

Stimulating or chilling competition

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INTRODUCTION

1. Markets work best when they are subject to effective competition. With free entry and strong rivalry, firms constantly strive to win customers by improving their products, lowering their costs, and keeping their prices down. Consumers are well-served, businesses operate efficiently, and overall productivity is maximised.²

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² This is expressed in many different ways. See, for example, Tim Hartford, *Financial Times*, 21 August 2008 'the market is a machine for producing good ideas, promoting experimentation and scything down concepts that fail, all the while giving the customer the power to choose'. See also Irwin Stelzer, *Brussels is right to restrict dominant companies*, *Financial Times*, 11 September 2007.

2. This is not, of course, a comfortable place for business to be in. Indeed economic theory and case work experience tell us that the comforts of monopoly and the lure of cartels are powerful aphrodisiacs. Competition policy enforcement, *properly designed and applied*, helps ensure that firms are not seduced either to act together or, where they have market power, individually, to deprive society of the benefits of competitive markets.
3. However, like any state intervention, competition enforcement can impose significant and, at times, unwarranted costs both on business and the wider economy. Eliminating these costs would require competition authorities³ to have, amongst other things, complete and flawless information, the perfect analytical and policy framework, the ideal incentives to optimise their own performance, and no resource-constraints. In the real world, of course, this is not the position in which authorities find themselves. Nevertheless, competition authorities must strive to operate a regime in which the benefits of their interventions are maximised and outweigh the costs. The aim of this paper is to identify and discuss the building blocks of such a regime.
4. The paper starts by setting out (section I) the risks of competition policy enforcement, examining the various arguments put forward by economists and business that enforcement can lead to a chilling effect on competition. Section II discusses the elements necessary for an optimal competition policy regime; that is one that stimulates pro-competitive behaviour and minimises chilling effects. Section III discusses the approach the OFT has taken to the design and application of its regime. Finally, section IV examines key issues arising out of competition enforcement in an international context.

³ This paper is concerned with public enforcement of competition policy by competition authorities. Many jurisdictions (including the UK and the EU), are promoting an enhanced role for private actions in the competition regime. While the benefits of private actions are well established, it is also recognised that they entail certain risks (see OFT 916resp, 'Private actions in competition law: effective redress for consumers and business, Recommendations from the Office of Fair Trading', November 2007). This paper does not discuss the role of private actions and its attendant benefits and risks.

I. RISKS OF COMPETITION POLICY ENFORCEMENT

5. As noted above, although capable of delivering significant benefits, competition enforcement is not cost-free.
6. The most obvious cost is the *direct* cost to the businesses under investigation. This includes not only the cost of external and internal counsel and the gathering of any information requested but also the diversion of management time from other operations. More generally, ongoing compliance with the competition rules entails training and/or the monitoring of changes to the law. From a societal perspective, these costs would be sub-optimal if they exceeded the benefits they generate.
7. Competition authorities must be sensitive to these types of costs. As explained in more detail in section III below, to this end the OFT has taken a number of steps to monitor and minimise the cost to business of its activities. However, by definition, such costs will never be zero. The key is to ensure that they are minimised as far as possible and are proportionate. We have found no convincing evidence or conclusive research which demonstrate that such *direct* costs systematically exceed the benefits accrued from competition interventions.
8. Whilst important, these direct costs are of course not the primary concern of those who fear the 'chilling effect' of competition law. A greater challenge to competition enforcement is the possibility that prohibition decisions can have the effect of disrupting and harming the very processes they are designed to protect.⁴ This, of course, is what Bork meant by the 'anti-trust paradox' and of a 'policy at war with itself'.⁵ In essence, he contended that most interventions harm competition itself by prohibiting welfare enhancing activities.⁶

⁴ For a discussion of the potential harm of competition law interventions, see a report prepared by Lear for the OFT '*Research into the cost of inappropriate intervention/non-intervention under Article 82*' (September 2006).

⁵ Bork, Robert H. (1978). '*The Antitrust Paradox.- A policy at war with itself*' New York: Free Press; for a more recent statement of this view see Rockefeller, Edwin S. (2007) '*The Anti-trust Religion*' Cato Institute eg at page 11: '*...no amount of economic theory can resolve the basic conflict inherent in the human desire for both efficiency and fairness -*

9. There are two main reasons why prohibition decisions can be harmful from this perspective. First, the legal framework or the enforcement process may seek to attain objectives other than the *economic* benefits outlined above. This can result in prohibition decisions which are harmful from an economic perspective. In this paper we refer to this an *ex ante* prohibition error ('wrong rule'). Second, it can be difficult, in practice, to distinguish anti-competitive from pro-competitive conduct. Thus, even where competition law interventions are driven exclusively by clear economic welfare objectives, beneficial activity can mistakenly be prohibited. We refer to this as an *ex post* error ('right rule, wrongly applied').
10. The cost of prohibiting pro-competitive conduct (Type I error), whether *ex ante* or *ex post*, is not limited to the particular case in which it occurs. Perhaps more significant is the multiplier effect that such an error will likely have – since most businesses are law abiding, they will seek to align their conduct with precedent. This can significantly increase the impact of an erroneous intervention.
11. Economically erroneous interventions – what we have called Type I errors - are not the only way in which welfare can be harmed by anti-trust authorities: the failure to condemn anti-competitive conduct (Type II errors) can also lead to 'chilling effects', resulting in higher prices, lower output, less choice and reduced innovation.⁷

Relative Incidence of Type I and Type II Errors

12. Discussion of 'chilling effects' often focuses on Type I errors. This is unsurprising given the continuing reverberations of the intellectual

goals that are often incompatible. The antitrust religion allows the pursuit of both goals simultaneously'.

