevertheless there are certain types of vertical restriction that are sometimes prohibited under competition law and these are reviewed briefly below.

Resale price maintenance

Resale price maintenance (RPM) is the practice in which manufacturers seek to fix the retail prices of their products, usually setting a minimum price below which the goods should not be sold, but occasionally setting a maximum price. A manufacturer involved in RPM may unilaterally determine what retail price level he wants and then imposes that on the retailers. More commonly, the manufacturer and retailers will have a joint agreement on the prices to be charged.

RPM obviously stifles intra-brand competition, with the retailers of the same brand unable to compete with one another on price. However, it may encourage inter-brand competition as retailers endeavour to capture economies of scale and scope. Both the manufacturer and the retailers may see benefit for themselves in having RPM and it can be argued that there are public benefits as well.

The public benefits arise principally from the fact that RPM can help to overcome certain problems that would otherwise exist in the supply/distribution chain because of market failure (or so-called 'externalities'). One example relates to the role of retail discounters and their impact on the services offered by the full-price retailers. The latter often offer free demonstrations of new products, fashion shows etc, which the consumers can attend without cost and then, having established what products they want, buy them more cheaply from the discount store. The problem is that this free riding may jeopardise the provision of the special pre-sale services that the full-price retailer has been providing, even though those services are valuable to the consumer. The problem can be overcome to a large extent by the manufacturer refusing to supply the discounters, by entering into exclusive dealing arrangements with the full-price retailers, and/or by introducing RPM.

RPM can also help to prevent cut-throat competition among competing retailers located close to one another and it may contribute to a pattern of retail distribution which is closer to the optimum in terms of the number and density of outlets. Finally, as mentioned above, it can assist retailers to achieve economies of scale and scope.

This should not be taken to imply that RPM is an unmixed blessing, particularly in developing countries. While RPM restricts intra-brand competition, this cannot be offset by a strengthening of inter-brand competition, if only one brand is being sold in the market. Yet this is

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often the situation in developing countries. Business concentration tends to be significantly higher than it is in developed countries because aggregate national income is much smaller and demand for branded goods correspondingly less, leaving room for only one or two major suppliers of each item.

Given these circumstances, developing countries are likely to continue to treat RPM as a *per se* offence although the trend in developed countries is to authorise RPM when there are demonstrable public benefits.

Exclusive dealing

Exclusive dealing is a very common commercial practice. It occurs when a manufacturer makes the supply of goods to its distributors or retailers conditional upon them not buying the goods of a competing manufacturer. Nearly all franchise agreements contain provisions of this nature.

Exclusive dealing will only represent an infringement of competition law if the purpose or effect of the agreement is to substantially lessen competition in a market. A case decided in the Federal Court of Australia in December 2001, involved two major record companies who were alleged to have cut off supplies to retailers who stocked parallel imports of Top 40 compact discs. The Judge found that their actions had breached the exclusive dealing provisions of the Trade Practices Act and they were also guilty of misusing their market power.

A different outcome resulted from a consideration by the Zambia Competition Commission of an exclusive dealing agreement in the local dairy industry. A brief summary of that case is given below.

Tie-in Sales and Full-line forcing

Tie-in Sales occur when a firm or group of firms require buyers of their products to take other products which they would not otherwise purchase. In the extreme case of full-line forcing, a purchaser is obliged to buy the entire range of goods produced by the firms in order to obtain the one or two that are really needed.

For a manufacturer it may be a profitable strategy to appoint exclusive distributors for its products and then insist that they stock the whole range (e.g. cosmetics, quality furniture). This ensures that the products are advertised more effectively and customers are saved the costs of shopping around.

However, in other circumstances tying arrangements can have a serious adverse effect on competition, allowing a firm already dominant in one market to extend its dominance to another. In its long-running case against Microsoft, the United States Department of Justice claimed that the company was tying its web browser to its PC operating system, where it had a monopoly. The effect would be to strengthen Microsoft's share of the web browser market and thus lessen competition in that market. (In the event, the Department of Justice decided in September 2001 that it would not pursue the claim of an illegal tying arrangement in order to focus on the fact, upheld by the Court of Appeals, that Microsoft had engaged in exclusionary conduct with the objective of illegally maintaining its monopoly in the market for PC operating systems.)

Concluding Remarks

This chapter has illustrated the wide range of restrictive business agreements that actually or potentially impinge on competition. While some types of agreement can weaken the extent of competition in a market without bringing any gain in efficiency, there are others where fine judgment is required to determine whether, in the particular circumstances of the case, the agreement is likely to bring a net public benefit.

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Case Study 2.3 Exclusive Dealing in the Zambian Dairy Industry

Parmalat, an Italian owned company which is understood to be the second largest dairy producer in the world, acquired a majority interest in Bonitta Zambia in 1998. It then set about restructuring and rationalising its distribution network. This included demarcation of the market into exclusive territories and the supply of refrigerated containers to distributors. In 1999, the company held about 60% of the national market for fresh milk and about 20% of the market for fresh fruit juice.

Parmalat Zambia, as it is now named, drew up agreements with some 15 distributors in various parts of the country, binding them for one year not to distribute competitors' products. For its part Parmalat agreed that in each demarcated territory it would sell only to the designated distributor for that territory. The distributor in turn was not to resell outside his assigned territory. These exclusive agreements were between Parmalat and the distributors alone. Retailers were not directly involved.

Under the arrangements Parmalat also supplied a refrigerated container to each distributor so that retailers could obtain supplies of milk and fruit juice from that source. The wholesalers were given a loan to purchase the container and the loan was easily repayable within months, rather than years.

The Competition Commission considered that these exclusive distribution agreements were not likely to be anti-competitive because:

- Other dairy suppliers enjoy unrestricted access to the retail outlets,
- Major supermarkets like Shoprite and Melissa stock milk and fruit juice products from different manufacturers who apparently make direct deliveries,
- The distributors have no exclusive rights in respect of retailers,
- The distribution agreements are aimed at making Parmalat's distribution system efficient and effective,
- The industry players contacted by the Commission stated that they had not been adversely affected by the exclusive distributorship agreement.

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CHAPTER III

THE ABUSE OF MARKET POWER

In this chapter the following issues are discussed:

- *The legal and illegal use of market power*
- *Establishing whether there is market dominance*
- *Some restrictive business practices that may be used by a dominant enterprise to substantially lessen competition:*
  - *Predatory conduct (including predatory pricing)*
  - *Price discrimination*
  - *Refusal to supply*
  - *Tie-in sales and bundling*
  - *Allocation of markets*
- *Recent cases involving the alleged abuse of a dominant market position*

3.1 The legal and illegal use of market power

In the previous chapter, the focus of attention was on collective agreements, arrangements and understandings between business enterprises, which may restrict competition. In this chapter, the focus is on the conduct of a single enterprise (sometimes jointly with another) whose intention is to lessen competition or deter other firms from entering the market.

Such conduct is unlikely to achieve its aims unless the enterprise is in a dominant position in a market. If, for example, an enterprise refuses to supply certain goods to a competitor, the latter would, in a competitive market, be able to obtain the goods at a satisfactory price from an alternative source. However, if the enterprise occupies a position of dominance in the market, there are likely to be few, if any, alternative suppliers able to provide those goods on reasonable terms and conditions. The dominant supplier could therefore succeed in its objective of damaging the competitor's business.

The abuse of dominant market power is prohibited in almost every country that has a competition law. In some, it is a criminal offence, which may be punishable by a term of imprisonment. Generally, such conduct is a per se offence that cannot be exempted or authorised on the ground of public interest.

However, it is important to recognise that an enterprise is not in breach of the law just because it has a monopoly or occupies a dominant position in a market. To quote a well-known dictum from a United States anti-trust judgment … *'Mere size is no offence'*. Indeed, in a market in which there are substantial barriers to entry, a dominant firm may be able to maintain its market position and continue to earn above-normal profits for a lengthy period, quite legally.

What the competition laws prohibit is the deliberate exploitation of a dominant market position in order to damage competitors, prevent other enterprises from entering the market, and lessening competition in the market generally. The case studies to be found later in this chapter illustrate how the law has been applied by the courts and competition authorities in recent years.

First, however, some questions about market dominance need to be answered. Which markets tend to be dominated by only one or two enterprises and what factors lead to this continued dominance?

Natural monopolies

In both developed and developing countries some markets are regarded as 'natural monopolies'. This is because economies of scale become progressively greater as output increases, up to the limit set by market demand. In this situation, the lowest possible unit costs of production can only be realised if there is a single efficient producer. If a second producer were to enter the market with the aim of duplicating the facilities of the existing monopolist, both would incur losses.

In developed countries, natural monopolies are found mainly in industries with extensive capital-intensive distribution networks, such as electricity transmission, water supply, telecommunication services and railways. Now that many of these industries have been privatised, government regulation has become necessary to ensure that prices are not excessive and that other competing enterprises can gain access to these networks on reasonable terms.

The question of access to essential facilities and the possible role of the competition authority in this matter is discussed in Chapter X.

In many small developing countries, the low-income levels limit the demand for locally manufactured consumer products, industrial materials, and capital equipment. If the domestic manufacturers of these products use a technology similar to that in use abroad (as they may need to, to compete with imports) the limited demand, coupled with economies of scale, means that there will be fewer firms, and higher levels of concentration, than in the corresponding markets in the developed countries, where demand is greater. The markets for manufactured goods in small developing countries are not natural monopolies in the usual sense of the term, but there is some similarity. In both cases, economies of scale help to explain why only one or two enterprises are likely to dominate the local market.

Other factors leading to high barriers to entry and market dominance

Market dominance, as interpreted by the courts in recent years, means that the enterprise has a measure of control of the market, so that it can vary its prices or the quality of its products to some extent, without being greatly concerned with the reaction of its competitors, its suppliers, or even its customers.

That degree of market control cannot exist unless the enterprise concerned is protected by relatively high barriers to the entry of new firms and is not subject to strong import competition or countervailing power from its customers. In fact, a firm, which accounts for 60 per cent or more of the local market, may not be in a dominant position in that market, if it is constrained in its pricing and other business strategies by the threat of potential entry or the threat of a substantial increase in competing imports.

By identifying those local, national, regional or global markets in which barriers to entry are high and imports low, one can get closer to finding the markets in which an enterprise may be able to sustain a position of dominance. As far as local markets are concerned, stone quarrying is an example of an activity where a single enterprise may be able to exercise dominant market power. The existing enterprise may own the only low-cost source of supply in the locality, with high transport costs preventing customers from obtaining supplies from more distant quarries. Because there are many individual customers ranging from small private buyers to public authorities, the purchasers as a group may not be able to exercise much countervailing power.

While competition in many local markets is limited primarily by high transport costs, several other factors may account for restrictions on competition in national and global markets. In particular, tariffs and import quotas may allow a domestic firm to maintain a dominant market position in some markets for manufactured goods while restrictions on direct foreign investment can have a similar effect in domestic markets for both goods and services.

High barriers to entry are clearly a significant factor in some markets in insulating an existing dominant firm from actual and potential competition. The factors that cause the barriers to be high differ from market to market, sometimes being attributable to government regulation and at other times to patents, the reputation built up over several years by a company's brands, or the ownership of intellectual property rights or scarce natural resources. Table 3.1 below lists the principal factors that cause high barriers to entry and examples of the national and global markets in which they occur.

Table 3.1 Markets with high entry barriers

Nature of the barrier	Markets affected
Brand reputation/advertising	Breakfast cereals, toilet soap, photographic film, beer
Intellectual property rights	Pharmaceuticals, certain computer software
Ownership of natural resources	Diamonds, mineral sands
Government regulation	Postal services, national airlines
Innovation & R & D	Computer hardware
Economies of scale	Electricity transmission, water supply, telecommunications

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It is useful to consider in what other markets barriers to entry are high and the principal factors that account for the high barrier in each market.

3.2 Establishing whether there is market dominance

In assessing whether or not a dominant enterprise has abused its position of market power, three issues have to be considered by the competition authority or the Court.

- Market definition
  - In which market(s) may the enterprise have a dominant position?
  - In which market(s) may the conduct of the enterprise have adversely affected competition?

- Market dominance
  - Does the enterprise dominate a market?

- Abuse of dominant market power
  - Has the enterprise taken advantage of its dominant position in a market to substantially lessen competition? If so, how was this done?

The issues of market definition and market dominance are closely related and are considered in this section. The ways in which the dominant enterprise may abuse its market power are discussed in the next section of this chapter.

The definition of the market is an important issue that can often determine the outcome in cases of alleged abuse of market power and proposed mergers and acquisitions. Typically, lawyers for the defendant business will want to define the market broadly, since the enterprise will generally account for a smaller share of the output or exercise a lesser degree of control, the more broadly the market is defined. The competition authority, in prosecuting the case, will probably argue for a narrower definition, including the goods or services supplied by the enterprise concerned and a few close substitutes.

It should not be overlooked that there is also a geographical dimension to a market, so that an enterprise that does not have a dominant position in the national market, may nevertheless be dominant in some State or local markets.

In seeking to determine the boundaries of a particular market, a test commonly applied by competition authorities is to ask the following question. If a hypothetical monopolist increased the price of a particular product by a small but significant percentage (say 5 per cent), would its customers be likely to switch a moderate fraction of their custom within a relatively short period, to some other products or to suppliers from other geographical regions? If the answer is in the affirmative, the implication is that these products or the supplies from other regions are close substitutes for the monopolist's product and should be included within the boundaries of the market. (a case study of market definition in the Australian banking industry may be found in Chapter IV Case Study 4.1)

The possibility of supply-side substitution should also be considered. Given an increase of 5 per cent in the price of the hypothetical monopolist's product, some enterprises may elect to switch part of their production facilities to manufacturing that product. This additional output should also be included as part of the relevant market.

In a case of alleged abuse of market power, more than one market may have to be defined – the market in which the enterprise is said to be dominant and the market or markets where competition is apparently being damaged by the conduct of that enterprise. To take a hypothetical example, a firm may have an effective monopoly in a particular country in the manufacture of paperboard for cardboard boxes. It also manufactures cardboard boxes itself, but in that market it has several competitors with similar market share. If the firm raises the price of paperboard substantially to take advantage of its monopoly power in the upstream market, it is likely to weaken competition in the cardboard box market. Such action would almost certainly be regarded as an abuse of market power.

Once the issue of market definition has been resolved, it is possible to address the question of whether an enterprise has a dominant position in that market. Dominance is sometimes assessed by reference to the firm's share of market turnover. A share of 40 percent or above may be taken as an indication that the firm has control of the market, at least to some degree. However, by itself, market share can be misleading, as the following illustration shows.

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Suppose that a domestic manufacturer of motorcycle crash helmets has 65 per cent of the national market for that product, with three other domestic manufacturers each having less than 10 per cent. Imports account for about 12 per cent of the market, but are generally regarded as being of high quality and representing good value at current prices.

In that situation, the major domestic manufacturer may well be restrained in its ability to increase its own prices, because of the risk that this would result in a substantial increase in imports. Despite its large share of the current market, it cannot be said to control that market.

A more appropriate general definition of a dominant market position is that adopted by the European Court in United Brands v. EC Commission (1978):

> '*…a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers, and ultimately of consumers'.*

The definition included in the United Nations Set of Principles and Rules on Competition ('the Set') 2000, adds the point that sometimes two or more enterprises may jointly have a dominant position.

> *'Dominant position of market power refers to a situation where an enterprise either by itself or acting together with a few other enterprises, is in a position to control the relevant market for a particular good or service or group of goods or services'*

In assessing whether a particular enterprise has a dominant market position, the competition authority needs more specific indicators to establish whether or not the enterprise can control the market. These will include:

- Market share,
- The nature and height of barriers to entry,
- The strength of import competition (actual and potential),
- The extent of countervailing power from buyers of the good or service,
- The vigour of competition from smaller enterprises in the market,
- Obstacles to direct foreign investment in the market.

3.3 Some restrictive practices that may be used by a dominant enterprise to substantially lessen competition

In many countries, the guidelines to the competition law provide examples of the types of conduct by a dominant enterprise that would be in breach of the law. As mentioned previously, such conduct cannot be authorised or exempted.

This section analyses briefly six types of restrictive business practice commonly used by dominant firms to lessen competition or prevent other firms from entering the market. The practices described are sometimes used by government-owned enterprises as well as by private enterprises. If the benefits of competition are to be fully realised, the law should be applied with equal severity to both public and privately owned enterprises.

The restrictive practices discussed below are:

- Predatory conduct (including predatory pricing),
- Price discrimination,
- Raising barriers to entry,
- Refusal to supply,
- Tie-in sales and bundling,
- Allocation of markets.

Summaries of some recent court cases involving the alleged use of one or more of these practices are provided to illustrate the points raised in the discussion.

Predatory conduct (including predatory pricing)

Predatory pricing involves a dominant firm setting unusually low prices for a limited period with the intention of driving some small competitors out of the market. In pursuing that strategy the firm expects to be able to increase its prices in the medium to long-term, once the competitors have been excluded. Thus, higher profits in the future will more than compensate for the profits sacrificed in the current round of price cuts.

Initially, consumers will benefit from lower prices for the particular good or service. However, as competition is reduced or is eliminated,

consumers will pay much higher prices than they would have done if the dominant firm had not engaged in predatory pricing.

In some countries, predatory pricing appears to be rare. In the United States, for example, the Federal Trade Commission (FTC) reports that in recent years there have not been any violations of the antitrust laws on this count. This may be partly because predatory pricing is difficult to distinguish from strongly competitive pricing during the early stage of price-cutting.

Evidence of predatory pricing can be found in two main ways. First, there may be incriminating letters, documents or recorded conversations which indicate that the dominant firm intended to eliminate one or more competitors from the market. (this was an important factor in a recent Australian case (Australian Competition and Consumer Commission v. Boral Ltd. & Anor (2001)). Secondly, predatory pricing may be inferred in some circumstances, when the dominant firm sets prices well below its cost of production and distribution.

The European Court in recent judgments has concluded that predation can be **assumed** if the dominant firm has cut its price for a particular product to below the level of average variable cost. At this level the firm is not even covering the labour, material and services costs that vary with output, let alone the fixed costs such as interest and capital charges. It would appear irrational for the firm to cut prices to that extent unless it expected to be able to increase its prices substantially in the near future – most probably by eliminating some of its competitors.

Could this pricing strategy have an alternative explanation? One possibility is that the product concerned is being used as a temporary loss leader. Once it has succeeded in attracting business to the firm, the price of the product will be moved back to a higher level. This is a common commercial practice and is not necessarily anti-competitive. However, it is unlikely that the firm would cut the price of a loss leader product to less than average variable cost, because of the difficulty of recouping that loss later. In any case, a firm in a dominant market position may have little need to employ a policy of loss leadership as a means of augmenting its long-run profits.

The European Court also considered the situation in which a dominant firm was setting its prices above average variable cost but below average total cost. It held that this might be an indication of predatory pricing, but the evidence was not conclusive, unless it could also be confirmed that the firm was intending to damage a competitor or prevent entry to the market.

A dominant firm may resort to other forms of predation besides predatory pricing. In particular, it may attempt to raise competitors' costs by charging high prices for a basic input, which it alone can supply. It may also deter entry to the market by raising the "sunk costs" that would have to be incurred by an entrant. (Sunk costs are those costs that an entrant would not be able to recover if it was later forced to leave the market under the pressure of competition). This might be achieved, for example, through:

- Heavy advertising outlays,
- The payment of "slotting fees" to retailers for the reservation of shelf space displaying the company's products.

Finally, the dominant firm may succeed in foreclosing the market to new entrants by building capacity in excess of the market's current requirements. Even an announcement that it is planning to build additional capacity, whether it intends to do so or not, may be sufficient to deter a potential entrant.

Price discrimination

Article 82 of the EEC Treaty prohibits an undertaking in a dominant position from abusing that position by…

> *'applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage'*

Similar provisions are to be found in the competition laws of many other countries.

This competition rule does not mean that a dominant enterprise must charge an identical price to each purchaser of a particular good or service. Some price differences may simply reflect the different costs involved in supplying one customer compared with another. For example, it is often less expensive (per unit) to satisfy a large order than a small one. Differences in transport cost may account for the fact that customers at a distant location pay higher delivered prices than those nearby. Retailers may charge different prices for the same product at different times of the year to clear surplus stocks.

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However, if the differences in prices are not justified by corresponding differences in the cost of supply and they are intended to limit or prevent competition, there is an infringement of the law. This is illustrated by a case decided by the European Commission in June 2001, involving the French tyre maker Michelin. (see Case Study 3.1 below)

Refusal to supply

It may be profitable for a dominant enterprise to refuse to supply a customer with a necessary input if it is competing with that customer in a downstream market. In a well-known Australian case (Queensland Wire Industries Pty. Ltd. v. B.H.P, (1987)) the latter company was the sole manufacturer of a steel section, known as Y-bar, which was used to manufacture steel fencing posts. It supplied its own subsidiary with Y-bar but refused to supply Queensland Wire. a competitor of the subsidiary in the rural steel fencing market. While BHP, through its subsidiary, was able to offer a complete fencing system to fencing contractors and others, it was preventing Queensland Wire from doing so, by denying it supplies of Y-bar. Customers of Queensland Wire were obliged to purchase their requirements of steel fencing posts from the BHP subsidiary.

