

Competition law and policy, innovation and the economic crisis Speech to FIW Symposium, Innsbruck

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Introduction

It is a great honour and privilege to be invited to attend this annual seminar in its 42nd year and on the eve of the celebration of the Institute's 50th anniversary in 2010. The programme is interesting and highly topical given the current economic crisis.

My thanks to Dr Niels Law and Margret Suckale for the invitation and for the impressive programme they have assembled as well as for the impeccable technical and social arrangements.

I am grateful that you welcome and accommodate non-German speakers such as myself in the knowledge that we have an excellent interpretation service which will turn my words and thoughts into perfect German.

I first sought German domestic competition law advice for a US company in 1976 and since then have worked with a number of well-known and some less well-known but highly competent practitioners. The quality of the intellectual debate that is to be had on competition issues in this country has always impressed me, and it is of course supported by the work of institutions, such as the FIW, and evidenced by seminars such as this.

I particularly welcome the increasingly international focus that the Institute has given its work over recent years, and which is reflected in the programme over these two days. The need for that international focus and discussion has never been more important than it is today.

I approach this subject – Competition Law and Policy, Innovation and the Economic Crisis – primarily as the chairman of a national competition authority, the Office of Fair Trading in the United Kingdom, but also from experience as a competition law practitioner who over a thirty year period advised during several periods of recession. But, I would be the first to admit, those recessions were nothing compared with the economic crisis that we face now.

My remarks at this stage are in some respects personal reflections, not necessarily reflecting established OFT policy as we are still working through the implications as events unfold, as they are doing almost on a daily basis. But there are some pegs that are firmly in the ground and, I suggest, must remain firmly there.

Some reflections on the discussions so far

I would like first to reflect on some points made in the preceding lectures and discussions which fit in neatly with some points I wanted to develop.

Margret Suckale in her introductory remarks pointed out the potential damage that the crisis in the financial markets has done to competition policy and law. Clichés abound from politicians – 'Extraordinary times demand extraordinary measures' – is perhaps one of the most common in the English language.

The way that we see it in a UK context is that public confidence in markets has been undermined. But we hope, and believe, that it has not been so far undermined that the damage may indeed prove fatal. I will come back to this point.

And we see it as an important part of our mission, as an independent competition agency, to engage in constructive and continuous dialogue with Government, with business, with consumer groups and with other stakeholders to rebuild that confidence and, as Margret eloquently put it, to focus beyond the immediate issues of today and to look to the future.

The stimulating presentation from Dr Rudiger Grube impressed on us so much about the spirit and enterprise in Europe and of its commitment to innovation. He conveyed the size and complexity of the European Aeronautic, Defence and Space Company (EADS) in serving a global market place and tackling the thorny problems of entry into new markets, such as China.

We were pressed for time, but it would have been useful to explore with him the complexity of the organisation both in its own activities and its many different supply chains involving thousands of suppliers around the world. And to ask the question: how do you ensure that innovation is stimulated within the organisation and amongst your suppliers so as to retain a competitive edge?

He also touched on one important aspect relevant to the financial crisis, namely the way that EADS had been able to use innovative currency and hedging instruments delivered by the financial markets to reduce the impact of Dollar/Euro currency fluctuations, as well as movements in the price of oil, on EADS' cost base. So this was an example where innovation in the financial markets had benefitted business in the real economy – in contrast to so-called innovation in financial markets which has spread toxic assets around the world's financial institutions.

Mr Suzuki took us through the challenges that face the intellectual property agencies across the world and how they are seeking to adapt to the world of 'pro-innovation'. To an English lawyer and former historian, it was comforting to be taken back not only to the Statute of Monopolies of 1624 but to the 'Spinning Jenny' and to the Steam Engine.