⁶ We follow convention in this paper by referring to interventions (as opposed to non-interventions) that are economically harmful as Type I errors irrespective of the objectives pursued by the competition authority. This is of course not an entirely accurate use of the term 'Type I errors' but is a useful short-hand.

⁷ Again, this can be because of *ex ante* ('wrong rule') or *ex post* ('right rule, wrongly applied') errors.

onslaught launched by the Chicago school thinkers and, more generally, the faith placed in market forces, in preference to governmental intervention, over the last 30 years. The tendency to focus on Type I errors is underpinned by the fact that competition policy is supposed to support the free market rather than replace it. Interventions by competition authorities are therefore arguably more closely scrutinised than actions by other state entities.

13. Substantively, and in line with this thinking, it is argued that Type I errors have a more lasting and negative effect on the market than Type II errors. This is because Type II errors are likely to be corrected by market forces at some point in time, whereas, by definition, Type I errors cause the potentially beneficial effects from the prohibited activity in question to be lost forever.⁸

14. Whilst superficially attractive, this argument however underestimates the significant harm that can arise from an under-inclusive competition policy in which Type II errors systematically take place. It must be noted that the effect of many anti-competitive practices (whether unilateral or coordinated) is to impede new entry or the growth of competitive pressure that might erode the substantial market power of the infringing undertaking(s). For instance, if a company engages in exclusionary unilateral conduct, it cannot be assumed that entry into the market or expansion by competitors will redress the resulting harm if the very conduct in question makes entry or expansion itself less likely. This would particularly be the case in sluggish markets where customers face barriers to switching and/or competitors do not have the ability to quickly respond by offering alternative supplies⁹. In many jurisdictions¹⁰ competition law intervention in the field of unilateral conduct now takes place only if the market is not likely to self-correct

⁸ We recognise that the considerations here may vary between types of conduct, for example between exploitative conduct (which may signal the attractiveness of entry to new entrants), exclusionary conduct (which may prevent entry) and mergers.

⁹ Where, on the other hand, markets are vibrant and responsive (at the level of demand or supply), they are more likely to be able to self-correct in the short to medium term to redress the potential harm from the conduct and thus not require intervention.

¹⁰ Except in the US for the offence of attempt to monopolise, which does not require pre-existing market power.

in the short to medium term: the need to show market power requires the authority to prove that entry or expansion by competitors is unlikely to occur.

15. Type II errors can also have significant effects outside the sphere of unilateral conduct. Price-fixing cartels for example, whilst likely to be unstable in the long term, can keep market prices artificially high for many years or even decades.¹¹ In such cases, the existence of Type II errors could lead to significant and long-lasting harm, both allocative and productive.
16. It is also sometimes claimed that Type I errors have a higher cost in terms of over-deterrence while Type II errors have a more limited impact, possibly confined to the case at hand. Whilst true up to a point, this argument underestimates the 'precedent' value of incorrect 'clearance' decisions by competition authorities:¹² although infringement decisions may be widely publicised, this may be equally true for certain 'clearance' decisions. Furthermore, systematic non-enforcement with respect to a certain type of potentially anti-competitive conduct may send a signal that such conduct is either allowed or tolerated. Depending on the probability of the conduct in question being harmful, the costs of under-deterrence may be significant.
17. Additionally, it has been argued that competition policy enforcement is unwarranted in certain industries, in particular 'new economy' markets that are highly innovation-dependent. According to Schumpeterian economics, in such industries, two factors make competition intervention inappropriate. First, large dominant companies are more likely to engage in innovation than smaller companies who lack market power because companies require monopoly rents to incentivise them to take on the risks and costs of innovation. Second, it is argued that in these industries the possibility for leap-frogging through significant

¹¹ For example, the European Commission has prohibited and sanctioned price fixing and market sharing cartels that lasted six years (sodium chlorate), nine years (chloroprene rubber), eleven years (bitumen); sixteen years (gas insulated switchgear), and nineteen years (international removal services).

¹² Such 'clearance' decisions may take different forms, including, for instance, case closures based on prioritisation criteria and non-infringement decisions.

innovation results in 'gales of creative destruction' that mean market power is in any event ephemeral and so may not have lasting detrimental effects.

18. Some of this is true. However, new economy markets also often exhibit substantial network effects such that the utility of any one purchaser of a good or service is directly related to the number of other purchasers. This can create substantial entry barriers that may not, in the medium to long term, be based on the quality or level of innovation of the goods or service in question. These entry barriers, often a direct result of the 'new economy' nature of the market, may make market power more entrenched than in markets for 'traditional' goods or services. Furthermore, there is research which suggests that monopolists with a steady stream of supra-competitive profits have less incentive to innovate than companies operating in competitive environments.¹³
19. Given all this, it is not possible to say with any real force that Type I errors must, as a matter of principle or in any particular industry, be considered more serious or harmful than Type II errors. Both types of error are capable of having a negative impact on the economy, the significance of which may vary depending on actual market conditions and the type of conduct at issue. Competition authorities must strive to assess the impact of their activities in terms of both false positives and false negatives.