The lower courts did not find that BHP had misused its dominant market position (in Y-bar) to lessen competition in the downstream market. However, on appeal to the High Court, this position was reversed by unanimous decision of the judges.

Are there any circumstances in which a refusal to supply by a dominant firm can be justified on economic grounds? The answer seems to be that there can be such circumstances, particularly when a dominant manufacturer has to determine a policy on the retail distribution of its products. If the manufacturer was obliged to supply all retail outlets that wished to stock his products, this could have adverse implications for his costs and for consumer welfare. For example, suppose that discount retailers were able to sell certain, high-quality beauty care products, previously sold only through department stores, which provided free advice and demonstrations. Although these latter services evidently have a value to consumers, they cannot be charged for separately. The discount retailers may not provide such services but could free-ride on the services offered by the department stores, placing the continued existence of these services at risk.

A selective retail distribution policy is a normal business practice, which is often justifiable on economic grounds. For example, it is appropriate and legal for a manufacturer to refuse to sell to dealers whose creditworthiness is suspect or to those dealers who lack the facilities to display the product to advantage. Even firms which are dominant in upstream markets will not necessarily lessen the competition among retailers (intra-brand competition) by choosing to distribute their products through a limited number of retail outlets.

Case Study 3.1 Abuse of market power in the French tyre market

Dominance:
Michelin has a market share in excess of 50 per cent of the market for new replacement tyres for heavy vehicles in France. Its share of the French retread market is even higher. None of its competitors are comparable in size.

Abuse of a dominant position:
The European Commission established that Michelin operated a complex system of quantitative rebates, bonuses and commercial agreements which constituted a loyalty-inducing and unfair system vis-à-vis its dealers.

Michelin's commercial policy for both the retread and the new Replacement tyre market had the effect of keeping dealers in close dependence and preventing them from choosing their suppliers freely between 1990 and 1998. This policy which artificially barred competitors' access to the market was suspended by Michelin in January 1999.

The European Court of Justice in recent cases has ruled that quantity rebates with exclusionary effects are illegal when granted by a company in a dominant position for more than three months.

Penalty:
The Commission imposed a fine of ECU 19.76 million on Michelin which was given two months to pay or appeal the decision to the European Court of First Instance.

Source: European Commission Press release, 20 June 2001

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Any lessening of competition which does occur must be weighed against the benefits arising from the selective distribution policy.

An area of greater concern to competition authorities in recent years has been the downstream activities of newly privatised "essential services", such as telecommunications, and electricity supply. The new owners of the network of telephone lines and electricity transmission lines remain dominant, (having a natural monopoly), but face competition in wholesale and retail supply from a number of smaller companies. Unless there is appropriate regulation in place, the dominant firms can take advantage of their market power and improve the position of their downstream affiliates, either by refusing to supply the smaller downstream competitors or, more commonly, by charging excessive interconnection fees to those companies. This can have a serious detrimental effect on downstream competition. A more detailed discussion of this matter may be found in Chapter X.

Tie-in sales, bundling and full-line forcing

A sole supplier of a product in high demand may, as a condition of the sale, require its dealers or customers to buy other goods or services from it. In the extreme case of 'full-line forcing', the purchaser is obliged to take the whole range of products, if he wants any one or more. Tie-in sales or bundling usually involve a requirement to buy at least one other specified product in addition to the product the purchaser wants.

This practice allows the dominant firm (the monopolist in this case) to maintain or strengthen its market power by unfairly damaging its competitors' business and foreclosing the market to prospective entrants.

One of the most-publicised cases of alleged tying in recent years involved Microsoft. The United States Department of Justice contended that Microsoft has a monopoly in the market for PC operating systems and uses this market power to require purchasers to also buy its web browser (where it faces some competition from two major corporations). In the event, the Department decided, in September 2001, to drop this particular charge and focus on the core allegation that Microsoft had engaged in exclusionary conduct with the intention of maintaining its monopoly in the market for PC operating systems. The latter charge has been upheld so far by the District Court and the Court of Appeals. Further Court hearings are expected in 2001-2002.

The allocation of markets

It is common for a supplier to allocate to its distributors particular markets where they are authorised to resell the product. The allocation may relate to a particular territory or to a given class of customer. The supplier may take measures designed to prevent each authorised distributor from reselling the product outside the territory (or customer class) that has been assigned to it. The purpose of such an arrangement is usually to ensure that intra-brand competition among distributors is minimised and resale prices are maintained at the highest level that each market will bear.

A firm with substantial market power is in a position to enforce such exclusive dealing arrangements because most of its distributors will be unwilling to take the risk of having their dealerships terminated if they resell to customers outside the specified territory or customer class.

Terminating or threatening a dealership for this reason will usually represent an infringement of competition laws. Moreover if the market allocation arrangements prevent distributors from selling the product outside the particular countries, which are assigned to them, international trade will be impeded and potential export opportunities lost.

In a recent case, the European Commission fined Volkswagen ECU 102 million (reduced to ECU 90 million on appeal) for systematically forcing its authorised dealers in Italy to refuse to sell Volkswagen and Audi cars to foreign buyers. The Commission found that the conduct of Volkswagen represented "…a very serious infringement of Community competition law".

For further detail on this case see the following Case Study 3.2:

Case Study 3.2 Market-partitioning by Volkswagen/Audi

Volkswagen/Audi is the largest motor manufacturing group in Europe. In 1995, the European Commission received a large number of complaints from consumers, particularly from Austria and Germany, that they had had difficulty in buying new cars in Italy. At the time, prices were relatively low in Italy, reflecting exchange rate movements.

Volkswagen, Audi and Volkswagen's Italian subsidiary in concert with their Italian dealers had devised a strategy to prevent or restrict sales from Italy to other Member States, especially Germany and Austria. In pursuing this market-partitioning strategy, the Group had engaged in a number of illegal practices including the following:

– Some dealers who sold to foreign customers were threatened with termination of their dealerships. A few were actually terminated.

– The profit margins and bonuses of authorised dealers who sold outside their allotted territories were systematically reduced.

– Deliveries to Italian dealers were rationed.

Documents found in the course of the investigation showed clearly that Volkswagen and Audi were well aware that these practices were unlawful under European competition law.

In its decision, the Commission imposed a very substantial fine of ECU 102 million on Volkswagen, which was reduced to ECU 90 million in 2001 on appeal to the European Court. The companies concerned were also required to remove from their dealership contracts all clauses restricting or prohibiting the sale in Italy of new vehicles to final consumers, authorised intermediaries or authorised dealers from other Member States of the European Community.

Source. European Commission (1998), European Court of Justice - Judgement (July 2000)

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CHAPTER IV

THE CONTROL OF MERGERS AND ACQUISITIONS

In this chapter the following issues are discussed:

- *What is a merger?*
- *Types of merger*
- *Why merger control is needed*
- *Pre-merger notification*
- *Evaluating the likely effects of a merger on competition*
- *Market definition*
- *Possible public benefits of a merger*
- *International co-operation in merger control*
- *Case studies of some recent merger decisions*

Background

The two previous chapters were concerned with anti-competitive **conduct** by business firms, resulting from either, agreements or understandings with other firms, or individual firms taking advantage of their dominant position in certain markets. Merger controls, however, are not aimed directly at stopping anti-competitive conduct, but at preventing those mergers or acquisitions that would allow one or two firms to attain or strengthen a dominant market position. In other words, in merger investigations, the focus of attention of the competition authorities is on the probable future **structure** of the market after the merger, rather than the current conduct of the market participants.

Many thousands of mergers and acquisitions take place each year. In the United States alone, almost 5,000 mergers were notified to the anti-trust authorities in the year 2000, up from just over 1,500 in 1991. The vast majority of these reported transactions were relatively small and would be unlikely to lead to market dominance or a substantial lessening of competition in any market. They were quickly cleared by the anti-trust authorities.

At the other end of the scale, 288 proposed mergers with a transaction value exceeding US$ 1 billion each, were reported in the U.S. in the year 2000. Many of these involved the merger of two or more firms currently competing with one another in some product or service markets. If those competing firms formed a single business entity through a merger, there is a *prima facie* argument that competition in the relevant markets would be significantly lessened. However, a detailed investigation may have to be undertaken to establish the validity or otherwise of this argument, taking account of the particular circumstances of each case.

Apart from the effects of a proposed merger on competition, consideration has to be given to the public benefits, such as efficiency gains, that could be achieved if the merger is allowed to proceed. The final decision of the competition authority to allow a particular merger will depend on whether the public benefits of the merger are judged to outweigh any adverse effects on competition. In some cases, a merger will not be permitted unless the proponents agree to the divestment of certain businesses or physical assets. Divestment was required, for example, before approval was given to two recent major mergers in the petroleum industry, Exxon/Mobil and BP/Amoco. Such divestments help to preserve competition in the relevant markets and thereby ensure that the merger will yield net benefits to the public.

Developing countries have a vital interest in mergers involving major foreign corporations as well as mergers of locally owned enterprises. Mergers of foreign parent companies are likely to result in less competition among their subsidiaries operating in a developing country, with the result that domestic output may be reduced and the prices of some goods or services raised above pre-merger levels. Even if a merger takes place between two

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foreign corporations, which have no direct presence in a particular developing country, there may be implications for competition in that country through the effect of the merger on trade flows and foreign investment. With increasing globalisation and freer trade, the effects of international mergers on the economic wellbeing of developing countries are likely to be more pronounced than in the past. That is one reason why it will be advantageous for the competition authorities in the developing countries to cooperate with their counterparts in the industrialised nations in evaluating the likely effects of large-scale international mergers.

Given the complexity of merger analysis and the detailed information needed on such matters as markets, barriers to entry, imports and potential efficiency gains it is not surprising that merger enforcement utilises a relatively large proportion of the resources available to competition authorities. In the United States, for example, more than half of the competition resources of the Federal Trade Commission have, on average, been dedicated to merger enforcement. But in periods of strong economic growth, when merger activity tends to be high, the proportion is considerably greater. In the year 2000, more than two-thirds of the Commission's competition resources were involved in merger inquiries.

In developing countries with a competition law, one also finds that mergers and acquisitions become a major focus of attention for the competition authority. There appears to be several reasons for this. First, large-scale mergers are highly visible and are widely reported, thus requiring some positive and prompt action by the competition authority. Moreover, the competition law generally requires that a decision on a merger proposal must be made within a few weeks of the proposal being put before the authority. Secondly, in small developing countries, concentration tends to be high in many key markets, especially in the manufacturing sector (e.g. beer, cement and soap). In this situation, and in the absence of strong import competition, a merger will often result in one or two firms attaining or strengthening a dominant position in the market. The competition authority must be alert to this threat to competition and only permit such mergers if they offer the promise of substantial efficiency gains.

We now turn to a detailed discussion of merger control from a practical perspective.

4.1 What is a merger?

As noted above, the objective of legislation to control mergers is to prevent a business from attaining or strengthening a dominant position in a market, with the likely consequence that competition in that market will be substantially lessened. Given that the central concern is with the effects of the merger on competition, it is important to have a broad definition of a merger encompassing all those forms of "merger-like" transactions, which could impact on competition. Such transactions include:

- The acquisition of a majority shareholding in a target business,
- The acquisition of a minority shareholding which gives effective control of the target business,
- The acquisition of the assets of a target business, which then ceases to operate,
- The establishment of a joint venture by two or more firms with products which overlap,
- The appointment of interlocking directors to the boards of two businesses which were previously independent of one another.

The common feature of these transactions is that two (or more) businesses that were distinct before the merger cease to be distinct after it has taken place.

However, that does not necessarily mean that competition in a market will be substantially reduced as a result of a merger. First, the two distinct businesses may have been operating in different markets with no significant overlap in the products or services they were buying or selling. Since they were not competing before the merger, it cannot be claimed that the merger will cause a reduction in competition.

Secondly, if the market under consideration is already dominated by a single enterprise, a merger of two rivals of lesser size may actually stimulate competition by putting competitive pressure on the dominant firm which was previously absent.

Thirdly, a merger of two firms purchasing similar goods and services may allow the merged entity to exercise stronger countervailing power against a dominant supplier of those goods or

services. The result could be a reduction in the price of those inputs and possibly a reduction in the price of the final product to consumers.

Fourth, a merger of two enterprises competing in the same domestic market, may not have a significant effect on competition in that market if imports account for a large fraction of total supplies and effectively determine the price level for the products concerned.

Moreover, small-scale mergers which only give the merged entity a small share of the relevant market will usually not be of concern to the competition authority. Although the threshold differs from one country to another, the authority will generally not intervene in a merger case if the combined enterprise will have a market share of less than 15 - 20 per cent.

The competition law of many countries, including some developing countries, now includes a requirement that the competition authority shall be notified in advance by the potential acquirer of a proposed merger or joint venture if the transaction will exceed a certain size. The advantages of pre-merger notification and the threshold levels that apply, are discussed in a later section of this chapter.

4.2 Types of merger

It is customary to classify mergers into three types**, horizontal, vertical and conglomerate.** Horizontal mergers involve businesses, which are, (or could be within a short period) direct competitors in the same market, buying or selling similar goods or services. Horizontal mergers are likely to pose the greatest threat to competition and therefore are of most concern to the competition authorities.

Vertical mergers involve the acquisition by a business of one of its major suppliers, distributors or business customers – that is a firm at an earlier or later different stage of the same production chain. Many such acquisitions will have little adverse effect on competition, although problems can arise if either the acquiring firm or the target already has a dominant position in its market. For example, if a motor vehicle manufacturer takes over the sole supplier of a key component, other vehicle manufacturers who use this component may be disadvantaged.

A conglomerate merger is one in which the businesses concerned operate in different markets and do not supply goods or services to one another. The motivation for such a merger is often to allow the acquiring firm to diversify its product range or extend its geographical coverage without the need to build new capacity, and/or to obtain synergistic benefits from bringing the two organizations together. Conglomerate mergers rarely cause a substantial lessening of competition.

Most of the mergers notified to the competition authority are horizontal mergers or joint ventures. In Australia, for example, just under two-thirds of mergers notified to the Australian Competition and Consumer Commission in the two years 1997-98 and 1998-99, were horizontal. Since the Commission is more likely to raise objections to a horizontal merger (compared with other types), the proponents of such a merger will be more inclined to provide advance notification, rather than run the risk of having to unscramble a merger, which has already been consummated.

Finally, mergers of very large and diversified business corporations will often contain horizontal, vertical **and** conglomerate elements. In order to overcome objections to the merger by the competition authority, the combined entity may be required to divest itself of some activities where there is overlap between the products and services of the acquiring and the target business. Stripped of all or most of these horizontal elements in the merger, the remainder of the transaction may yield substantial economic benefits.

4.3 Why merger control is needed

The case for the control of mergers rests on the view that it is needed to prevent increasing concentration in the market and market dominance by one or two enterprises. To allow all mergers to go unchecked would mean that, in some markets at least, competition would be substantially reduced, leading to a less efficient allocation of resources, higher prices, diminished incentives to innovate, and less pressure on firms to keep down their costs.

This view in favour of merger control does not go unchallenged by the business community. They often argue that almost all merger transactions, including horizontal mergers, are motivated by a desire to improve efficiency and lower costs, not to gain monopoly profits. In fact, as they point out, monopoly profits could not arise unless there are substantial barriers to entry into the market. It

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would be better to have policies to reduce such barriers, rather than prohibiting so-called anti-competitive mergers.

A common complaint from business is that, because of the way merger policy is being implemented, firms in small countries are unable to achieve the economies of scale and "critical mass" that are needed for them to be competitive on world markets. Rationalisation is seen as essential to achieve international competitiveness, because costs cannot be minimised if there are more than one or two firms operating in the domestic market. Mergers and takeovers are seen to be the quickest and most economical means of achieving the necessary rationalisation, yet it is believed that the competition authority will not permit such an acquisition if it would result in a monopoly or oligopoly situation.

This view is partly based on a misconception about the way proposed mergers and acquisitions are assessed under competition legislation. In most countries, the competition authority can, or is required by law to, take account of any efficiency gains that would result from a merger or take-over, and to balance those gains against the likely detriments caused by the reduction in competition. Even a merger, which would result in a monopoly in the market, could be allowed if the efficiency gains are sufficiently great.

However, the authority is likely to object to a proposed merger, even if it is expected to yield significant efficiency gains, if comparable gains can be obtained by an alternative route with less adverse effects on competition. For example, a firm may be able to obtain the necessary economies of scale to compete successfully on world markets, either by internal growth or by acquiring a firm (or firms) with a relatively small share of a large overseas market. Either of these alternatives is likely to be regarded as preferable to the creation of a monopoly in a domestic market.

The business view, that large scale is essential in order to be competitive on world markets has been criticised by a number of economists. First, they point out that the emphasis on economies of scale reflects a static view of the sources of competitive advantage. Dynamic factors, such as product and process innovations, skill development and improvements in management practices are often more important. It is questionable whether these dynamic sources of competitive advantage are strengthened when a firm has few rivals in the domestic market. Indeed, the opposite is more likely, since it is competition that forces firms to upgrade their performance. Porter (1990) concludes:

> *"A strong antitrust policy, especially in the area of horizontal mergers, alliances and collusive behaviour, is essential to the rate of upgrading in an economy."*

Secondly, there is substantial empirical evidence to indicate that success in developing export markets is by no means confined to large firms. Many small and medium-size enterprises have succeeded in selling innovative and specialised products in overseas markets.

Thirdly, the evidence indicates that, although there may be efficiency gains to be obtained from many mergers, the proponents of a merger often exaggerate the magnitude of the prospective gains. Several empirical studies have shown that, in a majority of mergers, the cost savings and the growth in profits have turned out to be less *ex post* than was anticipated at the time the merger took place.

Despite the strength of these arguments, some countries which already have a competition law consider that merger control is unnecessary and would be redundant, given their particular economic situation. Jamaica and Hong Kong are examples. Two principal points are advanced to support this view. First, in an economy which is very open to trade and foreign investment, a merger between local firms will not enable the merged entity to sustain prices that are higher than the internationally competitive level. Hence, in such an economy, much of the concern about the possible anti-competitive effect of mergers is alleviated.

Secondly, it is suggested that competition law should be concerned only with anti-competitive conduct and the abuse of market power, not with the structure of the market. Merger controls are aimed at preventing market concentration from increasing above a certain level, yet empirical studies do not show that high market concentration always results in weak competition. A market in which there are only two or three firms competing may be subject to periodic price wars, low profits, and the frequent introduction of new innovative products. Yet, in other markets with the same level of concentration, price/cost margins may be high and stable, with new product offerings rare. Given these doubts about the effects of greater concentration on competition it is argued that the better approach would be not to institute merger

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controls but to allow such transactions to proceed and take action later if it is discovered that the merged business is abusing its market power.

As to the first point, it has to be remembered that even in open economies a significant proportion of expenditure is on **non-tradeable** goods and services, such as electricity, water, telecommunications, transport and cleaning services. Even if foreign direct investment is largely unrestricted, and trade barriers low, there are likely to be some markets which are not "contestable" – that is, a monopoly or oligopoly would be in a position to set prices above an internationally competitive level. In these markets, at least, there is justification for merger controls to prevent any substantial lessening of competition.

As to the second point, most countries with a competition law now accept that it is wise to prevent market dominance arising through a merger, rather than waiting until there is evidence of an abuse of market power. Dominance itself may allow the combined firm to increase price/cost margins above a competitive level or diminish the incentive for the firm to reduce costs.

It should also be borne in mind that if there were no merger controls this might limit the effectiveness of other provisions of the competition law. In particular, firms could get around the prohibition on anti-competitive agreements or arrangements by entering into a merger instead.

After consideration of all the arguments, both for and against, it appears that the prohibition of those mergers that would substantially lessen competition should form an integral part of competition law. However, each case should be treated on its merits and any efficiency gains or other public benefits that are likely to flow from the merger (i.e. gains that cannot be obtained without the merger) should be carefully weighed against the probable detriments to competition. Competition authorities around the world have not sought to condemn mergers, which are legitimate business transactions capable of yielding important economic and social benefits. However, they have been inclined to prevent or vary a small number of mergers (mainly horizontal) considered to have no **net** benefit to the community. In Australia, for example, the Competition and Consumer Commission reviewed 569 mergers during the three years to June 30, 2000 and opposed only 16, or less than three per cent. In Mexico, the Competition Commission has declined to approve only 6 proposed mergers of the many that it has considered over its entire six year history.

4.4 Pre-merger notification

The competition law in many countries provides for compulsory notification of proposed mergers or acquisitions above a specified threshold size. In the United States, the threshold was increased in February 2001, and now companies are only required to notify the Federal Trade Commission and the U.S. Department of Justice of mergers with a transaction value of US$ 50 million or more. In South Africa, the 1998 Competition Act provides for a merger to be notified if the combined value of the parties exceeds R50million (about US$ 6 million) and the value of the target is greater than R5million (about US$ 0.6 million).