His presentation, together with that of Dr Gruber and some comments made by Pieter Kalbfleisch about the hearing aids merger in the Netherlands

brought home one important point. Do we, as competition lawyers, policymakers and practitioners, understand fully and clearly how the corporate structures, business models, commercial arrangements, supply chains and supplier/customer relationships have changed in the last, say, ten years? Do we understand what that means for innovation, in terms of the commercial drivers and how they play out in the market place – say, for example, in developing the new composite materials used in airframes and aero engines, but also in other applications?

Dr Bernhard Heitzer talked about the debate between intellectual property lawyers and competition lawyers as even taking on religious aspects. This was an interesting observation in several respects. First, a number of lawyers who took an early interest in competition law in Europe in the UK as well as, I believe, in Germany and the Netherlands - came from an intellectual property background.

Secondly, the early development of European competition law was heavily influenced by German lawyers and academics, including those from an intellectual property background – and I recall the name for instance of Hartmut Johannes, a longstanding and respected former official in what was DG IV, being mentioned yesterday.

Thirdly, and perhaps most important, there is the need for dialogue between intellectual property and competition lawyers just as there is the need for dialogue between followers of different religions.

And both Mr Suzuki and Dr Heitzer referred to the importance of international co-ordination and convergence in their fields – something that we at OFT have encouraged through the International Competition Network, through the European Competition Network and through the work of the OECD Competition Committee.

And, of course, the Bundeskartellamt, not only under present management but under the distinguished leadership of Dr Ulf Boge, has played an important role in that work. Indeed, without that work over the last 10 years of economic growth and prosperity, we would not be in the best shape to face what lies before us now.

I cannot do justice to all that prior speakers have said that is relevant to what I wanted to say, but these few points are some of the most important.

The relevance of the economic crisis to innovation

So what is the relevance of the economic crisis to innovation? In short it is this. If business does not innovate, the recession will be prolonged, our economic prosperity will be threatened and recovery will be slower and more difficult.

And what is the relevance of the economic crisis to competition law and policy? In a simplified form it is this.

One view, albeit perhaps a populist and media view rather than a well-informed one, of what has happened in the financial markets is that innovation and competition simply ran out of control, to the point that it has now undermined the world's banking and financial system, driven deep into the 'real economy' and created an economic crisis of epic proportions. A world banking and financial system that was supposed to spread risk, deepen liquidity and complement the growth of international trade and commerce has imploded.

In some minds this has undermined confidence in 'competition', 'innovation' and indeed in 'markets'. I refer to this as the loss of public confidence in markets.

As a result there have been demands for government intervention and new regulation. This in turn has led to claims that such measures taken by national governments will lead to new waves of protectionism, or 'economic nationalism', thus retreating from the progress made over many years to remove trade barriers and open up world trade.

The challenges for competition law and policy

The economic crisis we face raises novel issues and sets new challenges, not least for those businesses which have been at the forefront of their

sectors in terms of scientific thinking and research and development and for the competition agencies charged with developing the application of, and enforcing, the law. There are some who may suggest that the crisis is such that competition policy should take a back seat in favour of some forms of interventionist policy.

My position is to the contrary. It is important above all in the current conditions to continue to respect and develop the principles underpinning competitive, open markets which have provided the basis for successful economic development in the recent past. To abandon those principles will actually make the recession deeper, and last longer, and leave the world less well-placed for recovery. For business, it is now more important than ever that the focus on innovation continues.

What is innovation?

Ask the man or woman in the street, the businessman or the R&D professional what 'innovation' means and you are likely to find that this simple word is given a wide variety of different meanings.

To some innovation may simply mean anything new or different from what has gone before – marketing men love claiming 'innovation', even if it is only in the shape of an item or the form or colour of its packaging. To others, particularly those active in the field of intellectual property, innovation will mean the creative step that is crucial to gaining a patent.

Innovation is broad enough to refer to new inventions, such as the transistor or microprocessor, as well as those that improve existing products or services. It can also include the processes or materials used in manufacture, the method of supply (for example, packaging) and the business model (for example, franchising, e-commerce). Innovation is not based on a linear model, driven only by a firm's affirmative choice to invest in R&D: innovation can often be driven by changes in market demand, in customer requirements or expectations or in steps taken by suppliers, such as the development of new materials or components.