Non-uniform risk of chilling effects

20. One clear theme which emerges from the discussion above is that the risk of a chilling effect arises when competition enforcement does not sufficiently or properly take account of the likely economic impact of

¹³ Most recent empirical research points to there being an 'inverted U' relationship between competition and innovation. Competition increases innovation in concentrated markets and only decreases innovation when the markets become highly fragmented. See Philippe Aghion, Nick Bloom, Richard Blundell, Rachel Griffith & Peter Howitt, *Competition and Innovation: An Inverted-U Relationship*, (2005) *The Quarterly Journal of Economics*. See also OECD Roundtable on Competition, Patents and Innovation 2006, page 52. For a useful, though slightly dated review, see Scherer and Ross (1990) ch. 17.

the activity under review on the relevant parameters of competition in the market (be it price, output, innovation etc).

21. In the authors' view the risk of this happening today is significantly lower than it has ever been. There are two main reasons for this. First, in many jurisdictions, there is increasing agreement that the ultimate purpose of competition policy is the promotion of consumer welfare – the Chicago/Harvard/post-Chicago debates are now, instead, focussed on *how* anti-trust can best achieve this end goal.¹⁴ Second, there has been an exponential growth in the use of economic thinking and analysis in most major jurisdictions – the EC, for example, now has a Chief Economist with a significant complement of staff. This has resulted in an increasing convergence between competition economics and competition policy. In fact, as discussed below, it can be argued with some force that divergences between policy and economics have narrowed significantly for cartels and mergers and remain substantial only in relation to unilateral conduct and certain vertical agreements.¹⁵ This convergence has limited, and will continue to limit, the likely chilling effects many fear.

Cartels

22. Hard core cartels are universally agreed to be anti-competitive and harmful. In the words of Justice Scalia in *Trinko*, collusion is 'the supreme evil of antitrust'. Cartels aim to restrict the competitive pressures that companies would face in the absence of the collusion. The aim and/or effect of cartels is always to raise prices and/or restrict output with the result that, by their nature, cartels are detrimental in welfare terms. All major jurisdictions recognise that cartels should be *per se* illegal and subject to serious sanctions. As a result, competition enforcement in the area of cartels is always required. Enforcement against hard core cartels is highly unlikely to have negative chilling

¹⁴ Hovenkamp, Herbert. (2005). '*The Antitrust Enterprise – Principle and Execution*' Cambridge, Mass. / London: Harvard University Press.

¹⁵ The discussion below is heavily informed by the excellent lecture given on convergence between US and EU antitrust economics and law by Professor Sir John Vickers in *Competition Law and Economics: a mid-Atlantic viewpoint*, given at the Burrell Lecture of the Competition Law Association, London, 19 March 2007.

effects on competition through the imposition of unnecessary additional costs or the risk of Type I or Type II errors.¹⁶

Mergers

23. Similarly, there is increasing coherence between competition economics and competition law in the sphere of mergers. In this respect, the movement away from a formulistic, acquisition of dominance approach to mergers to the more economic test of a 'significant impediment to effective competition' or 'substantial lessening of competition' test has been key. By focusing on the likely net effect of mergers on price, output and innovation, rather than market structure, merger enforcement has steadily become more economically sound. Enforcement in the area of mergers is also therefore more likely to be consistent with sound economic principles and less likely to result in chilling effects, at least in all major jurisdictions (see further section IV below).

Unilateral conduct

24. Unilateral conduct is, in the authors' view, one of only two areas in which there is still some divergence between competition economics and competition policy.¹⁷
25. Chilling effects in this area arguably arise in two respects. First, as a matter of principle, it can be argued that competition enforcement in relation to unilateral conduct reduces the incentives for businesses to compete vigorously. In this respect, it is postulated that businesses should not be punished merely because they have, through their hard work, succeeded in capturing a large share of the market. To do so would amount to a significant disincentive to be efficient, to innovate, to identify new markets and develop new products. As Justice Learned-

¹⁶ There may be debate concerning what exactly amounts to 'collusion' or 'concerted practices', as well as issues such as appropriate sanctions, leniency programmes etc. However, the point here is that conduct that is correctly considered to be a price-fixing or output restricting cartel is presumptively harmful.

¹⁷ See *'Faull & Nikpay: The EC Law of Competition'* 2nd Ed. (2007).

Hand stated in *Alcoa*, businesses should not be punished simply for reaching a position of market power through 'superior skill, foresight and industry'. In Europe, the risk of chilling competition in this respect is largely avoided because it is the abuse, not the acquisition, of a dominant position that breaches the unilateral conduct rules. Nonetheless, it could be argued that the EC rules on exploitative abuses (such as excessive pricing) come close to punishing businesses for becoming dominant, and this is something that needs to be given further consideration.