In both countries fees are charged for the filing of pre-merger notifications, with the fees varying upward with the size of the transaction. The highest fee is US$ 280,000, payable for transactions in the United States of US$500 million or more.

In countries such as the United Kingdom and Australia, notification of a proposed merger is voluntary (except in the case of newspaper mergers in the U.K.). It is considered that the parties to any significant anti-competitive merger would choose to notify the authorities in advance, rather than run the risk of having to divest the target company, should the merger not be approved.

Early notification, whether on a voluntary or compulsory basis, has some important advantages. It ensures that the detailed information necessary for a proper analysis of the merger is made available to the competition authority at the earliest opportunity. Whatever objections the authority may have to the merger can be canvassed with the acquiring firm and undertakings that might overcome those objections can be considered more promptly.

There may also be advantages in establishing a threshold size for merger transactions that must be reported in advance (as in the United States and South Africa for example). If the value of the transaction is below the threshold level, the parties to the merger can then be certain that they are not at risk of breaching the competition law and are saved the expense of providing detailed information to the competition authority. The setting of the threshold value requires some careful consideration. The higher the threshold, the lower the administrative

costs that will be incurred by the competition authority and by merging enterprises (since there will be fewer mergers reported). However, a higher threshold increases the risk that some anti-competitive mergers, without merit from the public interest point of view, will go through unchallenged.

4.5 Evaluating the likely effects of a merger on competition

Once the competition authority has received an application for a major merger or acquisition and has obtained the requisite information about the market, the level of concentration, the extent of import competition, the barriers to entry and any anticipated efficiency gains from the merger, the detailed analysis of the merger proposal can begin.

The starting point is to establish the likely effects of the merger on competition in the market or markets concerned. Then, if the analysis indicates that were will be significant adverse effects on competition, which cannot be overcome by divestment or other undertakings that the authority may request, attention will be directed to the possible efficiency gains that could arise. Finally, the efficiency gains and any other public benefits that may be relevant will have to be weighed against the detriments to competition and a decision taken whether or not the proposed merger should be prohibited. This section of the chapter deals with the analysis of the effects of the merger on competition. The next section considers the nature of the efficiency gains and other public benefits that may be claimed by the parties to the merger.

Defining the market

In evaluating the likely effects on competition, an important first step is to define the market (or markets) – a matter on which the competition authority and the proponents of the merger will often not agree. The latter are likely to put the case for a broad definition, since the broader the range of goods or services included, the less is likely to be the market concentration after the merger and the less the apparent risk that the merged business will come to dominate the market.

In general terms, the market will have a **product** dimension, a **functional** dimension and a **geographic** dimension. The product dimension refers to the products currently being bought or sold by the two merging firms and any close substitutes for those products. The functional dimension refers to the particular stage of the production and distribution chain at which the proposed merger is to take place – manufacturing, wholesaling or retailing. The geographic market is the area within which buyers of the product could readily switch from one supplier to another. If transport costs are high or there are significant regulatory barriers, the great majority of buyers would not find it economic to obtain supplies from outside the region in which the merging firms are located. Hence, no other regions of the country should be included in the relevant geographic market.

In many OECD countries, including Australia, Canada, the United Kingdom and the United States, a standard method for defining a market has been adopted by the competition authorities, along the following lines. Suppose that a hypothetical monopolist of the products being sold by the merging businesses were to increase the prices of those products by a small but significant amount (say 5 per cent) and maintain that higher price level for a period. Would such a price increase cause customers to switch a significant part of their purchases to some other substitute products or to suppliers from a broader geographical area? If the answer to that question is " yes," the substitute products and the extended geographical region should be regarded as part of the market. The boundaries of the market are reached when the question is answered in the negative.

Also to be taken into account is the possibility that some suppliers, not currently selling the types of goods and services offered by the merging firms, might choose to do so quite quickly, if there was a small but significant increase in the price of those goods and services. These potential supply-side substitutes should also be included as part of the market.

In order to provide a practical illustration of some of the issues involved in market definition, a recent case study from the Australian banking sector is set out below (Case Study 4.1).

Market concentration and market shares

Once the appropriate market definition has been determined, it is possible to calculate the level of concentration that would exist in the market if the acquisition takes place. In most countries, concentration is measured as the share of market turnover accounted for by the four largest firms. It is usually assumed that after a horizontal merger has been completed the merged firm will have a

Case Study 4.1 Market definition in the Australian banking sector

The definition of the relevant markets was an important consideration in analysing a recent acquisition in the Australian banking industry. In 1997, Westpac Banking Corporation, one of Australia's four major banks, signified its intention to acquire the Bank of Melbourne, a much smaller regional bank, which nevertheless had about 12 per cent of the home loan market in the State of Victoria (somewhat more than Westpac). Was the relevant market, the financial services market as a whole, retail banking services, or certain parts of banking services?

The Australian Competition and Consumer Commission came to the view that consumers were tending to unbundle the services that were previously provided exclusively by the banks, and it was no longer appropriate to refer to a single market for all retail banking services. In particular, consumers were obtaining an increasing proportion of their home loans from non-bank sources, such as mortgage originators.

Apart from the home loan market, several other separate markets could be identified. These included the markets for transaction accounts, deposits and small business banking. The Commission considered that these were generally State markets, since it would be difficult for an individual or a business to obtain the requisite services from a bank located in another State. On this view of the geographic markets, the proposed merger would elevate concentration in the Victorian markets to quite high levels, particularly in the market for transaction accounts.

After concluding its market inquiries, the Commission took the view that the merger would result in a substantial lessening of competition in the transaction accounts market in Victoria, However, the parties to the merger undertook to grant access to their electronic networks to new and small financial institutions in Victoria and considerable autonomy to the State management under the Bank of Melbourne banner. On the basis of these undertakings, the merger was allowed to proceed.

market share equal to the total share of the two or more merging firms prior to the merger. However, this is a questionable assumption, which is discussed further below.

In some countries, including the United States, concentration in the market is often measured by the so-called Herfindahl index, which is sometimes seen as preferable to the four-firm concentration ratio. This index is the sum of the market shares of the individual firms, squared. It will have a maximum value of 1.0, reached when a firm has a monopoly in a particular market. Its principal advantage is that it reflects to some degree the inequality in the size of the leading firms in the market. So that if one or two firms (of the four market leaders) dominate the market this shows up as a higher value in the index compared with a situation where the four leading firms have approximately equal shares.

However, statistical measures of concentration are not as useful to the competition authority as the detailed information about market shares that can usually be obtained from market inquiries. If it is apparent that each of the firms planning a merger currently has a small market share, it is probably safe to conclude that the transaction will not lead to market dominance or a substantial reduction in competition in the relevant market. However, if the target firm is small, but the acquiring firm already holds a large share of the market, there is likely to be concern that, despite the small size of the transaction, competition could be lessened and the larger business could gain or strengthen a dominant position.

Merger guidelines, issued by the competition authorities in most OECD countries, usually stipulate what market share can be enjoyed by the merged entity without the acquisition warranting investigation by the authority. In Australia, for example, the Competition and Consumer Commission has indicated that, as a general rule, it is unlikely to be concerned with a merger in which:

- The market share of the combined entity is below 40 per cent, and
- If the market share of the combined entity is above 15 per cent, the combined share of the four largest firms after the merger is less than 75 per cent.

These market shares are based on the current market shares that are held by the participants, so they implicitly assume that the merger will not result in any loss of share for the firms involved in the merger. As noted above this is a questionable assumption. Empirical studies have shown that there is usually some reduction in market share

following a merger or acquisition. This could partly reflect the fact that in many markets, customers, particularly business customers, like to deal with more than one independent supplier of a particular good or service. By doing so they hope to increase their bargaining power and diminish the risk of a supply interruption. If they were previously dealing with two suppliers, and both merge, they could be expected to shift some of their custom to an alternative supplier.

By not allowing for the probable loss of market share following the acquisition, the competition authority may continue its investigations of some proposed mergers, when these could be cleared earlier. However, this problem is only minor and is much less important than correctly identifying the likely sources and strength of competition facing the merged entity.

Import Competition

So far, no account has been taken of imports, which, in some markets, provide a powerful competitive discipline on local firms. If imports have a significant and sustainable share of the market, and/or the **threat** of imports prevents local firms from pricing their products above a competitive level, the competition authority can safely allow the merger to proceed. The only qualification to be made is that the imports in question should be supplied by independent importers, not by importers owned or controlled by one or more of the largest domestic firms in the market.

The reduction in import tariffs, which has taken place in many developing countries in recent years, is helping to limit excessive market power in domestic markets, notwithstanding the fact that some mergers have been tending to increase the level of market concentration. In some cases the competition authority has been able to approve a merger, which would probably have been stopped if trade barriers had not been lowered. In Mexico, for example, the Competition Commission cited the gradual reduction in tariffs provided for in the North American Free Trade Agreement as one reason why it was able to agree to the Industrias Monterrey/Altos Hornos de Mexico merger in 1999.

The merger guidelines issued by the competition authorities of a number of countries indicate a threshold level for imports. Provided that imports have exceeded a stipulated share of the market for a period of years, the authority will usually not object to a proposed acquisition in that market, even if concentration is relatively high. In Australia, for example, the Competition and Consumer Commission will allow an acquisition to proceed if imports account for more than 10 per cent of the market on a continuing basis.

Barriers to Entry and Exit

Potential competition, that is the prospect of additional firms entering the market, can also restrain firms from taking advantage of their market power to set prices above their costs. The strength of potential competition depends on the height of barriers to entry and exit in the market.

If it is possible for firms to enter a market to take advantage of a temporary profit opportunity, and then exit again without penalty (hit-and-run entry) even a firm with a monopoly in that market would be unable to charge more than a competitive price for its products. Such a market can be described as" fully contestable".

In reality, very few, if any, markets are fully contestable. Usually there are significant costs of entry and exit. In determining whether or not it is profitable to enter a market a firm must take account of the irrecoverable costs that would be involved if it enters and is later forced to withdraw in the face of competitive pressures. Such costs will include most market-specific advertising and marketing outlays, fixed assets with no alternative use and some industry-specific training costs. The smaller the magnitude of these irrecoverable costs, the greater the opportunity for entry.

The competition authority is unlikely to be concerned about a proposed merger or acquisition in a market where potential competition is strong and barriers to entry are low. On the other hand, in a market where concentration is high and barriers to entry are substantial, any merger involving the largest firms will probably be regarded as anti-competitive. Substantial barriers to entry may be due to a number of factors including:

- Economies of scale (it may be uneconomic to duplicate an existing network)
- Brand loyalty for the existing brands
- Intellectual property rights held by the existing firms
- The large capital outlays needed to establish a rival business

Case Study 4.2 The clear beer industry in Zambia

In 1998, Zambian Breweries Plc applied to the Zambia Competition Commission for approval of its take-over of Northern Breweries Plc. The take-over would result in Zambian Breweries having 100 per cent of the clear beer market in Zambia. Imports only accounted for about one per cent of the market and Zambian Breweries itself was the principal importer.

Barriers to entry to the clear beer market were high, with the incumbents enjoying substantial brand loyalty. Zambian Breweries was a subsidiary of South African Breweries, and the financial strength of that company, its strategic position and the relatively slow growth in market demand for clear beer in Zambia were all factors likely to deter a new firm from entering the market.

The target company, Northern Breweries, was in a serious financial position and it appeared that further delay in implementing the take-over would result in the company's liquidation and a major loss of employment following the closure of the brewery.

The Commission accepted the failing company defence and provided interim authorisation for the merger, subject to further negotiation with the parties on any conditions that might be imposed.

The competition authority will need to make market inquiries about the nature and magnitude of such barriers to entry, before determining whether or not a particular acquisition is likely to substantially lessen competition.

Other factors

After going through the four steps described above, the competition authority may still have concerns that a particular acquisition is likely to be anti-competitive. However, those concerns may be allayed if the market has certain special features. First, if a few large suppliers dominate a market, a merger involving two or more of the major business customers may enable the latter to exercise some **countervailing power**, resulting in lower costs and perhaps better quality products. Before approving such a merger, the competition authority may need to be satisfied that the benefits will be passed on to the final consumers of these products, and not merely result in higher profits for the businesses that are merging.

Secondly, consider the case where a company in a highly concentrated market is about to fail, unless it is acquired by one of the largest firms in that market. Assuming that there are substantial barriers to entry and imports are not significant, the acquiring firm would increase its dominance of the market whether it proceeds with the acquisition, or the target company fails. Hence, it can be argued that the proposed acquisition would not lessen competition, (compared with the alternative of outright failure) and might allow some of the employees of the failing firm to remain in employment.

This so-called **"failing company defence"** may be persuasive, but the competition authority needs to be satisfied also that no other firm would submit an acquisition proposal which was more likely to preserve competition. While the shareholders of the failing company would benefit from accepting the highest bid for their shares, the community as a whole may be better served by the acceptance of a lower bid, if this means stronger competition in the market in the long run.

Case study 4.2 outlines a recent example from Zambia where the failing company defence was used.

A very different situation arises when a large and possibly dominant firm seeks to acquire a much smaller firm, which, despite its size, has been a particularly vigorous competitor, introducing innovative products and pricing them keenly. By means of a takeover, the large firm could eliminate this irritating source of competition, which may pose a threat to its longer-term profit prospects. Such an action would be tantamount to an abuse of a dominant market position conduct, which would clearly be in breach of a key provision of the competition law. It is important therefore that large firms not be permitted to take predatory action against a competitor by means of a merger when they are prevented from doing so through an alternative route.

This completes the discussion of the steps involved in analysing the effects of a merger on competition. Diagram 4.1 provides a summary picture of the matters discussed.

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Diagram 4.1

Steps in the Analysis of the effects of a Merger on Competition

1. Market Definition

2. Market Concentration
- If below the threshold level,
  NO FURTHER ACTION

3. Import Competition
- If strong and sustainable,
  NO FURTHER ACTION

4. Barriers to Entry & Exit
- If low,
  NO FURTHER ACTION

5. Consider other factors, including:
- Countervailing power
- Failing company defence
- Elimination of a vigorous competitor

4.6 Possible public benefits of a merger

The efficiency gains and other public benefits that may be obtained through a merger will only be considered by the competition authority, if the earlier analysis has shown that the merger is likely to have a detrimental effect on competition.

The proponents of the merger may point to such factors as economies of scale, cost saving in distribution, synergies in marketing, the ability to obtain finance on better terms or a more effective R & D programme as reasons for allowing the merger to proceed. The competition authority will need to be satisfied that these claims are realistic. As mentioned previously, empirical research has shown that, for most mergers examined, the cost saving and efficiency improvements actually achieved, fell short of what was anticipated at the time the transaction initially took place. This finding suggests that the competition authority needs to be cautious in accepting at face value the estimates of potential gains made by the parties to the merger.

Moreover, the authority will need to be satisfied that any cost saving resulting directly from the merger will not simply translate into higher profits for the combined firm but will also mean lower prices for consumers. The latter outcome is more likely if there is still relatively strong competition in the market after the merger. If not, the authority may have to place conditions on the merger to prevent the combined firm from earning monopoly profits.

In some countries, the competition law prescribes a number of specific public interest criteria that the competition authority must take into account before deciding whether or not to allow a merger. These may include export facilitation, import replacement, employment effects (including the effects on regional employment) and the contribution to innovation. If one or more of these factors are present, the question is whether the magnitude of the benefits counterbalances the detrimental effects of the merger on competition. It is important that the competition authority has the independence to make this judgement itself, without political intervention. Otherwise there is a danger that special interest groups will press for their particular view of the public interest to prevail, putting at risk the objective appraisal of the effects of the merger on competition.

4.7 International co-operation in merger control

With increasing economic globalisation, a single large-scale merger between two international corporations can have a substantial economic impact on many developed and developing countries. For example, the proposed merger between the Coca-Cola Company and Cadbury-

Schweppes in 1999 concerned more than 100 countries. In some, including Mexico, Australia, Belgium and many other European countries, the competition authorities objected to the merger proposal on the ground that it would lead to the combined enterprise gaining a dominant share of the domestic market for premium carbonated soft drinks. While the merging enterprises offered a compromise by which some brands would be licensed to independent firms, this was not thought sufficient to eliminate the anti-competitive aspects of the merger. Thus, faced with continuing opposition from the competition authorities, the merger proposal was abandoned in quite a number of countries. However, it is understood that the two companies plan to go ahead with the merger in some countries, which have no competition law or merger control. This includes many developing countries.

This case reinforces the argument that merger control is needed to protect competition in developing economies and keep down costs and prices. It also illustrates the point that a merger carried out overseas can have important implications for an economy. In devising an appropriate response to such an international merger it is important that the competition authority understands the global commercial strategy being pursued by the merging businesses, the extent of their participation in other national markets and the decisions on the merger being taken by other competition authorities.

This information can be obtained more readily if there is close collaboration between the competition authorities in different countries. (Such collaboration is very useful, not only in merger cases, but also in the pursuit of illegal international cartels, where the evidence from a number of countries may be needed to establish the extent of the collusion). In recent years there has been an increasing trend towards closer collaboration in the form of exchange of information, short-term exchange of personnel, and the analysis of the competitive effects of particular mergers. Bilateral agreements on co-operation between competition authorities have become common, especially among OECD countries, but developing countries probably have relatively more to gain from entering into such agreements, since they are more affected by international mergers, compared with domestic mergers, and have less extensive data banks to call on.

The existence of a bilateral co-operation agreement does not imply that the two countries concerned will take the same action on an international merger proposal, which affects them both. Differences in their economic situation, including differences in market concentration, imports and attitudes to direct foreign investment, may explain why the competition authorities arrive at different conclusions on the same merger. The benefit of the co-operation agreement lies in the improved information flow between the countries and the sharper analysis that then becomes possible.

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CHAPTER V

AUTHORISATIONS, NOTIFICATIONS AND EXEMPTIONS

In this chapter the following issues are discussed:

- *The process of authorisation and notification*
- *The need for transparency*
- *Information needed by the competition authority in order to assess an application for authorisation*
- *Criteria for assessing the public benefits*
- *Weighing the public benefits against the detriments*
- *Vertical restraints – a case for block exemption?*

5.1 The process of authorisation and notification

As indicated in Chapter I, competition law is intended to eliminate or prevent restrictive business practices, which lessen competition in or prevent entry to a market, in the belief that this will generally:

- Promote economic efficiency,
- Encourage innovation,
- Protect and promote social welfare.

The fewer the restrictions impeding competition in a market, the more likely that these goals can be achieved.

However, some restrictive agreements, mergers and acquisitions, which lessen competition, are capable of contributing to greater economic efficiency, innovation and improvements in social welfare. For example, a particular merger may result in economies of scale, which cannot be obtained by any other route. The public would probably benefit if it were allowed to proceed.

In most countries, the competition law provides an opportunity for the parties directly concerned to present a case to the competition authority for a particular restrictive agreement or proposed merger to be permitted, in view of the public benefits that would be realised if it was implemented. However, this opportunity to apply for the authorisation of a restrictive business practice does not apply to all such practices. In particular, the abuse of market power by a dominant firm (see Chapter III) is prohibited outright and cannot be authorised, while cases of collusive tendering, price-fixing, market-sharing and output quotas are generally treated in the same way (see Chapter II).

When authorisation is granted, it provides the concerned firms with immunity from legal proceedings for the particular restrictive practice, which was the subject of the application. The authorisation does not provide immunity from prosecution for any other breach of the competition law or for any revision to the authorised practice. The latter would require a fresh application for authorisation.

Some conditions may be imposed when the authorisation is given. For example, the immunity from legal proceedings may be limited to only a few years. This may be regarded as sufficient time for the industry to overcome some transitional problems, arising perhaps from deregulation or a tariff cut.

An application for authorisation is a voluntary exercise. The competition authorities generally discourage firms from making such an application unless the proposed agreement or proposed merger would be likely to **substantially** lessen competition in at least one market and there are offsetting public benefits. Preliminary discussions with the competition authority will usually help the applicants to discover the aspects of the agreement that concern the authority and the nature and extent of the public benefits that might result from its implementation. In the light of these discussions the applicants may elect to modify the agreement or decide not to proceed with it.

If a restrictive agreement is put into effect without an application for authorisation being made, and it is later discovered that the agreement infringes the competition law in some way, the full sanctions available under the law will be applied. At that stage it is generally too late to seek authorisation for a suitably modified agreement.

As far as mergers and acquisitions are concerned, some countries require that all transactions above a certain threshold be notified in advance to the competition authority. South Africa is one example. Other countries do not have a compulsory pre-merger notification requirement but allow the proponents of the proposed merger to submit an application for authorisation on a voluntary basis. (for further detail see Chapter IV). The law provides for sanctions to be applied on firms that fail to notify the authorities of their intention to merge, when there is a requirement to do so. Sanctions will also be imposed if an illegal anti-competitive merger takes place without prior authorisation from the competition authority.