The debate about innovation and competition law and policy is often presented around alleged conflicts and narrow issues, such as the relationship between competition law and policy and intellectual property rights, especially in respect of patents but also design rights (such as for spare parts) and in some cases copyright. It is beyond the scope of these remarks to engage on these specific and fairly well trodden paths, but I would like to look at a broader set of issues.

The relationship between competition and innovation can be seen, for example, in the distinction between real and spurious innovation. Claims of spuriousness in respect of innovation have been debated in academic literature. An innovation by one firm may be viewed by another to be a barrier to entry. Such barriers may be real but they can also sometimes be imaginary in the eyes of the new entrant, and it may be left to a competition authority or court to determine whether there is indeed a barrier to effective competition, and if so whether this is as a result of an abuse of a dominant position or arises from an anti-competitive agreement.

In a competitive market, one might expect the market itself to distinguish between the real and the spurious, with new products or services that do not add to the existing range failing to find a foothold. But distinguishing the real from the spurious is not always easy.

Competition authorities and courts must always be vigilant that some complainants will not always have the most altruistic of motives. They may resort to the use of competition law to shield them from a competitive threat because their competitor has developed and is seeking to exploit, innovative technology and they do not have an effective commercial response. This might be because they have not invested in R&D or the fruits of their work have been less successful.

The risk of so-called Type 1 false positive errors (that is, of erroneously prohibiting behaviour that increases consumer welfare) is very real, especially at a time when there are greater calls for intervention in markets due to the economic conditions. I shall return to this risk later.

Markets work best when they are subject to effective competition. Where vigorous rivalry exists in vibrant well-functioning markets, firms must constantly strive to operate efficiently and to win customers from their rivals. This may be achieved by improving the quality of their products, lowering their costs or reducing prices – or all these and perhaps others, such as enhanced service, greater range and choice etc. In doing this, productivity is maximised and, as Pieter Kalbfleisch illustrated so effectively yesterday, consumer welfare is optimised.

To maintain their competitive edge, firms need to be innovative and to become more efficient, both in the products or services they offer and in their methods of supply. As well as helping to gain a competitive edge, investment in innovation can add to the intellectual capital of the firm and thus help enhance the firm's financial performance: the greater the R&D expenditure the higher the subsequent productivity growth.

On the other hand it can be argued that a firm that already enjoys monopoly rents, while having the resources to invest in innovation that others may lack, may not have the necessary impetus to innovate to the greatest extent: it may be happy with the status quo, content to live off its monopoly profits – the so-called 'sleepy monopolist'.

Innovation and the law

Competition law recognises the value of innovation. Under the EC Treaty 'technical or economic progress' resulting from an agreement is to be considered in the balancing exercise under Article 81(3). A similar consideration is contained in section 9 of the UK's Competition Act 1998.

Similarly when assessing mergers under the ECMR, the European Commission will take into account 'the development of technical and economic progress provided that it is to consumers' advantage and does not form an obstacle to competition.' On the domestic mergers front in the UK, a merger may not merit a Phase II investigation by the Competition Commission if relevant customer benefits outweigh any substantial lessening of competition. The legislation provides that 'relevant customer benefits' include 'greater innovation' in relation to goods or services. To date the OFT

has not cleared a merger on the basis of greater innovation resulting from the transaction.

The objective here is for competition authorities to find a way to apply these legal frameworks consistently with current economic thinking, in a way that appreciates market dynamics and avoids formal interventions that may lead to errors. In other words, a 'stick' for 'lazy fat cats' and a 'carrot' for 'growing enthusiasts', to borrow from Dr Bernhard Heitzer's ox and cart examples yesterday.