26. Second, it is argued that enforcement against unilateral conduct does not properly take into account the pro-competitive aspects of many practices and therefore deters businesses from engaging in potentially beneficial conduct for fear of unwarranted enforcement. Current economic thinking indicates that many types of conduct which may be found to breach competition law (such as loyalty rebates, selective price cutting, tying and bundling) can, in fact, not only characterise normal competitive markets, but be crucial to their effective functioning.¹⁸ While such conduct can cause substantial consumer harm, there is a very real risk that beneficial competition could be stifled if businesses unduly curtail such conduct because of the risk of over-inclusive enforcement. In fact, it is hard to think of many forms of unilateral conduct that will always, or indeed on average, be harmful even when carried out by firms with market power, without considering the market context.¹⁹
27. In this regard, it has been argued by many commentators that enforcement by the institutions of the European Community continues to be insufficiently aligned with economic thinking.²⁰ For example, the

¹⁸ See *The Reform of Article 82: recommendations on key policy objectives*, speech by Dr. Amelia Fletcher, Chief Economist at the OFT, 15 March 2008.

¹⁹ Clearly, blatant attempts to damage competitors, such as burning down a competitor's factory or dishonestly obtaining patent protection to slow down the emergence of competing generic products, are not under consideration here. See, for example, Case T-321/05, *AstraZeneca v Commission*.

²⁰ See for example, 'Faull & Nikpay: *The EC Law of Competition*' 2nd Ed. (2007), 'Korah: *An introductory guide to EC competition law and practice*' 8th Ed. (2004), Niels and Jenkins 'Reform of Article 82: *Where the link between dominance and effects breaks down*' (2005) 26 *European Competition Law Review* 605, and Vickers '*Competition Law and Economics: a*

recent judgement of the European Court of First Instance in *Wanadoo*,²¹ upholding a predation finding by the European Commission, has been criticised for failing to give proper weight to the implications of the newly-emerging and fast-growing nature of the market. Similarly in relation to loyalty rebates, the European courts have been criticised for enforcing the competition rules on the basis of traditional, static and formalistic jurisprudence guided by concepts of 'fairness' and protecting the 'freedom' to trade rather than consumer welfare or efficiency. The relatively recent cases of *British Airways*²² and *Michelin II*,²³ in particular, highlight the disconnect observed by many between the European Courts' jurisprudence and economic thinking.²⁴

28. Whilst the criticisms of the case law of the European Courts are powerful, they are in the authors' view also somewhat backward looking. They do not reflect properly a growing consensus in Europe as to the need to bring unilateral conduct cases more in line with standard economic thought. The first step in this progression must be the publication of guidelines on Article 82 by the European Commission. These guidelines will need to be driven, inter alia, by three major

mid-Atlantic viewpoint', lecture given at the Burrell Lecture of the Competition Law Association, London, 19 March 2007.

²¹ Case T-339/04 *France Telecom SA v Commission of the European Communities* [2008] 5 C.M.L.R. 6

²² In *British Airways*, the Court of First Instance held, in line with prior case law, that 'for the purposes of establishing an infringement of Article 82 EC, it is not necessary to demonstrate that the abuse in question had a concrete effect on the markets concerned ...'. See Case T-219/99, *British Airways v. Commission* [2003] ECR II 5917, at 293. On appeal, the Court of Justice held that, even though Article 82 EC prohibits conduct that causes prejudice to consumers, this encompasses not only direct prejudice but also practices which are detrimental to consumers through their impact on the 'structure' of competition. As such it was not necessary to have carried out an examination of the impact of the scheme at issue on consumers. See case C-95/04P, *British Airways v. Commission* [2007] ECR I 2331, at 106-107

²³ In *Michelin II*, the Court of First Instance predicated its assessment of whether Michelin's rebate system was an abuse of a dominant position on the traditional view that a dominant company has a 'special responsibility not to allow its conduct to impair genuine undistorted competition on the common market'. The Court relied heavily on concepts such as the 'unfairness' of the rebate system and the restrictions that it placed on the distributors' 'freedom' to choose sources of supply, rather than focusing on the economic consideration of the net impact of the system on price, quality or output. See Case T-203/01, *Michelin v. Commission*, [2003] ECR II 4071, at 97.

²⁴ The chances of such cases ever succeeding in the US courts would seem slim, to say the least. See for example *Virgin Atlantic Airways LTD v British Airways PLC*, 257 F 3d 256, (2nd Cir 2001).

principles. The first is the acceptance that in the field of unilateral conduct, an overall negative effect on price, quality or output (i.e., consumer welfare) will arise only if there is significant and durable market power. Unilateral conduct enforcement will, the authors believe, have to be based on a proper assessment of market conditions to determine if market power is, in fact, present²⁵ - market shares, which for so long have been given significant weight, will play a more limited role. Second, even if a firm has market power, it is not axiomatic that its conduct will result in anti-competitive effects. A sound and economics-based assessment of the likely effect of conduct on competition and ultimately on consumers, taking proper account of the actual market context, must be carried out. Finally, future unilateral conduct enforcement will, no doubt, take greater account of the dynamic impact on firms' incentives: short term intervention benefits will probably be given less precedence over longer term dynamic gains than in the past.