Authorisation applications and pre-merger notifications must be in writing and fees are charged when they are filed. The amount of the fee varies considerably from one country to another, ranging from less than $US 4,000 to US$ 280,000 (the latter applying to a notification in the United States of a proposed merger with a transaction value exceeding $US 500 million).

The need for transparency

It is important that the process of considering an authorisation application or a notification be as transparent as possible. The competition authority plays the role of adjudicator in these matters and it must be seen to be acting fairly, openly, and even-handedly, with the interests of the public uppermost in its mind. To do otherwise, would damage its credibility and lessen public support for its activities.

To ensure transparency, the following steps should be undertaken:

- A public register of all applications for authorisation and all notifications should be created and maintained.
- The competition authority should be willing to receive representations regarding an authorisation application or merger notification from any persons who may be affected by it.
- The reasons for the authority's decision on each application for authorisation or notification should be made public.
- The authority should consider releasing a draft or preliminary report on its findings in each case, inviting public comment and/or holding a conference of interested parties, prior to making its final decision.
- The competition law should provide for a right of appeal from decisions of the competition authority to an independent court or tribunal.

5.2 Information needed by the competition authority in order to assess an authorisation application

In considering whether or not to grant an authorisation for a particular restrictive agreement, the competition authority has to make a judgment about the effect of the agreement on competition in the market(s) concerned, and the public benefits that are likely to be realised if it is put into effect. Finally, any adverse effects on competition will have to be weighed against the perceived public benefits to establish whether there would be a positive net public benefit.

Much of the information needed to make these judgments will have to come from the applicants for authorisation themselves. The onus is on them to demonstrate that authorisation would be of benefit to the public. However, it is likely that the competition authority will seek corroboration, on such matters as the market definition, the present state of competition in the market, and the possible public benefits that might flow from the agreement, from other participants in the market.

Typically the applicants will be expected to provide details regarding:

- The proposed agreement or merger for which authorisation is being sought and the firms involved.
- The state of competition in each relevant market in the absence of the agreement or merger.
- The likely future state of competition in those markets if authorisation is granted.
- The gains in economic efficiency and other public benefits that are claimed will result from the proposed agreement or merger.

- Any alternative ways of achieving these public benefits with less adverse effect on competition.

In order to assess the present and hypothetical future state of competition in the relevant markets, the boundaries of these markets must be defined. This issue of market definition is discussed in some detail in Chapter IV, The Control of Mergers and Acquisitions.

Criteria used to assess the public benefits

In a number of countries the criteria to be used by the competition authority in assessing the public benefits of a proposed restrictive practice are not spelt out in the competition legislation. The definition of public benefit is left to the discretion of the authority, guided by the definitions adopted by the courts or tribunals in similar cases in the past.

However, in the United Kingdom, the European Commission and most EU countries the Competition Acts specify some factors that must be taken into account before determining that a particular restrictive agreement or concerted practice should be authorised on the ground of public benefit. The U.K. Competition Act (1998) states:

"…to qualify for exemption, it must:

a) contribute to
-improving production or distribution, or
-promoting technical or economic progress

while allowing consumers a fair share of the resulting benefit, but

b) not
- impose on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives, or
- afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the products in question"

These criteria are largely self-explanatory but two comments are warranted. First, a restrictive agreement, which could result in significant technical and economic progress (such as a joint research and development venture) without eliminating competition in a significant part of the relevant markets, would not necessarily gain exemption (authorisation) unless the competition authority was persuaded that " a fair share" of the benefits would be passed through to consumers. Efficiency gains that merely result in higher profits for the companies participating in the agreement, without lower prices nor improvements in product quality for consumers, will not be counted as public benefits under these criteria.

Secondly, if there are other ways of achieving the same public benefits apart from the proposed restraint on competition, then they are to be preferred. This is implied by the point that the restrictions must be indispensable to the achievement of the objectives, otherwise they will not be authorised.

In some other countries, the competition authorities have identified several additional factors as public benefits, although these are not always stated explicitly in the legislation. Industry rationalisation, increased exports, import substitution and increased employment opportunities are often regarded as public benefits which may justify the authorisation of a particular restraint on competition. The inclusion of these factors as public benefits is consistent with the United Nations Set of Principles and Rules on Competition (the Set"), which recognises that the protection and promotion of social welfare is an objective of competition policy and not economic efficiency and economic growth alone.

5.3 Weighing the public benefits against the detriments to competition

As mentioned previously, authorisation should only be granted if the public benefits resulting from the proposed restrictive agreement or anti-competitive merger outweigh the detriments. However, this exercise of weighing benefits against detriments is not an exact science. Opinions may differ on whether or not authorisation is warranted in a particular case.

As recounted by Charles A. James of the U.S. Department of Justice at the OECD Global Forum on Competition in October 2001:

"…After reviewing the recent proposed $42 billion merger of General Electric and Honeywell, the Justice Department cleared the merger while requiring divestiture to address competitive concerns in two markets. But the European Commission, analysing identical product and geographic markets and having access to the same facts as we did, blocked the transaction in its entirety."

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In this case, the difference of view between the U.S. authority and the European Commission is attributed to an apparent difference on the proper scope of anti-trust law enforcement. While U.S. anti-trust law is designed to protect competition and not competitors it is said that the European approach is aimed at preventing competitors being driven out by a more efficient rival.

This characterisation of the European Commission's position is somewhat controversial and will not be debated here. However, there are other reasons why different authorities may differ in their assessment of the net public benefit of a proposed restrictive agreement or merger. In particular, the assessment requires that a comparison be made between the state of competition in the market(s) without the restriction and with it in place. While it is not difficult to discover the present market structure and other current facets of competition, it is not easy to establish how the markets will change over time under the influence of changes in technology and the pattern of demand. Yet it is the **future** state of competition, which is relevant when seeking to estimate by how much the proposed restriction would lessen competition in the markets concerned.

Given the uncertainty about future developments in the market, the competition authority will often elect to grant an authorisation for only three or four years. This provides an opportunity to review the impact of the restrictive agreement on competition and not to renew the authorisation should the adverse effects be greater than expected. However, the shorter the period of the initial authorisation, the greater the uncertainty facing the applicant firms, so that business investment may be lower than it otherwise would be. In other words, one of the important sources of potential public benefit could be smaller than it would have been had a longer period of authorisation been approved by the competition authority. (Note: The authorisation of a merger or acquisition is for an unlimited time).

Case Study 5.1 Agreements for the production and supply of sugar cane to certain sugar mills in Queensland, Australia

In July 2001, the Australian Competition and Consumer Commission (ACCC) authorised certain agreements affecting the production of sugar and its supply to a mill in Queensland owned by CSR Limited –one of Australia's largest sugar-milling companies. The agreements consisted of an Expansion Agreement, which specifies the terms on which new cane production areas will be created for the supply of sugar cane to the mill and a Collective Supply Agreement, which specifies the terms on which growers will supply cane to the mill.

The Queensland sugar industry is regulated by the Sugar Industry Act 1999. This Act provides for the making of collective supply and individual supply agreements for the supply of cane to a mill. It also regulates the granting, variation and cancellation of cane production areas and vests raw sugar in a single desk seller. Cane may only be grown in a registered cane production area.

It is also relevant that the bulk of raw sugar is exported, and raw sugar sales to the domestic market are set at the export parity price. There are many cane growers in the Queensland industry but few major millers.

The regulations contained in the Sugar Industry Act do restrain competition to a significant extent, although the Act does not determine the constraints on the manner in which new cane production areas are granted. Nor does it cover the differential payment scheme, which provides for various payment arrangements for new and existing growers linked to the length of the crushing season. Hence both these matters were included in the application for authorisation made to the ACCC.

The Commission considered that there were public detriments arising from these restraints on competition, but they were relatively minor, partly because of the localised nature of the arrangements. On the other hand the agreements could be expected to deliver public benefits in the form of:

– Increased mill throughput and farm output,
– Associated new investment,
– Efficiency gains from the improved use of infrastructure.

In addition, there was likely to be growth in exports and an associated increase in the sector's international competitiveness,

The public benefits of the agreements were considered to outweigh the detriments.

Case Study 5.1 illustrates how public benefits were weighed against the perceived detriments to competition in a recent case involving the Australian sugar industry.

5.4 Vertical restraints – a case for block exemption?

So far in this chapter no distinction has been drawn between horizontal and vertical agreements in considering the process of authorisation, exemption and notification. But it is apparent from the discussion in Chapter II that vertical restraints, and proposed mergers between firms at different stages of the production/distribution chain, are much less likely to have adverse effects on competition than horizontal restraints and mergers between competitors in the same market.

Moreover, vertical restraints, such as exclusive dealing and franchise arrangements are often capable of yielding significant public benefits, which outweigh any detriments arising from the restriction on competition.

Accordingly a case can be made out for a block exemption from the provisions of the competition legislation for vertical agreements or concerted action involving firms with turnover or market share below a certain threshold. One of the important advantages of this is that a large number of small firms could be saved the time and expense of having to apply for authorisation, while the competition authority would be able to devote a greater proportion of its resources to hard-core cases such as secret price- or output-fixing cartels.

Block exemption for small-scale vertical restraints does not mean that all such restraints would be immune from legal proceedings. Flagrant or serious breaches of the law, which might result in a substantial lessening of competition in a market, would still be investigated and appropriate sanctions imposed. However, the block exemption procedure would change the onus of proof. Many small and medium-sized enterprises would no longer have to prove that there would be a net public benefit in their proposed vertical arrangements. Rather the competition authority would have to show that a particular arrangement infringed the competition law.

The European Commission has recently adopted a new policy in relation to vertical restraints, which provides for a block exemption for such agreements where they relate to the conditions under which the parties may purchase, sell or resell certain goods and services, and where a single market share does not exceed a threshold of 30 per cent. Above the 30 per cent threshold the agreements are not presumed to be illegal but require individual examination. The block exemption also applies to agreements concluded by retailers' associations, provided that none of the members has an annual turnover of more than EUR 50 million.

According to the Commission " the basic aim of this new approach is to simplify the rules applicable to vertical restraints and to reduce the regulatory burden for companies, while ensuring a more effective control of agreements entered into by companies holding significant market power" This approach might well commend itself to developing as well as developed countries.

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CHAPTER VI

INNOVATION AND THE PROTECTION OF INTELLECTUAL PROPERTY RIGHTS: THE ROLE OF COMPETITION LAW

In this chapter the following issues are discussed:

- *The objectives of laws protecting intellectual property*
- *The TRIPS agreement and its significance for developing countries*
- *Parallel imports and prices of patented goods in developing countries*
- *Restrictive practices associated with the licensing of intellectual property*
  - *Tying clauses*
  - *Refusal to license*
  - *Extending the duration of a patent*
  - *Grant-backs*
- *Joint research and development*
- *Mergers and acquisitions where intellectual property is an issue*
- *Case studies (including the pharmaceutical industry)*

6.1 The objectives of laws protecting intellectual property

Competition law and laws governing intellectual property rights have a common objective – namely to encourage innovation and ensure that some of the resultant benefits flow through to the general public. Yet the methods that they use to achieve this objective are entirely different. Competition law seeks to free markets from restrictive business practices, so that firms with new and more efficient products or processes are able to enter those markets and subsequently expand production if there is sufficient demand. Laws relating to intellectual property rights (IPR), particularly patent legislation, provide the original inventor with exclusive rights to use, sell, or license the invention for a limited period of time. During this period it is illegal for others to make use of the invention without the authority of the patent (trademark or copyright) owner. This provides a long-run incentive for companies and individuals to undertake more research and development (R&D) in the hope of making more inventions, which will be commercially profitable. The rationale can be summed up as follows: “by slowing down the diffusion of new technology, the patent system helps to ensure that there will be more new technology to diffuse”.

Consider for a moment what would happen if either competition legislation or IPR legislation was not in place. In the absence of a competition law, it would be possible for a dominant firm with substantial market power to foreclose the market to a potential entrant, which has developed a new superior technology. For example, the dominant firm could threaten to refuse supply to any distributor who elects to purchase goods from the entrant. The effect would be to prevent, or at least delay, the introduction of the new technology.

Now suppose that competition legislation is in place, with provisions to prevent the abuse of a dominant market position, but there is no patent or IPR legislation. Then the problem is that there is likely to be less aggregate expenditure on research and development (R&D) than would be desirable from the community’s point of view. This is because firms in most market would find it much cheaper to copy what has been discovered by another enterprise than to mount its own R&D effort. If many firms aim to free-ride on the R&D efforts of others, total R&D expenditure will fall to low levels and there will be a corresponding decline in the number of product and process innovations.

In practice, in a number of industries, a significant proportion of firms protect their intellectual property by keeping it secret rather than by seeking a patent or copyright. These firms may not be inclined to cut their R&D spending in the absence of patent protection. Yet overall, if there were no patent, copyright or trademark legislation, fewer resources would be devoted to R&D and the rate of innovation would be slower.

The conclusion must be that competition law and IPR legislation have complementary roles to play. Both are necessary in order to promote an optimal level of R&D and a satisfactory rate of diffusion of new technology.

However, this is a global view. Some observers who have studied the impact of patent legislation in developing countries, question whether the introduction of the patent system has really benefited the public in those countries or will do so in the future after the TRIPS agreement has been fully implemented (see below for an outline of the TRIPS agreement).

A detailed discussion of this matter is beyond the scope of this manual, but the empirical studies on the effects of patent legislation on developing countries suggest the following conclusions:

- The introduction of a patent system in a developing country tends to result in an increase in domestic wholesale prices for newly patented goods and probably results in higher profits for the transnational corporations, which own most of the relevant patents.

- A stronger patent regime may lead to some additional local R&D by transnational corporations. However, small and medium-sized domestic companies will probably lack the resources to launch an R&D programme of sufficient size to be successful, particularly in pharmaceuticals where the minimum expenditure needed to discover, develop and trial new drugs is very high.

- Foreign direct investment in a developing country tends to be greater the stronger is the country's patent system (other things equal). Additional FDI could assist economic development in a number of ways (e.g. through increased exports, a more rapid transfer of technology from abroad and enhanced employment opportunities).

- The introduction of effective patent and copyright legislation in a developing country can be expected to reduce the domestic production of counterfeit and pirated copies of products subject to IPR protection in other countries (e.g. the copying of computer software and compact discs sold under copyright restrictions in the United States).

While the empirical evidence is somewhat ambivalent, on balance it suggests that most developing countries will benefit to some degree by having a system for the protection of intellectual property rights (IPR) – a system that they are now required to introduce under the terms of the TRIPS Agreement (see below).

It is worth emphasising that the protection of IPR is not simply another type of non-tariff barrier to trade, like a voluntary restraint on exports or an import quota. On the contrary, it should facilitate trade and, particularly, direct foreign investment, while contributing to the promotion of innovation and the transfer of technology within and between nations.

Nevertheless, introducing legislation to protect IPR in a developing country involves a difficult and possibly contentious balancing exercise. On the one hand, it is likely to result in higher prices for some products, which have an inelastic demand, including some essential items such as pharmaceuticals. On the other hand, it should result in higher levels of R&D expenditure and more innovation, although little of the increased R&D may take place in the developing country itself. Finally, it may serve to attract additional Foreign Direct Investment because investors can be more confident of the return they will obtain from the exploitation of their intellectual property.

Before exploring in more detail the interface between competition law and the protection of IPR, it will be useful to review some of the relevant features of the TRIPS Agreement.

6.2 The TRIPS Agreement and its significance for developing countries

The Agreement on Trade-Related Aspects of Intellectual Property Rights (the TRIPS Agreement) was negotiated at the time of the Uruguay Round of Trade negotiations and is an integral part of the Agreement establishing the World Trade Organization. It sets out the minimum standards of protection to be provided in the principal areas of intellectual property rights – patents, copyright, trademarks designs, trade secrets, plant variety rights and integrated circuits. It also lays down the procedures and remedies that should be available so that the holders of IPR can enforce their rights.

The developed countries and many developing countries have already varied their laws to conform to the standards of protection of IPR laid down in

the TRIPS agreement. The least developed countries have been given until January 2006 to meet their obligations under the agreement.

Articles 1 to 4 of the Agreement establish the broad principles underlying it, namely:

- Non-discrimination between the nationals of the different member countries of the WTO
- National treatment
- Most-favoured nation treatment (any advantage or privilege granted to one country must be accorded immediately to all other member countries)
- Transparency

As regards patents, the Agreement provides that patents shall be available for any invention, whether a product or process, in all fields of technology provided that the invention is novel, is an inventive step and has industrial applications (these are the criteria normally employed in national patent legislation).

Further, patent protection must not expire in less than 20 years from the date of filing the patent application. The minimum term of the patent is therefore somewhat longer than that typically found, even in developed countries, prior to the TRIPS Agreement. However, it should be borne in mind that for some products, such as pharmaceuticals, there can be an interval of several years between the date of filing and the first commercial sales. Moreover, the great majority of patents cease to have value long before the expiry date as they have usually been superseded by more recent superior technologies.

The TRIPS Agreement obliges member countries to grant a patent only when the application discloses details of the invention and information about how to use it. This public disclosure has two important advantages. First it saves other would-be inventors from pursuing avenues of research, which are likely to be less fruitful than those revealed in the patented invention. Secondly, it allows others to build on the knowledge obtained from the patent application to develop a superior technology or a generic product, which it can market as soon as the patent expires.

An aspect of the TRIPS Agreement of direct relevance to competition law is the statement (Article 40) that " members agree that some licensing practices or conditions pertaining to intellectual property rights which restrain competition may have adverse effects on trade and may impede the transfer and dissemination of technology" It goes on to indicate that member countries are free to legislate to prevent or control such practices where they are likely to have an adverse effect on competition in the relevant market. However, the Agreement stops short of **requiring** that each country include measures to stop anti-competitive IPR licensing practices, in either the competition law or the patent law. Further discussion of the nature of such practices and their effects on competition is to be found later in this chapter.

In the negotiations leading to the TRIPS Agreement, it appears that the views of developing countries and developed countries diverged on the issue of parallel imports. Parallel imports, sometimes referred to as "grey imports" are goods produced genuinely under patent, trademark or copyright protection in one country and then imported into another country without the authorisation of the local owner of the IPR. The owner is often a licensed distributor. For example, compact discs manufactured genuinely in the United States may be imported into Singapore without the approval of the Singapore firm that owns the local intellectual property rights.

Parallel imports can be a significant source of competition for the (almost) identical goods imported by the authorised local distributor. It is in the latter's interests to be protected from such competition. If there is legislation to stop parallel imports, the profits of the patent owner are likely to be greater than they would otherwise be. However, consumers are likely to pay higher prices for the products concerned.

At the TRIPS negotiations, most developing countries tended to favour legislation allowing parallel imports (sometimes referred to as international exhaustion of IPR) while developed countries generally favoured national exhaustion of IPR – that is a legal ban on parallel imports. In the absence of agreement on this question, TRIPS allows each member country to make its own choice whether or not to legalise parallel imports. The public benefits of allowing parallel imports remains a subject for debate, particularly in the area of pharmaceuticals. This issue is considered in a little more detail in the next section of this chapter.

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In summary, the TRIPS agreement recognises that the protection of IPR should contribute to the promotion of innovation and the facilitation of the transfer and dissemination of technology. To gain public acceptance, IPR protection must be to the mutual advantage of users as well as producers of technological know-how and take account of social welfare considerations. The action that should be taken to prevent restrictive licensing arrangements from adversely affecting competition in a domestic market is a matter left to individual member countries, although consultation and cooperation between members is encouraged. Similarly, the decision whether or not to prohibit parallel imports is left to the discretion of each importing country. If it is decided to allow parallel importing, the competition authority will usually be expected to ensure that such imports are not hindered by the misuse of market power by patent or copyright owners.

6.3 Parallel imports and the pricing of patented products in developing countries

It is evident that a legal ban on parallel imports would eliminate an important source of actual or potential competition in many developing country markets. This lessening of competition might allow domestic firms and non-parallel importers to increase prices above the level that would otherwise have been possible. The relatively high prices of certain essential items that are protected by patents or copyright, notably pharmaceuticals and computer software, are already of concern to consumers in developing countries and they are understandably reluctant to see further price increases resulting from a prohibition on parallel imports. It may be of little consolation that such a prohibition could lead to higher profits for the patent and copyright owners (e.g. global drug companies) and, eventually, to a more rapid rate of innovation.

However, some recent economic literature questions the assumption that a global ban on parallel imports would lead to higher prices of patented products in developing countries. The essence of the argument is as follows. Suppose that a large corporation has a worldwide monopoly in the production of a particular product based on an effective patent with 15 years to run. It is unlikely that a superior competitive product will be available on the market for at least 10 years. If parallel imports are prohibited, the corporation will be able to act as a discriminating monopoly, allocating its total output between different geographical markets in such a way as to maximise its profits. This means that a lower price will be charged in poorer countries where demand is more elastic and a higher price in countries with a higher per capita income (marginal cost must equal marginal revenue in each market to maximise profits).