It is sometimes claimed that competition policy has a chilling effect on innovation. For example, firms say they do not know how far they can collaborate. They may claim they are being punished for their success which is in turn due to their hard work. Dominant undertakings might say they do not know how far they can go in competing to defend their innovations and their market position. They argue that competition law and policy, and the threat of enforcement, can be a significant disincentive to them innovating further, identifying new markets and developing new products or services. This, they claim, causes them to be cautious in their market practices, trade terms, commercial arrangements, in a way that is damaging rather than enhancing to consumer welfare. Some companies may also point to alleged differences between US and EU approaches to competition enforcement, for example in the area of unilateral conduct, which could have chilling effects.

Over-active intervention can have the effect of disrupting and harming the very processes they are designed to protect. This can lead to Type 1 false positive errors. It can also have a multiplier effect when the deterrence effect is considered.

It has also been suggested that competition enforcement is unwarranted in certain industries, in particular in what Schumpeter called 'new economy' markets that are highly innovation-dependent. The argument goes that larger dominant firms are more likely to engage in innovation than smaller competitors who lack market power, and they need monopoly rents as an incentive to take on the risks and costs of innovation. Furthermore, they argue, the possibility of leap-frogging exists which may diminish the effects of any market power.

While some of this may be true, such 'new economy' markets often exhibit network effects, which can create substantial entry barriers and may in turn make market power more entrenched. Although it may be important to preserve the incentives of dominant firms to innovate, one must not forget the countervailing chilling effects that may arise: foreclosure of efficient competitors can have significant chilling effects on competition and innovation, not just in the market in question but across other markets in the economy.

As I mentioned earlier, the challenge for competition authorities is to apply economic thinking on innovation within the existing legal framework in a consistent manner that appreciates market dynamics and avoids erroneous formal interventions. I shall now give some brief reflections on the changes in that framework and their effects.

Changes in the operation of the framework

Experienced practitioners and observers of EU competition enforcement will recall the old notification system under Council Regulation No17 (EEC). Despite its shortcomings, the notification system helped flush out competition and innovation issues. It also enabled national competition authorities to become familiar with cases that raised these issues and assisted them in turn to take their own decisions, often at times when local competition law enforcement was itself nascent.

With Modernisation came self-assessment. Consideration as to the compatibility of agreements with the competition regime is now, by and large, taken internally within firms, with the help of their legal and economic advisers. As a result, competition authorities may get less notice of issues although the band of competition practitioners (legal and economic) who are equipped to advise has grown: experience has been shared, as well as spread.

Experience gained by the European Commission through the notification regime has also contributed to the development of guidance via block exemptions. These block exemptions have also moved away from the old

legalistic and prescriptive approach to a more economic, effects-based approach. For example, block exemptions for horizontal co-operation agreements (including specialisation and R&D agreements) now follow an approach that allow competitors to collaborate where it contributes to economic welfare without creating a risk for competition. These block exemptions and related guidelines and academic articles add to the resource base available to firms and their advisers.

The developments that I have noted here took place over the last 10 years, against the backdrop of a more benign and favourable economic environment. It is reasonable to question now how they might fit in today, with the challenging economic issues we now find ourselves facing. Do they provide suitable guidance, or the right precedents, or the ability to spot issues and identify whether or not they are the most urgent and/or have the biggest impact? And if they do not, what do we need that will? These are some of the issues that competition practitioners, as well as firms, now need to address.

Economic crisis, competition and innovation

There are many reasons why the economic crisis and recession may have dampening effects on competition and innovation. Potential new entrants' willingness and ability to invest in innovation and to enter markets with their innovations may be affected, or they may be deterred from developing them to the point of commercial exploitation, at least on their own.

There may be exit of incumbents, including incumbents who innovate. Remaining competitors' commercial strategies may become more conservative and focused on the short-to-medium term. Their efforts to innovate may be reduced – for example businesses have recently responded by cutting their R&D costs, rationalising production, reducing investment in staff training, and cutting product ranges.