Vertical agreements

29. The 'chilling effect' of competition enforcement has also been alleged to occur in relation to vertical agreements, in particular those relating to pricing. In a recent survey on deterrence carried out for the OFT, for example, a number of manufacturers surveyed stated that they were deterred from carrying out sale-generating activities such as price promotions because of a concern that promotional arrangements with retailers would be regarded as vertical price-fixing and be sanctioned as a cartel.²⁶
30. Over the last ten years, the European approach towards vertical agreements has fundamentally changed. Authorities have increasingly incorporated into their assessment of vertical agreements both the need

²⁵ See Case C-62/86 *Akzo Chemie BV v Commission* [1991] ECR I 3359. For an examination of the differences in how US and EC competition law address whether dominance or market power exists, see Calvani and Fingleton, *Dominance: A comparative economic and legal analysis*, ABA Section of Antitrust Law, Issues in Competition Law and Policy (2008).

²⁶ OFT962, The deterrent effect of competition enforcement by the OFT, A report prepared for the OFT by Deloitte, November 2007.

to show market power and the fact that such agreements can generate significant pro-competitive efficiencies. Thus, whilst intervention is still more likely under the EC rules than in the US, the authors believe that *in practice* the only area in which significantly different outcomes are likely is, following the recent US Supreme Court *Leegin* judgement,²⁷ in relation to resale price maintenance (RPM).

31. In almost all jurisdictions, RPM agreements have traditionally been treated either as *per se* illegal or, at the very least, viewed with suspicion. Under the EC rules, for example, such agreements are considered to be 'hardcore' restrictions of competition whilst in the US, the stance has only recently shifted away from regarding RPM agreements as *per se* illegal following the *Leegin* judgement.
32. However there is growing consensus amongst economists that this strict approach is no longer justified - RPM can, it is said, help align the incentives of manufacturers and retailers in a pro-competitive and consumer-welfare enhancing manner; it can combat free-riding, support investment in service-provision and improve inter-brand competition.²⁸
33. However this view is not held universally.²⁹ On balance, in the authors' view, there is insufficient evidence at this stage to say with certainty that the rules on RPM should be fully relaxed. For example, UK action to remove RPM in relation to book retailing appears to have had consumer benefits.³⁰ In addition, vertical RPM is often combined with horizontal restraints, which can certainly have adverse effects on competition (as, for example, was the case in relation to the OFT's decisions on price-fixing of football shirts and toys). Indeed, anecdotal evidence from the OFT's experience so far suggests that the efficiency

²⁷ *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, (127 S. Ct. 2705 (2007)).

²⁸ See the amicus brief filed by US economists in the *Leegin* case before the US Supreme Court. Indeed, these are the types of factors that can be taken into account in an assessment under Article 81(3) EC.

²⁹ For example, an amicus brief filed by the American Antitrust Institute in the *Leegin* case argued for the *per se* illegality of RPM to be upheld.

³⁰ For details, see OFT981, An evaluation of the impact upon productivity of ending resale price maintenance on books, A report prepared for the OFT by the Centre for Competition Policy at University of East Anglia, March 2008.

justifications for RPM agreements, and thus the arguments for a full market assessment in relation to RPM cases, are weak.

34. Nonetheless, the recent US judgment in *Leegin* and the economic criticism of a per se approach to RPM warrant further consideration. The OFT, for example, is carrying out research into the topic of RPM to consider these types of issues and to inform its competition policy going forward.

II. ELEMENTS OF AN OPTIMAL COMPETITION POLICY REGIME

35. An optimal competition policy regime stimulates pro-competitive behaviour for the benefit of consumers, while minimising the risk of chilling genuinely pro-competitive behaviour through *ex ante* or *ex post* errors. The design and operation of such an optimal regime requires a number of key elements.
36. First and foremost, the competition authority must have the correct analytical framework within which to develop and apply its policy. Second, it must have the institutional ability to carry out its mission. This requires both the effective use of its resources and a sufficient knowledge-base to inform its actions. Third, there must be sufficient motivation or incentives to consistently produce high-quality work product. This can be achieved in a number of ways, including regular evaluations, judicial oversight and ensuring clarity of approach to policy and enforcement. Finally, the authority must be independent, so that it can focus on its goals without undue influence, political or otherwise.

A. *Correct analytical framework*

Development of an underlying consumer welfare rationale for competition policy

37. Competition law interventions are determined, directly or indirectly, consciously or unconsciously, by the rationale which underpins the rules.

38. Over time, different rationales for competition policy have been propounded. On one view, competition policy aims to maximise consumer welfare; on another, it aims to protect the process of rivalry between firms. Competition policy has also been seen, *inter alia*, as a means to control private economic power or to further the goal of market integration. Which rationale is chosen will have a significant impact on the direction and development of competition policy.
39. It may seem somewhat unusual to a US audience that the underlying rationale of competition policy is still being debated in other jurisdictions: In the US the principal anti-trust ideologies have, by in large, converged on the idea that the protection of consumer welfare is antitrust's ultimate purpose. The remaining disagreements are about *how* antitrust can best achieve that end.³¹ Indeed, the US response to an ICN survey on unilateral conduct states that '[t]oday it seems clear that the general goal of the antitrust laws is to promote 'competition' as the economist understands that term. Thus we say that the principal objective of competition policy is to maximize consumer welfare ... while ... permitting [firms] to take advantage of every available economy that comes from ... production efficiencies or from innovation'.³²
40. To some extent in Europe and certainly elsewhere, the debate about the underlying rationale for competition policy is not yet fully resolved. In particular, goals other than the maximisation of consumer welfare may