Now consider the alternative situation in which parallel imports are allowed. The corporation can no longer act as a discriminating monopolist because it is unable to segregate the various geographical markets, If high prices are being charged in high income markets, supplies will be diverted there from other countries where prices are lower. In short, prices will tend to equality across the different markets although they will not be identical in practice because of factors such as differences in transport costs, tariffs, taxes and price controls.

This simplified analysis suggests that, if all countries were to agree to ban parallel imports (perhaps by an amendment to the TRIPS Agreement) there would be a win-win result for developing countries and for the suppliers of new intellectual property. That is, the developing countries would benefit from relatively low prices for some patented or copyright products while the owners of the patents or copyright would obtain higher profits than they otherwise could. The losers from the ban would be the consumers in high-income per capita countries who would face price discrimination against them.

While the theoretical analysis is basically sound, there are several reasons why a ban on parallel imports may not be the most appropriate practical solution to the problem. First, it reduces the pressure on domestic firms to become internationally competitive. This may retard the long-term economic development of the country, outweighing any short-term benefits that may be gained through lower prices for imported goods protected by patents or copyright. Secondly, it runs counter to the general thrust of world trade policy, which is to remove obstacles to international trade and foreign investment. Thirdly, if patent legislation is amended to provide for national exhaustion of IPR (the right to prevent parallel imports) this is a relatively inflexible policy measure which could not take account of the particular circumstances of each market (e.g. market structure, barriers to entry and the rate of diffusion of new technology).

A better way of dealing with the issue might be to allow parallel imports but permit the owners of IPR to apply to the competition authority for an

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authorisation of any agreement with distributors or others that would have the purpose or effect of preventing or restricting such imports. Authorisation would not be available in the case of an abuse of market power by a dominant firm. The authorisation route has the advantage of flexibility and transparency. Most importantly it enables the claimed public benefits of the import restriction to be tested and weighed against the adverse effects on competition in the particular circumstances of the case.

At present a number of developed and developing countries permit parallel imports. These include Australia, the European Union, Honduras, Hong Kong, India, Japan and Singapore. The developing countries that have recently enacted legislation to allow parallel imports of pharmaceutical products include. Argentina, Thailand and South Africa.

6.4 Restrictive practices associated with the licensing of intellectual property

Much of the intellectual property that is commercially valuable is licensed to other firms rather than being exploited by the original patent or copyright owner alone. Licensing is often a preferred option because:

- The licensees in different parts of the world will be better able to spot the range of market opportunities for the innovation than the inventor, who may have technical rather than commercial skills,
- The cost of transferring the necessary IPR to licensees is usually quite low.

It is generally the case that the licensor and the licensees are operating in different markets – the former competing with other inventive enterprises to develop new technology and the latter competing with other firms to market new products and processes based on such new technology. Thus, the licence agreement is typically a vertical agreement between firms engaged at different stages of the value-added chain running from invention through to production and distribution. As indicated in Chapter II, vertical agreements will rarely have a serious adverse effect on competition unless one of the parties to the agreement already has a dominant position in one market.

A particular problem that can arise in licensing agreements is the inclusion of conditions in the agreement that are not strictly necessary for the effective transfer of the technology but may have the purpose or effect of extending the market power of a dominant firm. Indeed, such conditions are better described as an abuse of market power than as a voluntary agreement between two willing parties. The abuse of market power, if proved, would represent a serious infringement of competition law (see Chapter III).

In this section of the chapter, some examples are given of restrictive conditions sometimes encountered in vertical technology licensing agreements, which may be of concern to the competition authority in particular circumstances. Readers will notice some similarities with the anti-competitive vertical agreements previously identified in Chapter II, although the welfare effects of IPR agreements can be different from those arising from agreements relating to goods and services.

Tying clauses

In the present context, tying refers to the practice whereby a firm with a virtual monopoly in a particular technology market will only license that technology to firms which will agree to purchase other unrelated goods or services. (see the reference to the Microsoft case in Chapter II). This may be regarded as an attempt by the dominant firm to increase its power in the market for the" tied " good and to prevent entry to that market. Whether the action results in a **substantial** lessening of competition (triggering an investigation by the competition authority) depends on the share of the market the firm has been able to gain, the market structure, the barriers to entry and the possibility of import competition in that market.

The possible anti-competitive effects of such tying clauses must be weighed against the possible welfare and efficiency gains that may be the principal reason for their introduction. For example, a manufacturer of newly developed and patented medical equipment may require purchasers of the equipment (mainly hospitals) to have it maintained on a regular basis by a nominated service company whose staff is trained in the proper use of the equipment. This tying arrangement is intended to preserve the reputation of the manufacturer and retain public confidence in the new technology. It will also help hospital patients and staff by reducing the risk of equipment failure. It seems unlikely that the competition authority would challenge such a tying arrangement. There are evidently some public benefits while any anti-competitive effects are

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likely to be slight – being confined to the market for servicing such equipment where there are usually many operators and entry is relatively easy.

Refusal to license

Should the competition authority take action to prevent a firm with a dominant position in a particular technology market from maintaining that position by refusing to license certain customers or customer-competitors?

This can be a difficult question. In the United States for example, different courts, faced with the same set of facts, have come up with different answers. However, there is widespread agreement that an owner of intellectual property rights with a monopoly in a particular technology market should not be **obliged** to offer licenses to other firms because:

- If the other firms are competitors or potential competitors, compulsory licensing would diminish the IPR owner's incentive to innovate, which is one of the principal objectives of the patent system.

- Competition law does not aim to reduce a monopolist's market power, which may have been obtained through greater efficiency or superior technology. Rather the aim is to prohibit the abuse of that market power. A refusal to licence is not of itself an abuse of such power.

- A manufacturer, who is usually the owner of physical or other non-intellectual property, is generally permitted under most competition laws to deal exclusively with a small number of distributors or not to deal with any, provided that this does not cause a substantial lessening of competition. The same general principle should apply to the owners of intellectual property in their dealings with their customers.

In brief, a refusal to license by a monopoly with a powerful array of IPR may be justified in some circumstances, but not in others. In Case Study 6.1, we see how a recent U. S. case against Intel Corporation, alleging that it had denied essential technical information to certain customers, was finally resolved.

Apart from the vertical arrangements between licensor and licensee of the kind just described, some types of horizontal arrangement involving intellectual property (i.e. between actual or potential competitors in the same market) might be regarded as anti-competitive. In some of these cases the anticipated efficiency gains may outweigh the adverse effects on competition. Four types of horizontal arrangement are discussed briefly here. These are:

- Agreements to extend the duration of a patent
- Grant-backs
- Joint research and development
- Horizontal mergers involving intellectual property issues

Agreements to extend the duration of a patent

In the past two years the Federal Trade Commission in the United States has taken action to stop three separate restrictive agreements, which had the purpose, or effect of delaying the entry into the market of less-expensive generic versions of widely, used branded pharmaceutical products. In each case the manufacturer of the branded drug (the patent holder) had paid a substantial sum to the generic supplier so that the latter would agree to file for approval to market the generic once the patent had expired, but then not actually put it on the market. Such an action also precluded any other potential generic manufacturer from marketing its version of the drug. This is because of a provision in the law that the first company to file an application to market a generic bio-equivalent drug is granted exclusivity for its product for 180 days from the date it is launched.

The FTC issued consent orders in these cases, under which the companies agreed not to enter into such agreements in the future. Moreover the generic manufacturers were required to waive their rights to a 180 day exclusivity period so that other generic products would have an equal opportunity of entering the market.

An agreement to extend the duration of a patent in this way evidently means that consumers will have to pay higher prices for the drugs for a period and patent-holders will earn higher profits, compared with the situation that would exist in the absence of the agreements. Yet it can be argued that striking out such agreements would also lower the incentive for brand name manufacturers to undertake research and development on pharmaceutical products. However, it must be remembered that in the cases under review the firms have already benefited from many years of patent

Case Study 6.1 Refusal to license – the Intel Corporation case

In 1998, the Federal Trade Commission (FTC) issued a complaint against the Intel Corporation alleging that it was a monopolist in the microprocessor market in the United States and had endeavoured to maintain its dominance by refusing to supply essential technical information and samples of soon-to-be released microprocessors to certain companies, mainly customers of Intel. The companies that were denied supply had been involved in disputes with Intel regarding alleged infringements to IPR and indeed had initiated or threatened to initiate litigation against Intel or its customers.

According to the FTC, the purpose of Intel's action was to coerce these companies into not continuing or initiating court action but instead licensing their intellectual property to Intel on terms favourable to the latter. If it was successful in this regard Intel would be able to strengthen its dominant position by lowering its royalty costs per chip and (potentially) offering improved products by incorporating technologies patented by the companies with which it was in dispute.

Intel defended its position by asserting that it was merely interested in preserving its IPR against the claims of infringement being made by the companies. It was particularly concerned that they might seek injunctions in the court, which would seriously disrupt its production schedule before the infringement claims were assessed on their merits. Moreover, it expressed doubts about the anti-competitive effects of its refusal to supply. Intel was basically in a different market from the customers who were taking legal proceedings. It was not obvious that its actions would foreclose the downstream market (where the chips are embedded in a variety of electronic products).

Intel and the FTC agreed upon a settlement of the case in 1999. The FTC acknowledged that an intellectual property holder, even a monopolist, is free not to license its product or provide secret technical information in the first instance. However, if a customer seeks to defend **its** IPR through the normal legal processes, a monopolist such as Intel should not be permitted to withdraw the licence or refuse to supply further information to that customer. If a customer or competitor seeks an injunction against Intel's sale of microprocessors, Intel would be free to discontinue the licence and the provision of information to that firm.

Sources for Case Study 6.1 Robert Pitofsky "Antitrust and Intellectual Property: Unresolved Issues at the Heart of the New Economy" a speech at the Antitrust, Technology and Intellectual Property Conference, University of California, Berkeley, March 2,2001 and Carl Shapiro "Navigating the Patent Thicket: Cross Licences, Patent Pools and Standard Setting" National Bureau of Economic Research seminar " Innovation Policy and the Economy" April 2000

protection prior to expiry. The normal duration of the patent should allow the patent holders to obtain adequate rewards for the technological advances that they have made, without the need for a private agreement to further extend the life of the patent.

One other consideration is that in the absence of this type of restrictive agreement the patent holders and the potential generic manufacturers are quite likely to resort to litigation over alleged infringement of the patent laws. Such litigation can be a waste of resources from the community's point of view and does not contribute to the innovation process.

On balance, however, the adverse effects of these agreements on competition appear to outweigh any benefits they may bring – including the possible benefits of increased research and development and reduced litigation costs.

Grant-backs

A grant-back is an arrangement whereby the licensee of a particular bundle of intellectual property rights agrees to provide the licensor with the right to any improvements that it may make in the course of using the licensed technology. Such an arrangement can be either pro-competitive or anti-competitive, depending on the circumstances. The pro-competitive aspects are that:

- Both the licensor and licensee gain prompt access to the technological improvements, which the licensee has made. This may lead to a more rapid dissemination of the relevant know-how, resulting in superior quality products or lower cost methods of production at an earlier date.
- The opportunities to further build on the improvements made by the licensee are enhanced because two firms rather than one have information about those improvements.

- The licensor may be induced to increase its R&D outlays given that the risks of licensing IPR to a competitor are somewhat reduced by the grant-back provision in the licence agreement.
- Costly litigation about possible patent infringements is less likely.

On the other hand, the anti-competitive aspects include:

- The licensee may have less incentive to undertake R&D, since it will not capture all of the benefits of the technological improvements that it may make.
- If the licensor is in a dominant position in the relevant technology market, the grant-back arrangement will help to maintain or even strengthen its market power. This is because the licensee will find that its own innovations in this area will not be such a powerful competitive weapon if the licensor also has access to them.
- Litigation is more likely, either for alleged patent infringement or for a breach of the conditions of the licensing agreement.

Where the balance will come out between the pro-and anti-competitive aspects of the grant-back depends on such factors as the market structure, whether the licensor has a dominant position in the market, the barriers to entry, and the rapidity of technological change in the industry in question. However, the grant-back arrangements will tend to be more pro-competitive if they are non-exclusive (i.e. other firms beside the licensor are given the right to use the technological improvements made by the licensee).

6.5 Joint research and development

An agreement between two or more firms to undertake a joint programme of research and development is generally treated favourably by competition laws. In the United States, for example, the Federal competition authorities have only challenged one research joint venture since the Sherman Act was passed in 1890.

The European Commission, in establishing new regulations relating to research and development agreements in November 2000, emphasised the benefits of cooperative research in the following terms:

> *"Cooperation in research and development and in the exploitation of the results generally promotes technical and economic progress by increasing the dissemination of know-how between the parties and avoiding duplication of research and development work, by stimulating new advances through the exchange of complementary know-how, and by rationalising the manufacture of the products or application of the processes arising out of the research and development."*

Nevertheless, the Commission and other competition authorities generally, do not exempt some R&D agreements **between competitors** from possible investigation for anti-competitive conduct. In the European Union countries, for example, such an agreement will not qualify for a block exemption if the participants' combined share of the market for products and services " capable of being improved or replaced by the results of the R&D" exceeds 25 per cent. Moreover, the agreement must not restrict a participant's freedom to conduct its own research independently of the joint R&D programme nor prevent it from undertaking research in cooperation with firms who are not parties to the agreement. Finally, all the participants must have access to the results of the joint R&D for the purposes of further research or exploitation.

The European Commission's attitude to joint R&D by enterprises, which are not competing with one another, is much more relaxed. A block exemption from the normal prohibitions applying to anti-competitive agreements is available for the duration of the R&D In addition, if the results of the R&D are jointly exploited, the exemption continues for seven years after the products arising from the research are first put on the market.

6.6 Horizontal mergers or acquisitions involving the transfer of intellectual property

As indicated in Chapter IV of this manual, some control is necessary on large-scale mergers and acquisitions, which might substantially lessen competition in a market. The fact that intellectual property rights and the future pace of technological change may be key issues in some merger proposals does not alter that conclusion significantly. It is true that there may be synergies and substantial efficiency gains from a horizontal merger between two high-technology enterprises, but if the merger would also lead to the combined enterprise dominating the market (e.g. because the key patents would all be in the hands of the one company) the

merger proposal should be treated with considerable caution.

In some “newer “industries, such as biotechnology and information technology, where technological change has been most rapid in recent years, many of the product innovations are attributable to relatively small or newly-established enterprises. This suggests that at least in some of the relevant markets the barriers to entry are relatively low. If this is correct, the case for allowing a merger between two of the leading firms in the market would then be correspondingly stronger. Indeed the competition authorities in most countries would be very likely to authorise a proposed merger between leading companies if it can be shown that it would bring efficiency gains and the barriers to entry to the relevant market(s) are low.

However, one difficulty confronting the authority is to establish whether barriers to entry are likely to remain low in the medium to long-term after taking account of the probable but uncertain future changes in technology and the future disposition of intellectual property rights among the leading firms. While it may be relatively easy for new firms to commence operations in a rapidly expanding industry based on a new technology, this may not be true when the industry begins to mature and the rate of growth of demand for its products begins to slacken.

In some recent merger cases, competition authorities in Europe and the United States have sought to ensure that prospective entrants are not prevented from entering a market, and R&D is not reduced, as a result of a merger between two large companies which between them have extensive intellectual property rights. For example, in the case of the proposed merger between Ciba-Geigy and Sandoz, the two leading commercial developers of gene therapy products in the United States, approval of the merger was made conditional on the combined firm granting non-exclusive licences to other enterprises to use certain of its gene therapy patent rights, know-how and technology. A further condition was that the combined entity should refrain from acquiring exclusive rights in respect of other genes. By imposing these conditions the Federal Trade Commission was aiming to maintain some measure of competition in this particular market and also preserve the incentive for innovation in this product area.

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CHAPTER VII

COMPETITION POLICY AND THE SMALL BUSINESS SECTOR

In this chapter the following issues are discussed:

- *In what ways does competition law impact on small firms?*
- *In what circumstances should the conduct of small firms be exempted from the normal prohibitions contained in the competition legislation?*
- *What additional policy measures should be undertaken to shield small firms from unfair dealing by larger enterprises?*

7.1 The impact of competition law on small firms

Beneficial effects

Small firms play a key role in creating employment opportunities and facilitating economic development, notably through the introduction of new products and processes and the transfer of technology from abroad. A competition law, which is properly enforced and applied universally across all sectors of the economy, is likely to benefit efficient small firms and contribute to the expansion of the small firm sector as a whole.

Factors such as the availability of capital, government regulation, inflation and barriers to international trade and investment may sometimes be regarded as more important for the health of the small business sector than competition legislation. But it would be a mistake to assume that competition law is aimed at big business alone and has relatively little impact on small firms or the informal sector of the economy.

Small firms, including the micro-enterprises which account for a large proportion of the informal sector in developing countries, need to purchase goods and services at the lowest possible prices. In the absence of a strong and effective competition law, price-fixing cartels are likely to proliferate, obliging small firms to pay above-normal prices for some of their supplies.

Moreover, an effective competition law is needed to stop overseas suppliers from imposing restrictions on parallel imports. Such restrictions tend to prevent small firms from engaging in the importation and distribution of the goods concerned (For a more detailed discussion of parallel importing see Chapter VI).

Small firms may also benefit from the control of mergers, which is a feature of competition legislation in most countries. The mergers that are opposed by the competition authority are those where the combined entity would gain or strengthen a dominant position in one or more markets, allowing it to raise prices or limit output. Thus, merger control diminishes the risk that small firms will have to pay monopoly prices for goods and services purchased in those markets.

Another aspect of competition law, which may be considered of particular benefit to small firms, lies in the prohibition of unwarranted price discrimination. Small firms often have to pay higher prices for a particular good or service than their larger competitors and it might be thought that this provision of the law would be widely used. In practice, however, the scope for legal redress under this provision is quite limited.

First, the difference between the prices charged or discounts allowed to a small enterprise, compared with a larger firm competing in the same market, is often explained by the difference in the cost of supplying small orders compared with large. Also, a small enterprise may have to accept a lower price for the goods it sells, if it can only provide limited quantities, compared with larger suppliers of the same items. In both cases there is justification for the price discrimination.

Secondly, as indicated in the United Nation Set of Principles and Rules on Competition (the Set), unjustifiable discrimination in pricing, or in the terms and conditions applying to the supply or

purchase of goods and services, should be stopped if it represents an abuse by an enterprise of a dominant position of market power and will unduly restrict competition in a market (the Set-D4). However, this implies that a firm which does not occupy a dominant position in a market does not normally breach the law if it charges higher prices to its small business customers, even if the difference in price cannot be justified by reference to cost differences or availability of supply.

While this may seem to be a weakness of the law from the perspective of small business owners and managers, two other considerations need to be taken into account. First, if a supplier (or a purchaser) is not in a dominant position in the market this implies that it will be exposed to competition from other firms if it elects to discriminate unjustifiably against one or more of its small business customers (suppliers). This potential competitive pressure may be enough to ensure that unjustifiable price discrimination does not take place.

Secondly, while competition law is intended to preserve competition in markets, as distinct from protecting the interests of individual competitors, some countries include in their competition legislation provisions designed to prevent unconscionable conduct. Such conduct occurs when a firm knows that the other party in a business transaction has a weakness or disability and seeks to exploit that weakness so as to obtain the maximum commercial gain from the transaction.

Typically, the victims of unconscionable conduct in trade or commerce are small firms, including small family businesses. Often the owner/managers are aged, are migrants with poor command of the local language, have low incomes and very little understanding of their legal position.

A recent case study and some further discussion relating to unconscionable conduct may be found in the concluding section of this chapter.

In summary, a competition law, properly enforced, is likely to bring benefits to the small business sector of the economy, as well as net benefits to the community as a whole. However, it cannot, and is not intended to, shield individual small firms from normal competitive pressures which may threaten their survival, even if those pressures are from larger domestic enterprises or major transnational corporations.

It may be argued that, in a developing country, it is inappropriate, or at least unnecessary, to have a policy that seeks to encourage competition, when a large proportion of small business entrepreneurs consider there is already too much competition in the market. For example, in the National Baseline survey of micro and small enterprises in Kenya in 1999, more than one-third of respondents stated that the most severe constraint on their firms arose from marketing problems, including having too many competitors or insufficient demand for their products. Other problems, such as lack of credit, poor infrastructure and a shortage of skilled labour were ranked much lower in importance as a constraint on the firm's operations.

Yet these results do not undermine the conclusion that the small business sector in a developing country is likely to benefit from the introduction of an effective competition law. The great majority of small firms in developing countries are to be found in markets with very low barriers to entry, such as agriculture, retail trade, repairs, and personal services. Because the entry barriers are so low, a strong competition law, which is successful in improving the terms on which small firms are able to purchase goods or services from large or dominant enterprises, will induce an influx of additional competitors into the relevant markets. Hence, the profitability of the individual small firms will show little improvement and competition will remain intense (as observed in the Kenyan survey results).