More specifically, innovation can become constrained for a number of reasons. One consequence is that recovery from the recession may be more difficult. Amongst the reasons that innovation may be constrained are:

- Consolidation: incumbents may seek to consolidate their businesses during an economic downturn, typically in order to achieve cost savings and economies of scale at a time of static or falling demand. Such consolidation can lead to a lessening of competition and a dampening of innovation in the market. Incumbents may argue that a potentially anti-competitive merger gives rise to synergies and leads to efficiencies which will promote innovation. Such claims need to be thoroughly tested and supported by convincing evidence to show not only that they are real, but that the benefits will not just be internalised by the parties but will be shared with consumers.
- Failing firm defence: incumbents seeking to exit the market, or being forced to exit (for example, through bankruptcy), will wish to maximise the value of their business and/or minimise the write-off by selling their business to a competitor and will seek to raise the so-called 'failing firm defence'. Again, such defences need to be thoroughly tested and supported by convincing evidence, including evidence that no less anti-competitive alternatives are available.
- Cartels: the adverse market conditions may also increase the risk of incumbents seeking to 'manage the market' through cartels or other hardcore infringements, presenting these as essential for survival and innovation in the current economic climate. There is no case for lightening enforcement action against cartels, whatever the economic conditions.
- Anti-competitive use of market power: dominant companies may seek to use their market power to defend their market position by raising barriers to entry and discouraging potential new entrants, also perhaps reducing investment in R&D and thus innovation, thereby slowing or stopping the introduction of new innovative products and services.
- Anti-competitive government or regulatory intervention: government or regulatory interventions aimed at aiding recovery from the recession may in fact distort competition and discourage innovative solutions. For example, insufficiently targeted state aid may lead to rescuing

inefficient firms/creating incentives for wasteful rent-seeking activity, and supporting firms that do not seek to innovate.

Restoring public confidence in markets

As I have said, public confidence in markets and in competition needs to be rebuilt and this is essential to aiding recovery from the present economic crisis.

Obtaining support for pro-market competition policies will depend, in part, on competition authorities' ability to convey the nature of the benefits of competition to government and the broader public, including even some business participants who might otherwise seek to oppose such an approach. In order to achieve this, competition agencies will need to explain how competition has a positive impact on productivity and how this in turn can promote economic recovery by:

- placing downward pressure on costs
- acting as a spur to innovation
- leading to more efficient allocation of resources between firms, and
- forcing firms to be more focused on meeting customer needs.

In the medium to long-term, maintaining effective competition and a robust competition regime can, therefore, enhance productivity and promote economic recovery. By contrast, relaxing or suspending the application of competition rules and the competition principles that have been developed over a long period would harm consumers, impede necessary adjustments by maintaining inefficient companies and (as past experience demonstrates) could ultimately delay an economic recovery.

Particularly in a global marketplace it is important for businesses to continue to innovate and compete actively and effectively during the current crisis – for example in order to be able to meet increased demand for lower-cost products which may require new innovative solutions. In addition, businesses that rely on innovation to compete with lower-cost products should continue to innovate in order to ensure that they 'future-proof' their businesses. For instance, recent announcements that certain manufacturers in the car

industry are slashing their R&D expenditure and are moth-balling plans for new models may offer short-term relief from pain, but prove to be damaging to their business in the medium to long-term.

In addition, businesses may be contemplating arrangements that are designed to promote innovation beyond that which we have seen to date. For instance, in some sectors, novel forms of collaborative arrangements between actual or potential competitors may be necessary in order to bring innovation in goods or services to the market. Major infrastructure projects may require the same. From time to time competition authorities may want to clarify how and when competition law applies to such arrangements – for example, through the making of infringement or non-infringement decisions. What is equally important however is that competition authorities continue to take a robust, principled and consistent, yet pragmatic, approach to enforcement.