³¹ See Hovencamp, *The Antitrust Enterprise, Principle and Execution*, 2005. However, we recognise that at state-level within the US differences of approach remain between circuits as to certain practices, such as bundled discounts. In addition, we note that some prominent US commentators have argued in favour of adopting a total welfare standard; that is, a welfare standard which includes business profits as well as consumer welfare. See, for example, Dennis Carlton, *Does Antitrust Need to be Modernized?*, NBER, January 2007 and RH Bork, '*Legislative Intent and the Policy of the Sherman Act*', (1966) 9 *Journal of Law and Economics* 7. In our view, however, a consumer welfare standard will typically be a better proxy for innovation and productivity growth, which is arguably the final objective of competition policy. See R Nazzini, 'Welfare Objective and Enforcement Standard in Competition Law' in A Ezrachi and U Bernitz (eds), *Private Labels, Brands and Competition Policy: The Changing Landscape of Retail Competition* (Oxford: OUP, forthcoming).

³² See ICN Report on the Objectives of Unilateral Conduct Laws, Assessment of Dominance/Substantial Market Power, and State-Created Monopolies, presented at the 6th Annual Conference of the ICN, Moscow, May 2007, page 32.

still, at least potentially, be taken into account. While the majority of respondents to the ICN survey identified the goal of competition policy as the promotion of consumer welfare, many authorities also identified additional objectives such as ensuring a level playing field for SMEs, promoting fairness and equality, achieving market integration or facilitating market liberalisation.³³

41. Nonetheless, consumer welfare is increasingly at the forefront of developments in Europe. For example in relation to Article 81 EC the European Commission has explicitly stated that the goal of 'enhancing consumer welfare and of ensuring an efficient allocation of resources' is the aim of competition policy.³⁴ Perhaps more importantly the Court of First Instance clearly based its recent *GSK* judgement³⁵ on the impact of the agreements in question on consumer welfare.³⁶ In relation to Article 82 EC (unilateral conduct), the European Commission's emerging policy is also likely to be firmly based on a consumer-welfare rationale.

Consumer welfare framework for competition policy action

42. A fundamental premise of this paper is that a focus on consumer welfare produces the optimal outcome for the market and its participants. This requires authorities to consider the likely net impact of conduct (whether unilateral, coordinated or merger-related) on price, quality and output. From this perspective, conduct violates the competition rules if it reduces competition without creating sufficient efficiencies or competitive benefits to offset any potential adverse effect. Intervention is justified only where conduct would be likely to have a net negative effect on consumer welfare.

³³ Ibid.

³⁴ Communication from the Commission, 'Guidelines on the application of Article 81(3) of the Treaty' [2004] OJ C101/97 (27.4.2004), para. 13. For a fuller consideration of this topic, see Faull & Nikpay, *The EC Law of Competition* 2nd Ed (2007) and R Nazzini, 'Article 81 EC between time present and time past: a normative critique of 'restriction of competition' in EU law' [2006] CML Rev 497-536.

³⁵ Case T-168/01 *GlaxoSmithKline Services v. Commission* [2006] ECR II 2969, at 118-119.

³⁶ The scope of application of this judgement has been challenged by some commentators. For a discussion see 'Faull & Nikpay: *The EC Law of Competition*' 2nd Ed (2007), at paragraphs 3.137 to 3.144.

43. The economic assessment of consumer harm should take into account both the immediate, direct impact and the potential, indirect impact of conduct on price, quality and output. If conduct gives rise to efficiency benefits for a firm, these benefits are cognisable as long as they are sufficiently passed on to consumers to ensure that consumers are not harmed by the conduct.³⁷
44. This assessment does not balance negative effects on consumers against the benefits to the firm engaging in the conduct (so efficiencies obtained through anti-competitive conduct that are not passed on to consumers cannot justify that conduct). However, where conduct may have a mixed effect on consumers, the overall effect on consumer welfare must be assessed. For example, in the Microsoft case it was argued that no harm to consumers resulted from Microsoft's tying of Windows Media Player to its operating system because prices remained low. This had to be weighed against the reduction in consumer choice resulting from the foreclosure of alternative competing products and an assessment made of the ultimate effect on consumer welfare. While it is important to preserve the incentives of dominant companies to innovate, 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.
45. The effects-based approach under the consumer welfare rationale can be contrasted with the formalistic, bright-line approach that often prevailed under traditional competition policy frameworks in Europe (which focused on the structure of the market or on freedom of contractual relations). The risk with bright-line rules is that their application, although easy, may lead to significant chilling effects. This is because conduct that formally meets the triggering factors may be prohibited regardless of any potential efficiencies (over-inclusion or Type I errors), whereas conduct that has a negative effect on competition and consumers may escape prohibition because of its formal categorisation (under-inclusion or Type II errors). With bright-line

³⁷ S. Salop, *The controversy over the proper antitrust standard for anticompetitive exclusionary conduct*, Fordham Competition Law Institute (2006) 477.

rules, the risk of Type II errors is particularly high, as companies may often easily take steps to change the formal structure or classification of conduct to avoid prohibition, while ensuring that the substantive effect of the conduct is not changed.