Who then is likely to benefit from the competition law? The most likely beneficiaries in this situation are ordinary consumers who can be expected to enjoy lower prices as the cost savings are passed through to them. While small firms individually may not experience any reduction in the intensity of competition, the aggregate output of the small firm sector is likely to increase to match the growth in consumer demand.

The excessive competition that small business entrepreneurs in developing countries sometimes complain of, is brought about by a combination of factors – the industrial structure, low barriers to entry to the markets in which small firms predominate and a lack of alternative employment opportunities. These problems have to be addressed directly by other economic and social policies. The implementation of an effective competition policy will certainly not worsen these problems and may well help to create additional employment within the small business sector.

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Illegal practices by small firms

Competition law is intended to prohibit business practices, which substantially lessen competition in a market. Small enterprises are subject to that prohibition just as much as giant multinational corporation. However, the great bulk of small firms, defined as firms with less than 20 employees including the working proprietor(s), clearly have no market power and are not able individually to bring about a substantial lessening of competition in any market.

Whether a collective agreement, arrangement or understanding among a number of small firms is likely to substantially lessen competition depends on:

- their combined share of the relevant market,
- the type of agreement in which they are involved,
- the particular circumstances in which the agreement applies.

In the United Kingdom, for example, the Director-General of Fair Trading takes the view that a restrictive agreement will generally have no appreciable effect on competition if the parties' combined share of the relevant market does not exceed 25 per cent. In Germany, the Federal Cartel Office will not usually challenge co-operation agreements between small firms where their combined market share is 5 per cent or less.

However, there are important exceptions to these guidelines depending on the nature of the agreement. In both countries, agreements that fix prices or discounts; impose minimum resale prices for goods; share markets territorially (or otherwise); limit production; or involve collusive tendering; are prohibited, regardless of the size of the firms involved or their combined market share. This is also the position in most of the other countries with a competition law.

The two case studies to be found below illustrate the fact that firms with only a small number of employees (or a low annual turnover) may be involved in anti-competitive restrictions, by virtue of an agreement or because of a decision of a trade association. In markets that are small, perhaps because of their geographical isolation or the specialised nature of the services provided, the combined share of the market held by small firms may be large. By acting in concert they may have substantial market power and the ability to raise prices above a competitive level.

Case Study 7.1 Panel Beaters in an outback region of Australia found to have fixed prices

In December 2001, the Federal Court of Australia found that four panel beating and spray painting businesses in the sparsely populated Port Hedland region of Western Australia had colluded on the prices they would charge motor vehicle insurance companies for repair work.

The Australian Competition and Consumer Commission had alleged that in mid-2000 the four firms had held discussions culminating in an agreement on the prices that would be charged from 1 September 2000. In a letter sent to 18 insurance companies on 25 August 2000 they specified the agreed charges for repair work.

Price-fixing is illegal under the Trade Practices Act 1974. The court granted injunctions to prevent the four from engaging in similar conduct, ordered them to attend a trade practices compliance programme and pay costs. The action was settled by consent of the parties.

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Case Study 7.2 Illegal pricing discussions by trade associations in New Zealand

In late 1997, the New Zealand Commerce Commission investigated an arrangement between two trade associations, the Retail Merchants Association and the National Association of Retail Grocers and Supermarkets of New Zealand, and Foodstuffs (NZ) Ltd., concerning the pricing of groceries during the Christmas period. The arrangement was intended to ensure that suppliers to the retail grocery trade would not change wholesale prices or launch new products over that period.

The Commission stated that it had no concern with such an arrangement being discussed independently between a retailer and a supplier. However, it did have concerns with pricing arrangements reached jointly by retailers who compete with one another. Such conduct is prohibited by the Commerce Act. If an association enters into such an arrangement, under the Act all the members are considered to have entered into the arrangement.

In this particular case the Commission did not take court action against members of the associations or Foodstuffs, since there was no detriment to consumers of groceries and it was assured that such conduct would not occur in the future.

The impact of competition law on professional rules and regulations

In a number of countries, competition law has treated anti-competitive arrangements by the professions differently from those put in place by other small businesses or by trade associations. In the United Kingdom, for example, professional rules notified to, and designated by the Secretary of State for Trade and Industry, are excluded from the prohibitions that would normally apply to such restrictions. However, in a report on competition and the professions published in 2001, the Office of Fair Trading pointed to the numerous restrictions on competition that remain in the professions and recommended that the scope to exclude professional rules from competition be removed.

In Australia, until recently, the competition authority was not able to take legal action against several professional bodies for a breach of the Trade Practices Act, because the Act did not apply to unincorporated businesses (such as barristers), but only to corporations. This obstacle to the equal treatment of incorporated and unincorporated enterprises has now been removed by amendments to the law.

Some of the more important anti-competitive restrictions that are still to be found in the rules of professional bodies in certain countries are listed below. It is highly desirable that these should come within the ambit of competition law. The professional body concerned would still be able to justify the continuation of a particular rule if it could demonstrate that the rule was indispensable to the achievement of greater efficiency and the realisation of benefits to the consumer.

Legal profession restrictions which inhibit competition:

- Clients cannot see a barrister without a solicitor.
- Limitations on the advertising of fees.
- Demarcation between barristers and solicitors.
- The rules that hinder or prevent the establishment of multi-disciplinary practices (e.g. the rule that practising barristers must be sole practitioners).
- The Queen’s Counsel system (including rules requiring a Q.C. to appear in court with a junior counsel whose fee is a specified fraction of that payable to the Q.C.).

Architects rules which may inhibit competition:

- Guidance from the professional body on the fees that architects should charge. Even if it is not mandatory to charge these fees, the issue of guidelines is likely to distort or inhibit price competition.

Accountants rule affecting competition:

- Statutory audits can only be carried out by those practising in a firm controlled by qualified persons. This rule could inhibit the formation of some multi-disciplinary practices involving auditors.

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Authorisation and exemption of small-business co-operation agreements

Many of the co-operative arrangements involving small businesses do not have the restriction of competition as their primary purpose. The principal objective may be to improve efficiency or marketing capability; lower costs; improve quality control, gain access to the latest technology, or gain a stake in a joint research and development programme which would be too expensive for an individual small firm to pursue. Provided an arrangement of this kind will not substantially lessen competition in a market, or will result in public benefits which outweigh any adverse effects on competition, it is unlikely to be opposed by the competition authority.

What public benefits can be realised if a co-operation agreement among small firms is permitted? Clearly this depends on the particular circumstances of the case. Consider first a case where the agreement relates to joint purchasing of certain key inputs supplied by larger enterprises. By pooling together the buying orders of a large number of small firms, the purchasing agency acting for them should be able to negotiate lower prices or better terms and conditions from the suppliers. However, while this may represent a significant cost saving for the small firms themselves, it does not necessarily constitute a public benefit. That will only arise if some of the cost saving is passed on to the consumer in the form of lower prices.

Moreover, there could be a possible loss of public benefit if the agreement requires the small firms (e.g. all the members of a particular trade association) to make all their purchases through the joint purchasing agency. This would tend to restrict the scope for competition by eliminating the possibility of individual firms striking their own bargains with the suppliers.

These considerations are reflected in German competition law which exempts joint purchasing by small and medium-size enterprises from the general ban on cartels, provided the participating firms are not compelled to buy through that route and provided that an improvement in efficiency will be obtained through the arrangement.

Case Study 7.3 provides an example of a joint-selling arrangement by small-scale enterprises, which was authorised recently by the Australian competition authority. In this case also, some conditions were necessary in order to ensure that there would be public benefits arising from the arrangement.

Case Study 7.3 Authorisation of collective bargaining arrangements by dairy farmers in the State of Queensland, Australia

Prior to July 1, 2000 the farm-gate prices for drinking milk were regulated by each State government. The farm-gate prices for milk used in manufactured dairy products were determined on a commercial basis and were significantly below those for drinking milk. The regulatory controls allowed little scope for arbitrage and hence the large price premium for drinking milk was maintained.

The State governments agreed to remove these regulatory arrangements concurrently on July 1, 2000. Thereafter, dairy farmers had to negotiate farm-gate prices for all milk with the milk processors, on a normal commercial basis.

In the State of Queensland there are approximately 1500 milk producers, the majority of which are family-owned and operated farms. There are only three major processors.- Pauls, Dairy Farmer’s Co-operative and National Foods Limited. The latter buys its milk supplies from Pauls, rather than directly from the producers.

The Australian Competition and Consumer Commission was asked to authorise an arrangement by which a single new company, Premium Milk Supply Pty. Ltd would collectively negotiate farm-gate prices and milk standards with Pauls Limited, on behalf of participating dairy farmers in South East Queensland.

In granting authorisation until July 1, 2005, the ACCC indicated that there was public benefit in smoothing the transition from a regulated to a deregulated market by providing farmers with an opportunity to develop skills and experience so that they can successfully operate in a commercial environment. It also pointed to other benefits such as transaction cost saving and the encouragement of new investment by farmers now faced with a more competitive market.

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Other important factors influencing the Commission's decision were:

- individual milk producers could (given due notice) opt out of the collective arrangements with Premium Milk Supply and negotiate their own supply arrangements with Pauls or any other processor. This preserved some scope for competition between dairy farmers.
- Pauls itself faced competition from the other processors.
- Pauls could negotiate to purchase milk from any source. It was not bound to purchase exclusively from Premium Milk Supply.

In these circumstances, the Commission took the view that the public benefits of the arrangement outweighed the anti-competitive effects, Authorisation would allow a smoother and less painful transition to a competitive market.

When it comes to agreements relating to such matters as:

- joint research and development,
- the sharing of training facilities,
- the diffusion of technology,
- the use of joint transport facilities,
- joint advertising (other than the advertising of uniform prices),

the public benefits are evident and the anti-competitive effects usually relatively small.

Co-operation of this kind between small firms is actively encouraged by governments, particularly in developing countries. The Government of Kenya, for example has indicated that:

"Small firms will be assisted to become dynamic and competitive through adopting new and more efficient technologies and effective work organization techniques. The linkages between firms will be achieved through a range of organisational arrangements which include increased cooperation, coordination and networking amongst smaller firms in specific sectors so that services such as marketing, research and development, skills acquisition and even production can be shared."
(Enhancing the Development of Micro and Small Enterprises in Kenya, 2000)

In general, these policy objectives are not in conflict with the objectives of competition law.

7.2 Policies to shield small firms from unfair dealing by larger enterprises

In a market economy, small firms and large often play a complementary role in the production and distribution of goods and services to the final consumer. Franchising arrangements, commercial tenancy arrangements, and agreements on the use of intellectual property are examples. In most cases, a formal contractual arrangement will usually define the rights and responsibilities of each party. However, in drawing up the original contract, amending or renewing it, the small firm will often lack the bargaining strength of the larger firm on the other side of the deal. This disparity in bargaining power may give rise to disputes, which have to be resolved through the courts or through mediation.

The core elements of competition law, namely the prohibition of anti-competitive agreements and the abuse of a dominant position of market power (described in detail in Chapters II and III) do not deal with this issue. However, in some countries there are provisions in the competition legislation itself specifically aimed at assisting small businesses by seeking to ensure that:

- Adequate information is available to the firm about the scope of the contract and the risks involved in entering into it.
- The large firm (i.e. the stronger party) does not, in some types of commercial transaction, take unfair advantage of its greater bargaining strength.
- The large firm is penalised for "unconscionable conduct", if it was aware of a weakness or disability affecting the bargaining position of the other party and sought to take advantage of that.

Where this type of legislation is in force, most of the complaints received by the competition authority from small businesses relate to franchising arrangements and retail tenancy problems. A useful starting point for reducing the number of such complaints is to devise Codes of Conduct for the relevant sectors in consultation with both large and small firms (e. g. reflecting the views of both franchisers and franchisees) The Code should specify the information that must be disclosed before the contract is entered into, renewed or extended. It should also indicate what notice is required for the termination of the contract or its transfer to another enterprise as well as the

procedures to be followed if mediation is needed to resolve a dispute between the parties.

Initially such Codes may be voluntary, but in Australia, for example, the franchising code of conduct was made mandatory in 1998, with further amendments taking effect on 1 October 2001. Under the Australian legislation the franchiser is required to provide a prospective franchisee with a disclosure document with details on 23 items at least 14 days before the franchise is entered into, renewed or extended.

The information to be included in the disclosure document includes *inter alia,* details on the franchise territory, (e.g. whether it is an exclusive territory or whether the franchiser or its associates may establish other similar franchises in the territory); the business experience of the people running the franchising company; its liquidity situation; the financing arrangements for the franchise; and any restrictions on where the franchisee can buy goods and services. A short-form disclosure document containing only 11 items has been permissible since October 2001, but only for franchises with an annual turnover of less than $A 50,000 per annum (approximately $US 26,000).

Unconscionable Conduct

A mandatory code of conduct of the kind referred to above helps to ensure that small businesses have adequate information when they are considering a franchising opportunity or a retail tenancy agreement. What additional safeguards are needed to dissuade the stronger party in a commercial transaction (usually the larger firm) from engaging in conduct that is unfair or unconscionable as far as the small firm is concerned?

In Australia, the safeguards are provided through a new section of the Trade Practices Act which took effect from July 1998. This prohibits unconscionable conduct in transactions or possible transactions of goods and services valued at less than $A1 million. However, relief under this section is not available to companies listed on the stock market.

While unconscionable conduct is not defined in the legislation, a list of factors, which may be taken into account by the court, is mentioned. These factors include:

- The relative bargaining strengths of the parties
- The use of any undue influence, pressure or unfair tactics against the small business
- Was the small business able to understand the documents used?
- Is the small business required to comply with conditions that are not reasonably necessary to protect the legitimate commercial interests of the stronger party?
- Has the larger party disclosed all terms that could affect the commercial viability of the small business and shown a willingness to negotiate?

Case Study 7.4 below provides an example of a recent case in which the court found that a company had engaged in unconscionable conduct in breach of the competition law.

In some countries, separate agencies are responsible for the administration and enforcement of competition law and consumer protection (fair trading) law. Where this is the case, the consumer protection (fair trading) body is likely to be in the best position to deal with cases of alleged unconscionable conduct. This is because:

- Consumer protection and the protection of small businesses often involve similar issues (e.g. misleading representations and deceptive conduct).
- The government body that has responsibility for devising and monitoring business Codes of Conduct.(usually the fair trading authority) should also be concerned with breaches of those Codes through unconscionable conduct.
- Economic analysis, which is usually a key element in assessing possible breaches of competition law, is not required to anything like the same extent in cases involving unconscionable conduct.

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Case Study 7.4 Unconscionable Conduct

In 1994, a land-owning company in Australia entered into agreements with two farmers to lease a particular area of land. The leases were to run for eight years and allowed unlimited use of the water available to the landlord from a bore on the land. This land was later sub-let to five other farmers from Vietnam who invested considerable resources in working the land as market gardens. They had had little formal education and their knowledge of English was poor.

In 1998 the landlord unlawfully claimed a right to break and vary the leases. In that year, and also in the following year, the farmers were required to sign new leases, which reduced the amount of water available to them. They were advised, however, that the lease conditions were the same as in 1994, except for the rent and the terms of payment.

In 1998 the landlord sold a significant proportion of the water allocated to the bore, with the result that the farmers incurred substantial excess water charges. Moreover they had to pay higher taxes because of the lease variations.

The landlord then demanded payment of the excess water charges amounting to $A67, 000 for the two years 1998/99 and 1999/2000.

The Federal Court of Australia found in February 2002 that the landlord was guilty of conscionable conduct and granted injunctions requiring it to:

- Indemnify the farmers for the excess water charges claimed,
- Waive any excess water charges for the remainder of the lease, provided the water consumption was no greater than the amount stipulated in the original 1994 lease.

The lease is now due to expire on 1 January 2004.

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CHAPTER VIII

THE INSTITUTIONAL FRAMEWORK FOR THE ADMINISTRATION AND ENFORCEMENT OF COMPETITION LAW

In this chapter the following issues are discussed:

- *The respective roles of government, the competition authority and the courts*
- *The importance of independence, transparency and accountability in decision making by the competition authority*
- *The competition authority*
  - *Functions*
  - *Membership*
  - *Resources*
  - *Co-operation with competition authorities in other countries*
- *Courts and tribunals*
  - *The functions of courts of law and specialised competition tribunals*
  - *Courts of appeal*

8.1 The respective roles of government, the competition authority and the courts

An appropriate institutional framework is a prerequisite for the effective administration and enforcement of competition law. The centrepiece of this framework is the competition authority (usually entitled the Competition Commission or the Competition Council) This should be independent, have adequate resources to investigate and prosecute alleged breaches of the competition law and be accountable for its actions to the minister or the Parliament.

The legislature, the executive (in this case, the competition authority) and the judiciary all have a part to play in ensuring that restrictive business practices are minimised and consumer welfare enhanced.

Typically, the government and the legislature will determine the:

- Scope and coverage of the competition legislation, including the types of anti-competitive practice that shall be outlawed and any exemptions that are to be granted to particular industries (e.g. government instrumentalities, agriculture, or the professions),
- Powers of the competition authority,
- Membership of that authority,
- Budget of the authority,
- Types of sanction and remedy that can be imposed for breaches of the competition law (leaving the details to be determined by the competition authority or the court in the light of the particular circumstances of each case),
- Public interest factors that the competition authority should take into account in deciding whether or not a merger proposal or an anti-competitive agreement should be authorised,
- Procedures for appeals from decisions of the competition authority or a lower court.

The powers accorded to the competition authority differ significantly between countries. In some, the authority is not only responsible for the administration of the competition law, but also for the administration of other laws such as those relating to consumer protection; price surveillance or control; and the access of businesses to essential facilities (e.g. following the privatisation of a natural monopoly), The focus of this chapter is on the authority’s role in respect to competition law and policy alone.

In some countries, the competition authority is given a good deal of autonomy to stop restrictive practices, abuses of market power and anti-competitive mergers. Although the authority

operates under the auspices of a government minister (usually the Minister of Economic Affairs, the Minister for Industry or the Minister for Trade), it is able to make decisions without the approval of the minister concerned. Further, with this type of organisational model, the authority, or its Director-General, can issue injunctions and impose penalties for breaches of the law without reference to the courts. However, there is generally a right of appeal from the authority's decision to a court or a specialist tribunal.

In broad terms this type of institutional framework applies in the United Kingdom, Zambia and Germany, for example. However, even in these countries the minister may intervene in special circumstances. For example, in Germany, the Federal Minister of Economics can authorise a merger, which has been prohibited by the competition authority, the Federal Cartel Office, if this is justified by public interest considerations.

An alternative organisational model is one in which there is closer collaboration between the competition authority and a government minister and his department. In some countries the competition authority investigates suspected breaches of the competition law and makes recommendations to the minister on the action that should be taken. This is the situation in Morocco, for example. In a number of other developing countries, representatives of government departments are members of the competition authority.

A third model is one where the competition authority makes its own decisions on individual cases without reference to the minister or his department, but must prosecute in the courts in order to establish whether or not there has been an infringement of the law. The court also decides the penalty that is to be imposed if an infringement is proved. This model is to be found in Australia, New Zealand and Finland, for example.

Which of these models is the most efficient for a particular country depends on a variety of factors, including past experience in implementing and enforcing a competition law, the legal system, and the expertise available to the competition authority and the judiciary respectively.

While the choice of an appropriate institutional framework must be left to each individual country, there are some general principles, which should be observed in making that choice. These are discussed in the next section.

8.2 The importance of independence, transparency and accountability

Independence of the competition authority and the courts

The establishment of an independent competition authority has been a feature of competition law in almost every country, developed and developing, that has introduced such legislation in recent years. Independence is an important issue just as it is for the judiciary.

Decisions of the authority will not be respected or have the necessary deterrent effect on anti-competitive practices if it is perceived that the authority is exposed to political interference or can be captured by particular interest groups.

Moreover, the authority should not be put in a position where it believes its budget would be endangered if it does not grant a particular authorisation or if it prosecutes particular companies for a breach of the competition law.

Transparency

In the interests of transparency, the reasons for each decision made by the competition authority or the court should be made known to the public. This helps to build confidence in the fairness of the system and also acts as a safeguard to the independence of the competition authority.

It is sometimes suggested that reasons should not be given in cases where commercially sensitive information has been provided by one or more of the parties, and the authority has relied on some of this material to reach its decision. However, experience indicates that this is rarely a significant problem. While the authority must not disclose any secret or confidential information, this does not preclude it from explaining in broad terms how it arrived at its findings.

Transparency is also important so that the public can understand the general guidelines employed by the competition authority in analysing the cases that come within its purview. Developed countries with long-standing competition laws, such as Australia, Canada and the United Kingdom, publish a wide range of guideline documents to assist businessmen, lawyers and others in understanding how the authority interprets the law and what procedures it follows.

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Developing countries also need to publish such guidelines, although a less extensive publication programme is probably warranted, given the limited availability of suitably qualified staff and the fact that the competition law in those countries tends to be less complex.