Perhaps, one of the best ways of demonstrating the positive effects that innovation and competition can have in achieving economic recovery is by reference not only to previous empirical studies on this subject but also to previous competition interventions by competition agencies. Reference to the latter can explain how and where competition law applies, and that its application has had positive impacts on the relevant market. In particular, work undertaken by agencies in assessing the impact that competition interventions have had on the market can be influential in this regard. At OFT, for instance, we have a significant programme for evaluating our work.

As mentioned above, competition agencies' advocacy efforts should target not only government but also business. Competition advocacy to government can influence industrial policies in a pro-competitive manner. Likewise, competition advocacy to business can influence corporate strategies in a similarly pro-competitive manner.

Finally, competition agencies may wish to focus their advocacy efforts on sectors or projects that are seen to be of particular importance to recovery or to the future long-term health of the economy, for example on infrastructure investment, private sector provision of public services, and sectors where there is particular technical or research expertise. In the UK, the government

has already started an interesting debate on the relationship between the State and industry – for example it has recently announced that it will focus on helping certain industries to emerge from the recession more quickly and has committed investment to help the UK economy successfully through the downturn. Similarly, the European Commission's European Economic Recovery Plan promotes 'smart' investments – investments in the right skills and markets. This creates opportunities for vibrant businesses – those who are the most innovative will have the best chance to succeed.

An interesting question here is the potential role that competition law and policy – and competition instruments – might play in advancing any such agenda. For instance, where important sectors of the economy are identified there may be scope for using such instruments to identify whether the development of those sectors is being impeded through unlawful arrangements or the actions of incumbents. In addition, there may be a need for determining whether competition law issues are perceived by the market players as holding up innovation and, if so, whether that perception is well grounded or false.

On a broader front, are there other factors, such as government regulation or procurement rules that are restraining the development of the market innovation in it or the scope, scale or speed of innovation? Market or sectoral studies are a valuable resource here. They can be employed to undertake a broader review of the sector than might be possible using other competition instruments, in order to identify any restrictions of competition.

Commissioner Rosch in his remarks at dinner last evening referred to the value of the European Commission's sectoral studies. In the UK we also have a sectoral studies regime – indeed two regimes with OFT carrying out market studies and able to send market investigation references to the Competition Commission.

Closing remarks

Before I close, I want to draw together some of the more important issues I have presented.

Uppermost in our minds in the UK – and the term has also been used by Commissioner Neelie Kroes – is that competition law and policy are **part of the solution** to the economic crisis, rather than being, as some may see it, as **part of the problem** itself.

To go back to Mr Suzuki's reference to the Spinning Jenny and the Steam Engine, innovation has been the spur to economic development since the Industrial Revolution. Consumer welfare lies at the heart of competition law and policy and to abandon or suspend the basic principles, such as in relation to cartels, would jeopardise not only what has been achieved but also future recovery.

The undermining of confidence in competition and markets leads to at least a substantial risk of competition policy being pushed to the sidelines, being seen as not relevant, necessary or even applicable in the current crisis.

I firmly believe however that competition policy has a vital role to play in response to the economic crisis, albeit one that is pragmatic and flexible. To borrow a phrase from my colleague Dr John Fingleton what is needed is 'micro-surgery rather than drastic amputation'.

Increased engagement and advocacy with government, businesses and consumers is essential. This is particularly important in the sectors I identified earlier, namely infrastructure investment, private sector provision of public services and sectors where there is particular scientific or other expertise. Initiatives, led by business or government, may have competing policy objectives such as financial stability, health or environmental goals which may restrict competition in the short (or even long) run. They may also weaken incentives for firms to innovate.

Market studies, or sectoral inquiries, as I have already mentioned, can be an extremely useful tool, especially when targeted at a specific sector, for discovering whether or not problems exist there.

Agencies must display understanding, recognising the pressure that government may be under to intervene and where competition policy may be overridden by other policy interests. Engagement must be proactive and

independent. To go back again to the religious parallel drawn by Dr Heitzer, competition practitioners must avoid being seen as 'competition zealots'. To be perceived as 'competition zealots' will undermine the credibility of agencies' competition advocacy.

Thank you.