46. A consumer welfare framework avoids such a formalistic approach and significantly reduces the risk of Type I and Type II errors. The economic assessment required by the consumer welfare standard reduces significantly the likelihood that efficiency-enhancing conduct will be prohibited simply because of its formal categorisation (over-inclusion or Type I error) or that efficiency-reducing conduct will be allowed to continue because it is not classed as a particular type of conduct (under-inclusion or Type II error). Under a consumer welfare framework, it is the likely economic effect of the conduct that is key. As such, a proper effects-based approach involves a conscious consideration in each decision of the impact of intervention by the authority in terms of false positives and negatives.
47. Nonetheless, despite the clear advantages of a consumer welfare approach over bright-line rules in avoiding potential chilling effects, concerns remain on two issues. The first is the cost of undertaking an economics-based assessment of consumer welfare – it is argued that such an approach often requires significant amounts of information to be gathered and then analysed by expensive experts.³⁸ Second, since economics is not an exact science, uncertainty for business will increase.
48. In terms of additional cost, it is indisputable that businesses will have to evaluate the economic effects of conduct to determine the likely net effect of that conduct on consumers. This will sometimes require the accumulation and analysis of more detailed business information than is the case under a formalistic conduct-categorisation approach. However, there is no reason to suppose that the type of information required to carry out an economic assessment of the effect of conduct would not

³⁸ See A. Douglas Melamed, *Exclusionary Conduct under the Antitrust Laws: Balancing, Sacrifice and Refusals to Deal*, 20 Berkley Tech. LJ 1247 (2005).

be available to businesses in their ongoing business planning and operations. It is the type of information that is normally provided in merger cases. More importantly, correct economic analysis will limit intervention to cases where there is market power. This should significantly reduce the scope of application of competition law, thereby lowering the overall cost to business.

49. In terms of uncertainty, the economic, effects-based approach under a consumer welfare framework has been criticised somewhat for being less able than bright-line rules to provide the legal certainty needed for an optimal competition regime.
50. Bright-line rules, by their nature, provide considerable certainty in relation to the specific practices covered, as they specify in definitive terms the triggering factors that will result in prohibition or sanction for identified conduct. This provides the necessary legal certainty for businesses for effective self assessment and makes the rules easy for both competition authorities and courts to enforce, giving rise to administrability benefits.
51. As such there is little dispute that when it is possible to predict with confidence that the effects of the conduct are generally harmful or beneficial, there is a strong case for adopting bright-line rules. Cartels are prohibited as such without any inquiry into the effects of the conduct. This is because cartels are almost certainly harmful to consumer welfare and the benefits of a bright-line rule outweigh the risk of a Type I error in the wholly exceptional case in which a cartel might be beneficial.³⁹ Similarly, in the US, above cost pricing is *per se* legal under section 2 of the Sherman Act.⁴⁰ This is not because above cost pricing can never be harmful but because the benefits of a bright-line rule outweigh the risk of Type II errors for the US economy.

³⁹ It must be noted, however, that in the EU even cartels can, as a matter of law, be 'exempted' under Article 81(3), although this is highly unlikely to happen in practice.

⁴⁰ *Brooke Group Ltd v Brown & Williamson Tobacco Corp*, 509 US 209 (1993). The situation may be different in Europe: *Joined Cases T-24 - 26/93 and T-28/93 Compagnie maritime belge transports SA v Commission* [1996] II-1201.

52. However, in the authors' view the benefits of bright-line rules, and the disadvantages of an effects-based approach, are often heavily over-emphasised. For practices that fall outside the bright-line rules, business can face significant uncertainty (some have argued that the repeated infringement proceedings against *Michelin* are a direct result of this uncertainty). More generally, when the effects of the conduct are ambiguous and it is not possible to predict with any reasonable degree of confidence whether they are generally harmful or beneficial, bright-line rules give rise to *systematic ex ante* Type I and Type II errors, the magnitude and frequency of which would be hard to predict and impossible to control. This is why an effects-based approach is superior to bright-line rules in most cases.
53. An effects-based approach does not mean that authorities have *carte blanche* to assess cases in any way they deem appropriate. Authorities should base their economic analysis on tried and tested principles rather than the latest theoretical economic thinking set out in cutting-edge journals. Similarly in evaluating the likelihood and magnitude of consumer benefits or harms, they should rely on the information reasonably available at the time the conduct was undertaken. In this way, the economic analysis of conduct is based on what a company knew or should have known at the time that the conduct was undertaken.⁴¹ In the UK, for example, penalties for infringement of the Competition Act 1998 can only be imposed for intentional or negligent infringements.
54. Between the two extremes of per se illegality and per se legality, there is scope for the use of 'soft' presumptions and safe harbours⁴² in designing an optimal principles-based framework which is both administrable and capable of providing sufficient guidance to business. Type I and Type II errors may also be balanced *ex ante* by an

⁴¹ See S. Salop, *Exclusionary conduct, effect on consumers and the flawed profit-sacrifice standard*, *Antitrust Law Journal* Vol 73 (2006).