Accountability

Although the competition authority is usually an independent statutory body, it should be accountable for its actions to the government or the parliament. In many countries accountability is met by a legislated requirement that the authority prepare an annual report for the Parliament, detailing how its funds were spent, the degree of success achieved in curtailing anti-competitive practices, and its priorities for future work.

8.3 The competition authority

Functions

Listed below is a range of functions typically undertaken by the competition authority. However, not all of these functions are carried out by every competition authority around the world, and the list is not exhaustive. Therefore it should be regarded as indicative rather than comprehensive.

- Investigating complaints about possible breaches of the competition law (In a few countries this function is performed not by the competition authority, but by a different body. In Belgium, for example, the Competition Service, which is a unit of the Ministry of Economic Affairs, is responsible for " seeking out and noting the existence of anti-competitive practices. It investigates all cases in which action must be undertaken and enforces any rulings").
- Initiating inquiries or investigations into markets where anti-competitive conduct or abuse of market power is suspected.
- Receiving applications for authorisation or individual exemption and adjudicating on them (for further details see Chapter V).
- Publishing the reasons for its decisions.
- Maintaining a register of notifications (see Chapter V).
- Enforcing the competition law by launching prosecutions in the courts when that is deemed appropriate.
- Imposing injunctions or pecuniary penalties to stop anti-competitive conduct (in the United Kingdom this power is vested in the Director-General of Fair Trading rather than in the Office of Fair Trading of which he is head).
- Acting as an advocate for competition. This is an important function, which can take several forms. First, the competition authority may be invited to, or be required to, comment on the implications for competition of new laws, rules or regulations that the government is proposing to introduce. This is especially important when privatisation of government instrumentalities is under consideration. Second, the authority should conduct a public education programme designed to increase understanding of the objectives of competition policy and to inform the public how to lodge a complaint about an anti-competitive practice or an abuse of market power.
- Preparing an annual report on its activities for the information of the Parliament and the public.
- Assisting companies to devise suitable training programmes that will ensure that their employees comply with the laws relating to competition and consumer protection.
- Acting as an arbitrator in relation to disputes between companies regarding access to essential facilities (for further details see Chapter X).
- Taking class or representative actions in the courts on behalf persons directly affected by a breach of the competition law.
- Implementing internal training programmes to enhance the skills and knowledge of its own staff about competition law and policy.
- Co-operating with other competition authorities around the world (e.g. exchanging information about international cartels).

The composition of the competition authority

The Competition Act typically specifies the composition of the competition authority, including such matters as:

- The number of members, both full-time and part-time
- The experience or qualifications required for appointment as a member
- The appointment of the Chairman
- The tenure of the appointed members

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Different countries have different approaches to these matters and it is difficult to discern any consistent pattern. Some examples will help to illustrate the extent of these differences.

The number of members

As far as the number of members is concerned, some countries do not have a fixed number, allowing the relevant authority to appoint as many full-time and part-time members as are required (Australia is in this category). In Belgium, however, the Competition Council has 20 members, with the Chairman, Vice-Chairman and two other members holding full-time positions. The Competition Commission in Zambia has 14 members, all of them part-time. In Germany, the Monopolies Commission has five members, while decisions of the Federal Cartel Office are made by decision divisions consisting of only three members, a chairperson and two other members.

Qualifications and experience required for appointment

In many countries, the legislation specifies that, in order to qualify for appointment as a member of the competition authority, a person should have knowledge or experience in fields such as economics, law, business administration, commerce or public administration. This requirement applies in Brazil, Germany and Australia, for example.

To avoid any possible conflict of interest, some countries will not appoint as a member of the competition authority a person with close links to industry and commerce. For example, in Germany, a member of the Federal Cartel Office cannot be an owner or manager of any undertaking nor be a member of the management board or supervisory board of an undertaking, cartel, professional organization, or a trade or industry association. This is in contrast to the situation in Zambia where representatives of employer and employee organizations, the Council of Commerce and Industry, and professional bodies are all members of the Competition Commission.

While this is a stark contrast, it does not necessarily follow that there is less likelihood of a conflict of interest in Zambia. The Zambian legislation provides that a member of the Commission must, at the commencement of a meeting, disclose any direct or indirect interest in a matter before the Commission and not take part in the discussion nor vote on the matter, unless directed by the Commission.

Appointment as Chairman

Three different approaches are discernible in the appointment of the Chairman (President) of the Competition authority. One is election by the Commission from amongst its members (as in Zambia, for example). A second approach is appointment by a Minister, the Parliament, the President or the Head of State (as in Germany, Croatia, and Australia, for example). The third approach is to have a senior government official occupy the post of Chairman (President) by virtue of his office (as in Argentina, where an Under-Secretary of Commerce is designated as President of the Competition Commission).

Any one of these approaches may be suitable for a developing country introducing competition laws for the first time. However it is important that the appointment of a Chairman should not compromise the independence of the competition authority in any way.

Tenure of office

Again, there is considerable variation between countries in the length of tenure of members appointed to the competition authority. In Italy, members are appointed for 7 years, in Belgium and Hungary for 6 years, in Algeria for 5 years, in Zambia for 3 years and in Brazil for 2 years. In Australia, the tenure may vary but is not to exceed 5 years for any appointee.

In general, the appointment of a member may be renewed for a further term.

Conclusions regarding the role of the competition authority and its composition

What conclusions can be drawn from the diversity of approaches described above? It is apparent that each country must make its own choice and there would be little value in seeking to obtain uniformity. However, there would probably be a wide measure of agreement on the following points:

- Some members of the competition authority should have knowledge and experience either in the fields of economics or the law. These are indispensable tools in the proper

analysis and understanding of anti-competitive practices.

- The competition law should include provisions designed to overcome the possibility of conflict of interest by members of the competition authority.
- Appointments to the membership and the chairmanship of the authority should not in any way compromise the independence of the authority.

Resources

The availability of resources to implement and enforce the competition law effectively is a critical issue in most developing countries. Initially there is often a shortage of skilled staff able to investigate infringements of the law and analyse merger proposals. Moreover, budgetary pressures may result in the government providing insufficient funds to finance the whole of the planned work programme of the competition authority.

It may be difficult to find a solution to these problems in the short-run. However, in the longer term, they can be alleviated by devoting attention to training courses for staff (provided either by the authority itself or by external organizations) and by strengthening the advocacy function of the authority.

The advocacy role is important because it helps to build public support for an effective competition policy. It also emphasises to government the need to have a strong independent authority capable of assessing the impact on competition of proposed legislation and regulations. If the advocacy is carried out effectively, the competition authority is likely to be better insulated from budget cuts.

Co-operation with competition authorities in other countries

The United Nations Set of Principles and Rules on Competition ('the Set') emphasises the need for the exchange of information between countries in order to control restrictive business practices. As stated in section E.9:

> *"States should ... supply to other States, particularly developing countries, publicly available information, and to the extent consistent with their laws and established public policy, other information necessary to the receiving interested State for its effective control of restrictive business practices"*

The OECD has also been putting forward recommendations designed to encourage co-operation between countries on anti-trust matters.

In the past decade, these suggestions have begun to bear fruit. Bilateral anti-trust co-operation agreements have been signed between the United States and Australia, Brazil, Canada, Germany, Israel and others. The European Commission has similar agreements with the Czech Republic, Hungary and Poland for example. These include provisions for the exchange of information on State aid. Finally, in Australia, the Competition and Consumer Commission has concluded bilateral agreements with its counterparts in Taiwan and Paua/New Guinea and a tripartite agreement with Canada and New Zealand.

Globalisation makes it more necessary for developing countries to participate in such bilateral or multilateral arrangements for co-operation on competition issues. The information available to the competition authority in a developed country may be critical to an understanding of what impact an international price-fixing cartel is having on the domestic economy of a developing country. Moreover, joint action by the competition authorities in a number of countries may be required if the cartel's operations are to be curtailed.

A further advantage to a developing country from co-operation with an established and experienced competition authority overseas is the opportunity it may provide for procuring technical assistance, including the exchange of staff, internships, training courses and assistance in the drafting of competition legislation.

A new initiative towards multilateral co-operation among competition law authorities was announced in October 2001 with the establishment of an International Competition Network (ICN). This will consist of competition law enforcement agencies from both developing and developed countries who will be aiming to reach a consensus on proposals for convergence on procedural and substantive issues relating to the enforcement of competition law. The recommendations of the ICN will be put to governments but will not be binding on them.

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8.4 The role of courts and tribunals

In many countries the ordinary courts continue to play a very important role in the enforcement of competition law. However, in recent years, the competition authorities have been making increasing use of other ways of achieving the objectives of the law, without having to resort to litigation. These other ways include:

- Voluntary compliance programmes,
- Authorisation by the competition authority of proposed mergers and certain types of anti-competitive practice, and
- The acceptance by the authority of written undertakings as to a firm's future conduct.

Such methods are often more expeditious and less costly than launching a prosecution through the courts and yet they can be just as effective in deterring firms from infringing the law.

The role of the courts

The role of the court is to determine, in the light of evidence presented by the competition authority and the defendant whether or not there has been a breach of the competition law. It may also issue a temporary injunction to stop an alleged anti-competitive practice prior to a hearing of the substantive issues in the case.

If the court finds that there has been a breach of the law it can impose a variety of sanctions or remedies depending on the seriousness of the offence (for further details see Chapter X).

In some countries the Competition Act allows private individuals or corporations, as well as the competition authority, to take action in the court for a suspected infringement of the competition law. However, it appears that such private actions are rarely successful.

In some countries, the competition authority can take only civil proceedings in the court in respect of a breach of the competition laws. This is the situation in Australia, for example. In most countries criminal as well as civil proceedings are possible.

In arriving at its decision in any particular case, the court normally has to indicate how it has interpreted relevant clauses in the competition legislation. These interpretations are significant, as they will act as a precedent for the judiciary and the competition authority in similar cases in the future, unless they are challenged.

The composition of the court

A question that is often debated is whether the ordinary courts should hear cases involving restrictive business practices or whether it would be better to establish a specialist court for the purpose. The latter solution is said to have the advantage that persons with specialist knowledge of competition matters would be appointed, procedures could be streamlined, and therefore cases could be determined much more efficiently and expeditiously.

Scherer (1980) pointed to one extreme example, which supports the argument that a specialist court could result in faster and less costly decision-making. In the United States, a Federal Trade Commission case involving alleged illegal price-fixing by cement manufacturers, required three years of hearings, with 11 years elapsing between the filing of the complaint and the final resolution by the Supreme Court. In Great Britain, a similar case involving the British cement industry required just 16 days of hearings before the Restrictive Practices Court. Only three and half years elapsed between the initial complaint and the final judgment.

One practical reason for retaining a system in which the ordinary courts hear restrictive practice matters is that, under that arrangement, hearings can take place in different parts of the country and witnesses have less distance to travel to give evidence. A specialist court is likely to be located in a single central location, such as the capital city.

Indeed a specialist court seems somewhat unnecessary, provided that:

- There is adequate legal, economic and business expertise in the membership of the competition authority,
- The process of deciding cases can be speeded up by using non-adversarial approaches to a greater extent (e.g. authorisations, written undertakings, and advisory opinions),
- A right of appeal to a court or tribunal is available to a party who is not satisfied with a decision of the competition authority. This preserves the rule of law.

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Courts of Appeal

The competition legislation in developing and developed countries alike nearly always provides for a right of appeal to a higher court of tribunal. However, the institutional arrangements are not uniform across countries.

In Zambia a decision by the Competition Commission can be appealed to the High Court and then to the Supreme Court. In the United Kingdom, an appeal against a decision of the Director-General of Fair Trading relating to an anti-competitive agreement or an abuse of market power, would be heard by the Competition Commission in its role as an appeals tribunal. Decisions of the Competition Commission could be the subject of further appeal to the Court of Appeal, but only on points of law and the level of penalty.

In Australia, if the Competition and Consumer Commission refuses to grant an authorisation that has been requested, the applicant can seek a review of the decision from the Australian Competition Tribunal – a specialist body established for this purpose. The President of the Tribunal must be a Judge of the Federal Court. Appeals from the decisions of the Federal Court generally, can be made to the High Court, but only when leave is given and points of law are involved.

These examples once again illustrate the diversity of the institutional arrangements for the control of anti-competitive business practices. Each country has to choose the arrangements that suit it best – there is no single correct model. The fact that nearly all countries have appeal mechanisms of one kind or another based on the rule of law is encouraging. These can help to provide some of the checks and balances needed to ensure fairness and transparency in the process of evaluating anti-competitive practices.

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CHAPTER IX

SANCTIONS AND REMEDIES

In this chapter the following issues are discussed:

- *The objectives of sanctions and remedies*
- *The nature of the sanctions in various jurisdictions*
- *Factors to be taken into account in fixing the amount of a pecuniary penalty*
- *Maximum pecuniary penalties and the size of penalties recently imposed*
- *Leniency for "whistleblowers"*
- *Desirable features of an enforcement regime for a developing country.*

Competition legislation generally provides for sanctions to be imposed for a number of offences specified in the Act. Most interest centres on the sanctions that can be imposed for anti-competitive conduct in breach of the law, but sanctions usually apply also if:

- An enterprise has not honoured undertakings it has given to a Court or to the competition authority (e.g. on the divestiture of shares or assets following a merger),
- A person or enterprise has failed to supply documents or information within the requisite time,
- Information provided to the competition authority or a Court is false or misleading in some material respect,
- Orders made by the competition authority or a Court have not been complied with.

This chapter only deals with the imposition of sanctions when there has been anti-competitive conduct in breach of the competition law.

9.1 The objective of sanctions and remedies

Sanctions for breaches of the competition law are essential; otherwise the law will be ineffective. However, when the competition authority or the Court determines the sanctions it considers appropriate for a particular offence, it may have more than one objective in mind. The possible objectives may include:

- To stop an anti-competitive practice from continuing, or a merger from proceeding,
- To penalise the firm or firms responsible for the offence,
- To deter other firms from engaging in similar anti-competitive conduct,
- To compensate those firms or individuals that have suffered damages as a result of the conduct,
- To correct misleading information that a firm has provided to the public,
- To ensure that an effective compliance programme is introduced in the offending firm(s) to avoid a repetition of the offence.

For example, if a case of collusive tendering has been proved, the competition authority will probably seek Court orders designed to bring the practice to an end, prevent its recurrence, penalise the offenders, deter others from entering into such an arrangement, and ensure that a compliance programme is put in place. It may also seek compensation for those adversely affected, or allow the right of private action for the recovery of damages.

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However, for a minor offence, such as the inadvertent inclusion of misleading information in a brochure sent to customers, it may be regarded as an adequate penalty if the firm is required to reissue a corrected version of the brochure at its own expense.

9.2 The nature of the sanctions employed

The principal sanctions available for breaches or suspected breaches of competition law are:

- Injunctions or interim orders
- Pecuniary penalties
- The award of damages, and
- Divestiture

Injunctions and interim orders

In some jurisdictions, the head of the competition authority is empowered to take **interim** measures to terminate an anti-competitive agreement or stop a continuation of anti-competitive conduct (pending a full investigation of the matter) where he has reason to believe that it infringes the law. The persons involved in the suspected anti-competitive conduct or agreement must be advised in writing of the reasons for the interim measure and have a right of appeal. This is broadly the procedure in the United Kingdom, following the passage of the Competition Act in 1998.

In other jurisdictions, the competition authority must seek a Court injunction to stop a suspected restrictive business practice or a proposed merger. If the Court grants an interim injunction this will only provide a temporary halt, pending a full hearing of the matter.

In some countries, including Australia, it is possible for a firm or individual to take private action to seek a Court injunction, but this only applies to a restrictive business practice, not a merger or takeover. The latter provision is designed to prevent the target firm, or another company, from using spoiling tactics to prevent an acquisition, which might be in the public interest.

Pecuniary penalties

Pecuniary penalties are frequently employed for breaches of competition law, usually with an eye to their deterrent effects. In a number of developed and developing countries, the competition authority has a limited power to impose such a penalty. For example, the Director General at the Office of Fair Trading in the United Kingdom has the power to impose on a firm that has infringed the competition law, a financial penalty of up to 10 per cent of that firm's turnover in the U.K. The amount of the penalty can be appealed. This right of appeal is important since, without it, the Director-General might be seen as prosecutor, judge and jury in cases of restrictive business practices.

In some countries, including Australia, Canada and the United States, the power to impose a financial penalty for an offence under the competition law rests exclusively with the Courts. Typically, the competition authority will recommend to the Court what it believes to be an appropriate penalty in the particular circumstances of each case and this may be accepted by those responsible for the offence to avoid further litigation.

It may be noted that fines for breaches of the competition law may be imposed on individuals as well as on corporations. While the maximum fines for individuals is generally well below that for corporations, experience suggests that a fine on a senior manager in a company can have an important deterrent effect and result in better compliance with the law in the future.

Imprisonment of a senior manger would, no doubt, have an even stronger impact in this regard. However, in many countries, including Australia, criminal proceedings cannot be brought for contraventions of competition law, and a prison sentence will not be imposed on an individual unless he or she fails to pay a fine. In Argentina, Canada, Norway and the United States (under the Sherman Act), however, certain offences, notably price-fixing, can result in a prison sentence for the individuals concerned.

Damages

Generally, a private individual who has suffered loss or damage as direct result of a contravention of the competition law can take civil proceedings against the perpetrator of the offence to recover that loss. In the United States, under the Clayton Act, persons injured by anti-trust violations, such as price-fixing, are able to sue for three times the amount of the damages sustained. The number of private suits commenced under this piece of legislation rose from about 200 per year in the 1950's to 1500 per year in 1976 and there are no signs that the number is diminishing.

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According to a leading U.S. economist (Scherer, 1990) the treble damages approach has added a potent weapon against monopolistic practices.

> It *"...has compelling advantages – e.g. decentralising initiative to buyer groups and private law firms with superior access to market information and more legal talent than a government enforcement agency can normally command"*

It should also be noted that class actions seeking damages for anti-competitive behaviour can also be instituted in countries such as France, Canada and the United States.

Divestiture

In most major mergers or acquisitions, the firms involved will usually seek informal discussions with the competition authority beforehand to see what concerns the authority may have. Sometimes the concern may be limited to a small part of the proposed acquisition (e.g. a single market where the two firms currently compete). If the acquiring firm gives an undertaking to divest itself of its assets or shares in this market, the authority's objections to the merger may be overcome, without the need to go to Court. (For further discussion of this issue see Chapter IV The control of mergers and acquisitions).

Compulsory divestiture is seldom employed as a remedy for a contravention of competition law. However, if a firm has acquired control of an enterprise, or two firms have merged, without prior authorisation from the competition authority, and this is likely to substantially lessen competition in a market, a divestiture order can be sought from the Court. This remedy is available in a number of developing and developed countries, including Malawi, Zambia, Australia and the United States.

A much broader issue, much debated in the United States, is whether it is appropriate to break-up a giant enterprise, which dominates one or more markets, in order to allow greater scope for competition. The argument is that the prohibition of anti-competitive conduct is unlikely to be effective in diminishing the market power of a monopoly or near-monopoly and that a structural remedy is needed. This is not to say that it is appropriate to break-up all large monopolies, but only those where the market power derives from past deliberate anti-competitive behaviour.

The Federal Trade Commission in the United States has sought structural fragmentation in a number of celebrated cases over the past thirty years, including those against the breakfast cereal manufacturers Kellogg and others, the Exxon Corporation, IBM and the current case against Microsoft (still under appeal in the Court at the time of writing).

Such cases are very expensive to litigate, for both the Commission and the defendant. It seems doubtful whether developing countries should take the initiative in seeking to break-up large transnational corporations, although the competition authorities in those countries may be able to provide valuable evidence to the FTC in support of the cases fought in the United States courts.

9.3 Factors to be taken into account in fixing the amount of a pecuniary penalty

What criteria should be taken into account by the competition authority (and the Court) in determining the appropriate penalty for a particular offence? While there are differences between countries in their approach to this question, there are also some criteria, which are almost universal. The common features include:

- The gravity and the duration of the infringement,
- The impact on the market, including any economic or social benefits,
- Whether the infringement represents a repetition of past anti-competitive conduct,
- Whether the firms involved cooperated with the competition authority,
- Whether there are mitigating circumstances.

In addition, some countries take account of other criteria including:

- The size of the company involved in the infringement,
- Its market power (including barriers to entry),
- The involvement of senior management,

- Evidence of a corporate culture of compliance with the competition laws.

9.4 Maximum pecuniary penalties and the size of penalties recently imposed

The maximum fines that can be imposed for breaches of competition law have increased significantly in recent years with the aim of providing a stronger deterrent against anti-competitive conduct. In the United States, for example, the maximum corporate fine for a single offence was raised tenfold in 1990 to US$ 10 million. In Australia, it was increased by a factor of 40 in 1993 to A$10 million. (Equivalent to about US$ 5.5 million, at current exchange rates)

However, these legal maxima do not give an accurate representation of the fines actually imposed in developed countries in recent years. In the United States, it was not until 1995, in the ICI (Explosives) case, that a fine as high as the new maximum of US$ 10 million was imposed. However, since then, fines between US$ 10 million and US$ 100 million have become almost commonplace, under the Sherman antitrust Act. Fines of this magnitude are possible, despite the fact that they exceed the normal legal maximum figure, because of a provision that allows the penalty to be increased to twice the pecuniary gain derived from the criminal offence or twice the pecuniary loss caused to the victims. In determining the magnitude of the gain and loss, the Court takes account of the activities of the cartel as a whole, not only those of the defendant.

In the European Union, a fine equivalent to about US$ 110 million was imposed in the Volkswagen case in 1998, and Tetra Pak was fined 75 million ECU for misuse of its market power in 1991. In Japan, a fine of US $80 million was imposed on a cement cartel in the same year. Fines in Australia have been lower than in these larger economies. The highest aggregate fine was imposed in March 2001 on three suppliers of animal vitamins found guilty in the Federal Court of a price-fixing and market-sharing arrangement. Total fines of just over US$ 14 million are to be paid in this case.

It is to be expected that fines imposed by the Courts in developing countries will generally be below the average in developed countries. This is partly because the pecuniary gains accruing to a cartel from a price fixing or market-sharing agreement are likely to be less, the smaller the country's Gross Domestic Product. However, it is worth mentioning that in the European Union, the penalty that may be imposed on a cartel can be assessed as a percentage of the turnover of all products **worldwide**, not only the products involved in the infringement. If the same provision were included in the competition legislation of a developing country, a breach of the law by transnational corporations operating in that country could result in substantial penalties for those corporations or their affiliates.

9.5 Leniency for whistleblowers

Many secret cartels and price-fixing agreements are likely to remain undetected unless an "insider" firm or individual provides evidence about their operation. In an effort to discover and then prosecute such cartels, the United States authorities devised a programme by which amnesty or a smaller fine would be offered to such whistleblowers who were prepared to implicate other members of the cartel and disclose the details of their clandestine activities. The programme was revised in 1993 and since then about 20 applications per year have been received, resulting in a number of successful convictions, notably in the vitamins case, where two firms were fined a total ofUS$725 million (amnesty being granted to the third firm).

Following the United States lead, the competition authorities in several other countries have now adopted policies of leniency for whistleblowers. These include the European Commission, Canada, Germany, Korea and the United Kingdom. Generally the policy only applies to secret cartels between firms aimed at fixing prices, production or sales quotas, sharing markets or banning exports or imports.

Evidently the potential whistleblower may not be willing to confess and implicate others unless there is an adequate incentive. The incentive is the amount of the fine, which the firm is able to escape by the confession, recognising that it is uncertain when any fine would be imposed if that firm does not reveal the secrets of the cartel's operations. Generally, the incentive to confess is likely to be greater, the larger the turnover and profitability of the cartel members.

For small developing countries the adoption of a policy of leniency towards whistleblowers is desirable but not a high priority. Such a policy is likely to become more effective when the level of pecuniary penalties is raised. Meanwhile, the competition authorities in developing countries can

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play a valuable role in passing on information regarding the local operations of international cartels to their counterparts in the developed countries, where the cartels are usually domiciled.

9.6 Desirable features of an enforcement regime for a developing country

If competition policy is to be successful in achieving the key objectives of fostering economic development, increasing productive efficiency and encouraging innovation, competition law must be properly enforced. For a developing country, which is about to pass competition legislation, what would be the desirable features of the enforcement regime? The following are some suggestions:

- Pecuniary penalties should be high enough to act as a deterrent to anti-competitive conduct. This means that the amount of the penalty should be related to the turnover or assets of the firms that have infringed the law.
- Private actions for damages should be permitted.
- The reasons for imposing penalties should be explained by the Court or the competition authority in each case, while the general criteria used in determining the amount of a penalty should be widely publicised in an enforcement guideline.
- As a general rule, the management of a firm, which has infringed the competition law, should be required to put in place an effective compliance programme to avoid a repetition of the infringement.

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CHAPTER X

REGULATING A NATURAL MONOPOLY AND ACCESS TO ESSENTIAL FACILITIES

In this chapter the following issues are discussed:

- *Privatisation, public utilities and essential facilities*
- *What is a natural monopoly?*
- *Policy options for regulating a natural monopoly*
  - *Reliance on competition law*
  - *Rate-of-return regulation*
  - *Price-cap regulation*
  - *Access regulation*
  - *Vertical separation*
  - *Price monitoring*
- *Industry-specific regulators or regulation by the competition authority*
- *Dynamism in regulatory reform*

A notable feature of economic development in many developing countries and economies in transition in the past two decades has been the privatisation of public utilities and other government business enterprises. This shift towards private ownership and a greater reliance on market forces has often been accompanied by reforms in the framework of business regulation, as well as the introduction of competition laws prohibiting restrictive business practices.

The aim of this chapter is to explore the scope for competition in the markets for utility services following privatisation. If competition is not feasible, as in the case of a natural monopoly, what forms of light-handed regulation are likely to yield the greatest economic benefit? What role should the competition authority play in order to improve the performance of regulated and unregulated utilities respectively?

10.1 Public utilities and essential facilities

The industries that have traditionally been regarded as public utilities include electricity, gas, postal services, telecommunications, railways, air services and maritime transport services. They are often described as "essential facilities" because some of their services are indispensable inputs to many other industries both upstream and downstream. The other common characteristic that they share is the fact that each is a natural monopoly, or, more accurately, a major component of each industry's activities is a natural monopoly. A precise definition of a natural monopoly will be given shortly, but for the present it can be regarded as an activity in which competition is not feasible, because there is only room for one firm to operate efficiently in the area.

In most utility industries, there are some activities subject to actual or potential competition as well as some which are akin to a natural monopoly. Table 10.1 provides some details. Vertical integration of the competitive and non-competitive activities is common. For example, an electricity supply company involved in high voltage transmission of electricity (a non-competitive activity, because it would be uneconomic to duplicate the existing transmission lines) may also engage in competitive activities such as electricity retailing. There is a danger that the company, if privately-owned, could use its dominant position in the upstream market to restrict competition in the retail sector. A further problem is that a firm owning an essential facility, such as the telephone network, could deny access to that facility to a firm that is its competitor in the provision of other telecommunication services.

These potential problems as well as others arising from the market power of a natural monopoly have to be addressed, either by general competition legislation or by industry-specific regulation. The various policy choices are explored later in the chapter.

Table 10.1 Industries featuring Both Competitive and Non-Competitive Components

Sector	Activities which are usually non-competitive	Activities which are potentially competitive
Railways	Track and signalling infrastructure	Operation of trains Maintenance facilities
Electricity	High voltage transmission of electricity Local electricity distribution	Electricity Electricity retailing or marketing activities
Gas	High-pressure transmission of gas Local gas distribution	Gas production Gas storage (in some countries) Gas retailing and marketing
Telecommunications	The provision of a ubiquitous network	Long-distance services Mobile services Value-added services Local loop services to high-volume business customers, especially in high density areas
Air services	Airport services such as take-off and landing slots	Aircraft operations Maintenance facilities Catering services
Maritime transport	Port facilities	Pilot services, port services
Postal services	Door-to-door delivery of non-urgent mail in residential areas	Transportation of mail Delivery of urgent mail or packages Delivery of mail to high-volume business customers, especially in high-density areas

Source: OECD

10.2 What is a natural monopoly?

A natural monopoly exists when, over the range of output needed to satisfy demand, a single firm can always produce that output at lower total cost than any two or more firms. This occurs in activities that are subject to economies of scale and/or economies of scope.

Economies of scale mean that a given increase in output will result in a less than proportionate increase in total costs – a situation to be found in most capital-intensive utilities, including electricity transmission, telecommunications and airport services. The firms engaged in these types of activity typically have substantial fixed costs but low marginal operating costs – i.e. additional customers can be supplied at very little additional cost by making more intensive use of facilities that have already been constructed.

Economies of scope occur when one firm can supply additional products more cheaply than if other firms supplied them separately. For example, a company supplying telephone services can also supply cable television services, at a much lower cost than separate service providers would be able to achieve, because it can avoid duplication of expenditure on cabling.

Traditionally, in market economies, the main reason for public ownership of utilities was that they were considered to be natural monopolies. It was essential to have a monopoly in order gain the benefit of economies of scale and scope and produce at the lowest possible cost. However, a privately owned monopoly would evidently have considerable market power. There was an obvious danger that it would charge high prices and the allocation of resources to that activity would be less than optimal. Public ownership was seen as a means of restraining that market power and ensuring a better outcome for consumers.

Subsequent experience has shown that public ownership has its own drawbacks, in particular:

- The incentive to improve efficiency may be lacking because the managers are often not rewarded for reducing costs or introducing innovations.

- Government pressure to keep prices down may prevent a public utility from earning

sufficient revenue to finance necessary investment in plant and equipment.

- If the utility is not permitted to discriminate in price between different categories of customer its revenue will be lower than it might otherwise have been and this may also retard investment.

These problems are alleviated to some degree if the public utility is set up as a corporation with freedom to pursue a profit goal, with the government retaining a majority of the equity. In a number of countries, including Australia, this has been an intermediate step towards full privatisation of certain government-owned instrumentalities.

10.3 Policy options for regulating a natural monopoly

Reliance on Competition Law

Apart from public ownership, other options for curbing the market power of a natural monopoly can be considered. One is to rely on the normal provisions of competition law to prevent any abuse of market power by a dominant firm (as discussed in Chapter III). While it is certainly necessary to have this provision in the law, and it should apply to both government and privately-owned enterprises, it is not sufficient of itself to prevent a privately-owned natural monopoly from setting prices well above its average costs and earning above-normal profits.

Competition law only prohibits the **abuse** of market power, and the abuse occurs when a firm in a dominant position in a market takes advantage of that position to prevent entry to a market or to restrict competition. In the case of a natural monopoly there is little likelihood of entry to that market (in the absence of a dramatic change of technology) because, as mentioned earlier, the cost incurred if two firms were involved in the activity would be much higher than if there was only one. It is therefore improbable that the natural monopolist would need to breach the law by seeking to prevent entry to **that market**. Similarly, the natural monopolist would have little reason to restrict competition in that market since, by definition, it has no current competitors there.

However, this does not mean that the competition law is incapable of influencing the conduct of a firm which has a natural monopoly. The provisions relating to the abuse of market power prohibit such a firm from using that power to damage competition in **any other** market. So that, for example, if a large privately-owned telecommunications company owning much of the telephone network were to refuse to connect calls through the network by the customers of one of its competitors in the retail market, this could well constitute a breach of competition law. To prove that there had been a breach in this case, it would usually be necessary for the competition authority to show that the network owner **intended** by its action to restrict competition in the retail market.

It can be argued that refusing access to an essential facility, such as the telephone network or railway tracks is rather unlikely to occur in practice. This is probably correct, since the marginal cost of making the facility available to other firms is low and it should be possible for the owner of the facility to negotiate a price for access, which exceeds that cost, and therefore adds to the firm's profit. The question is whether the access price that is charged by the natural monopoly is "reasonable" and is likely to encourage competition in upstream or downstream markets. These are matters that may have to be resolved by regulation of profits or prices rather than by recourse to the normal provisions of competition law.

Rate-of-return regulation

A second option available to control the market power of a natural monopoly is so-called "rate of return" regulation. This has been widely employed in the United States over a long period. The aim is to allow the firm a fair rate of return on its capital assets, after due allowance has been made for risk. This should ensure that its profits are normal rather than being excessive and customers pay lower prices than they would if the monopoly were unregulated. However, this form of regulation also has a number of significant disadvantages in practice including:

- To calculate an appropriate rate of return, the regulator requires detailed information about the firm's costs and revenues. The firm has an incentive to overstate its costs and understate its revenues. Perhaps more importantly the regulator ought to be basing its estimate of a fair rate of return on the costs of an efficient firm rather than those of the firm in question.

- The profits that are allowed to the firm under rate of return regulation are greater the greater is the value of its capital assets. This

causes a bias towards the excessive use of capital, assuming that the allowed rate-of-return is above its cost of capital. Moreover, the firm's costs per unit of output may be elevated by the fact that more capital is being used, relative to other factors of production, than would be the case if the activity were unregulated.

- It is customary for the regulator to reset each year or two the prices that may be charged by the firm to achieve the allowed rate of return This largely removes the incentive for the firm to reduce its costs, since any cost saving will be promptly passed on to its customers in the form of lower prices.

- The costs incurred by the regulators in collecting, and analysing for each utility the mass of information necessary to determine the prices that should be charged are considerable. To these costs must be added the compliance costs of the regulated firms, which have to supply the information and assist in its interpretation.

It should be noted that for the purposes of rate of return regulation or price-cap regulation (to be discussed below) it is imperative that separate sets of accounts be prepared for each non-competitive (natural monopoly) activity that the enterprise is engaged in. These accounts are distinct from those relating to the whole enterprise, as those include competitive activities, which are of no concern to the regulator. Without a proper separation of accounts and the correct allocation of common costs (e.g. for an administrative building used for competitive and for non-competitive activities) the regulator may be unable to detect an attempt by the enterprise to increase its allowable profits by overstating the capital assets attributable to the natural monopoly activities.

Price-cap regulation.

Given these practical difficulties associated with rate-of-return regulation it is not surprising that regulatory authorities have tried to find alternative methods of regulation, which would more efficiently limit the market power of a natural monopoly. During the 1980's a form of price-cap regulation known as CPI minus X was developed in the United Kingdom. First applied to the telecommunications industry in the U.K. it is now used for other utilities in that country and for utilities in other parts of the world.

A CPI – X price cap sets the maximum increase allowable in the average price of a basket of services supplied by the natural monopoly for a specified period. The increase in the Consumer Price Index, CPI (in some countries RPI, the Retail Price Index) is a proxy for the percentage increase in the average cost of the inputs used by the utility. X refers to the percentage improvement expected in the productivity of the utility relative to the national average improvement during the period. Thus if the CPI is expected to increase at an average rate of 2 per cent per annum and a natural monopoly in the telecommunications industry is expected to achieve an above average productivity improvement of 3 per cent per annum, the monopoly will have to reduce its prices by at least 1 per cent per annum over the period.

If the firm is able to achieve a better productivity gain than 3 per cent per annum, thus lowering its costs per unit of output by more than originally expected, it is allowed to retain the additional profits. This clearly creates an incentive to increase efficiency, which is virtually absent with rate-of-return regulation. However, if the X factor in the formula is adjusted frequently to take account of likely future changes in productivity, say each year, then the firm does not have sufficient time to gain much in the way of additional profits, before they are eliminated. In other words, the apparent superiority of the CPI – X method of regulation as an incentive device is a mirage. It is superior only if there is a longer time interval in the adjustment to allowable prices than occurs under rate-of-return regulation.

However, there are other advantages in price-cap regulation. First, the bias towards excessive capital expenditure that was noted in the discussion of rate-of-return regulation is not present if the CPI – X formula is used. Secondly, the utility can vary the prices for the individual goods and services that it supplies, subject only to the requirement that the average increase in the prices of the basket of goods and services subject to regulation is within the price cap. This increased flexibility is likely to result in a more efficient allocation of resources. Thirdly, the costs to the regulator are likely to be somewhat less because the prices for individual goods and services do not have to be fixed.

Despite these advantages, some problems remain in price-cap regulation of this kind. As pointed out by the Productivity Commission in Australia (Productivity Commission 2002):

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"...the need for detailed cost assessment seems inevitable even under price caps in order to ensure that there are adequate incentives for efficient investments. In particular, the regulator must assess investment proposals and determine the prices required to facilitate efficient investment..."

The Commission concluded that:

"...price caps should be reserved for situations where excessive pricing is likely to result in significant inefficiency."

Access regulation

An important objective in regulation of a natural monopoly is to promote competition in markets upstream or downstream from the essential facility by ensuring that access to that facility is available on reasonable terms and conditions. Unless this is done the owner of the facility would be in a position to disadvantage its competitors in those markets by charging them access fees substantially greater than its costs while giving access to its own affiliate at lower cost.

A light-handed regulatory approach to this issue is to allow the owner of the facility to negotiate the terms and conditions of access with each individual user, on a commercial basis. If the negotiations fail to obtain an agreement satisfactory to both parties, an official regulator will be called in to arbitrate and determine appropriate terms and conditions. Clearly the knowledge that an arbitrator will intervene as a last resort will have an influence on the initial commercial negotiations and may result in a speedier resolution of the matter and an outcome more favourable to the user than would otherwise have occurred. This approach to access regulation (with some additional elements) is used in regulating components of the telecommunications industry in Australia.

An alternative approach would be to dispense with the initial commercial negotiations and appoint a regulator at the outset to determine the terms and conditions of access. While this is a more heavy-handed approach it could have the advantage of a more speedy determination and a more consistent outcome over time.

Vertical separation

Thus far, the focus has been on regulation, which affects the **behaviour** of a natural monopoly – in particular, the prices that it is permitted to charge and the terms and conditions under which it will allow access to the essential facility.

A **structural** remedy is also a way of promoting competition in a market downstream from the essential facility. That is, the company owning the facility can be precluded from owning or controlling a firm, which is operating in such a market. In that event the company concerned can no longer influence the competitive conditions in that market and has no incentive to discriminate in price between the various firms competing there.

However, the company may have invested in the downstream market in order improve its efficiency not to restrict competition. If it is required to divest its downstream affiliate the economies of scale and scope that it could have realised by vertical integration will be lost. This probably represents a loss of benefits to the public as well as to the firm itself. These considerations suggest that mandatory vertical separation should not be undertaken lightly. Only when it is evident that in a particular case, vertical integration would yield few economies. And competition will be impaired should it be considered.

Price monitoring

Finally, the most light-handed option for regulating the behaviour of a natural monopoly is price monitoring. In this option a public authority, such as the competition authority, would report to the public and the government annually on the profitability of the major utilities and the price increases that have occurred during the period, with some explanation of the reasons why such increases were necessary, Price monitoring does not involve recommendations to government for a price-cap to be imposed on certain activities, although if the monitoring uncovered evidence of anti-competitive conduct by some natural monopolies this might be referred to the competition authority for detailed investigation.

This particular option works to the extent that increased public awareness of the prices and profits of the major utilities will persuade the enterprises concerned to avoid profiteering and desist from anti-competitive conduct in upstream and downstream markets.

As noted earlier, it is important to have separate accounts for the non-competitive and the competitive activities being undertaken by a utility. Without that, price monitoring is unlikely to be successful in achieving its purpose since the underlying profitability of the natural monopoly will not be revealed.

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10.4 Try specific regulators or Regulation by the Competition Authority?

When regulation of access to certain essential services is necessary there is a choice to be made between using an industry-specific regulator or using the general competition watch-dog, the competition authority, for the purpose, The British model developed in the 1980's was to establish independent industry-specific regulators such as OFTEL (the Office of Telecommunications) OFGEM (the Office of Gas and Electricity Markets) and OFWAT (the Office of Water Services). These Offices were not merely to ensure that there was an adequate supply of gas, electricity, water and telecommunications services to meet consumer demand at reasonable prices but to promote competition in their respective sectors. For example, OFTEL states that one of its key roles is " maintaining and promoting effective competition".

This type of institutional arrangement has been followed in some other countries that have privatised former public utilities. A different model has been followed in Australia where the competition authority (the Australian Competition and Consumer Commission) was given an administrative and regulatory role in respect of access to essential facilities following amendments to the Trade Practices Act in1995. It has a role in arbitration of disputes over access to facilities declared to be essential under the terms of the Act. It also has a role in the assessment of undertakings by owners/operators of facilities.

It is not clear that one of these models is superior to the other. Normally, in Great Britain, the industry-specific regulator would consult with the competition authority on competition issues relevant to both of them. Thus there should not be a lack of coordination. The choice of regulator in a developing country may therefore depend on which institutional arrangement is likely to require fewer resources (e.g. of scarce skilled labour), and the knowledge and experience of individual utilities that has already been built up in the competition authority.

10.5 Dynamism in regulatory reform

In conclusion, it is worth emphasising that continuing change is, and has been, a feature of the regulation of natural monopolies. The principal reasons are:

- More utilities are being privatised.
- The theory and practice of regulation has been evolving quite rapidly, with more attention now being paid to efficient outcomes as well as to restrictions on competition.
- Changes in technology and the pattern of demand are continually changing the particular activities that are true natural monopolies.
- Increasing attention is being given to the questions of when and how to **deregulate** utilities that are already subject to regulation. For example, the Office of Telecommunications in Great Britain conducts a review every two years on each market segment of the telecommunications sector that is currently regulated. In the course of each review it examines whether the indicators point to the possibility of sustainable effective competition emerging in that market. If it finds that possibility exists, an action plan is developed to either remove or modify the existing regulation almost immediately or to defer any changes to the regulatory regime until a further assessment has been made.

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