⁴² That is, a safe harbour that imposes a higher standard of proof on the competition authority to prove the infringement as opposed to an absolute safe harbour, which amounts to per se legality.

appropriate allocation of the evidential burden⁴³ and by modulating the standard of proof⁴⁴ depending on the likelihood of the type of conduct under review being harmful or otherwise.⁴⁵

55. In these ways authorities can ensure that the consumer welfare approach does not increase legal uncertainty or cost to such an extent that the obvious substantive benefits of this approach are undermined.

B. Institutional ability

56. While adopting a consumer welfare framework is a necessary condition for enabling competition authorities to best ensure that they stimulate competition to the benefit of consumers and avoid chilling effects, this alone is not sufficient. The analytical framework must be supported by the institutional ability to take high-quality, economically-sound decisions on competition policy and enforcement. In particular, the type of analysis required by an economic, effects-based approach to competition policy is highly resource-intensive and may require differently skilled staff. Effective resourcing and a sufficient knowledge base are therefore vital to providing the necessary institutional ability.

Effective resourcing

57. Competition authorities, like any other public body, do not have unlimited appropriately skilled resources. Whatever action they take is subject to constraining factors such as budgetary limitations, staff numbers, and the amount of staff time that will be taken up with the action. In other words, when an authority is considering competition policy action, it has to consider whether it has enough money, a sufficient number of qualified and appropriately skilled staff and

⁴³ The more likely it is that the conduct under review is harmful, the more quickly can the evidential burden shift onto the allegedly infringing companies.

⁴⁴ The more likely it is that the conduct under review is pro-competitive, the higher the standard of proof on the competition authority.

⁴⁵ On the allocation of the legal and evidential burden of proof in unilateral conduct cases, see R. Nazzini, 'The wood began to move: an essay on consumer welfare, evidence and burden of proof in Article 82 cases' (2006) 31 EL Rev 518-539.

adequate time available to undertake and complete that action to a satisfactorily high quality level.

58. As a result, competition authorities cannot, and should not, attempt to address every conceivable instance in which competition may be restricted.⁴⁶ An overly-expansive approach to enforcement would stretch resources to a point where the quality of an authority's policy development and decision-making would be substantively harmed and therefore more likely to result in over-inclusion or Type I errors. An effective competition policy regime therefore requires that the competition authority focus its efforts so that, although it may engage in fewer actions, those actions will be of a higher quality. In particular, by focusing on fewer cases, an authority should be able to reduce the time necessary to resolve the cases it takes on and to devote more attention to improving the analytical foundations of those cases.⁴⁷
59. Securing the institutional capability to properly carry out the complex analyses that a competition authority must engage in requires that the authority is adequately staffed with trained and experienced personnel. In many jurisdictions, a revolving door policy that encourages professional movement between competition authorities and the private sector has proven very helpful in this respect. Ongoing training, know-how and personal development activities once personnel are in place can further support the professional development of staff and secure the capability for high-quality, soundly-based decisions.
60. These measures can be expected to increase the quality of the decisions being made and have a knock-on effect on future cases

⁴⁶ See also Wils, P.J. '*Principles of European Antitrust Enforcement*' Hart Publishing [2005] at paragraph 474 where, in the context of reviewing the need to reform the European system of private enforcement, it is argued that 'in all likelihood [it is] not in the general interest that all antitrust violations are prosecuted....How much antitrust enforcement is desirable depends of course on how much value society attaches to the avoidance of antitrust violation, but that value is certainly not infinite given the multitude of other societal concerns'.

⁴⁷ See, for example, the comments of William Kovacic regarding the mismatch between FTC's enforcement objectives and institutional capability in *The Importance of History to the Design of Competition Policy Strategy: The Federal Trade Commission and Intellectual Property*, delivered at a symposium on the intersection of antitrust and intellectual property law [2007].

through the availability of better precedent and more consistent decision-making (which will increase certainty for businesses and reduce the risk, in particular, of ex-post errors). Effective resourcing is therefore key to an optimal competition policy regime.

Sufficient knowledge base

61. Institutional knowledge is clearly vital to the ability of a competition authority to take soundly-reasoned, consistent decisions. As well as training and know-how provision, promoting transparency in relation to the authority's approach to policy and enforcement can, *inter alia*, ensure the maintenance and development of institutional knowledge.
62. Measures such as taking reasoned decisions, publishing guidance on how it applies competition law and engaging in educational programmes not only increase clarity and certainty for businesses, but also have internal benefits for the authority. Through the creation and dissemination of guidance, for example, personnel obtain a clearer view of the analytical and policy framework within which they carry out their work and the lessons learned are not lost through staff turnover. The overall knowledge base of the authority is thereby secured and developed.

C. Institutional motivation

63. Competition authorities can be considered to be subject to so-called 'soft budget constraints' on performance. This essentially means that, as the only bodies charged with competition policy development and enforcement, they have weaker incentives to carry out their activities within short time frames and to higher standards than they would if alternative providers existed. The challenge for competition authorities is therefore to ensure sufficient institutional motivation for the type of high-quality, timely action that is needed for an optimal competition policy regime. Institutional motivation can be created through means such as regular evaluation, judicial oversight and transparency.

Regular evaluation

64. By assessing the quality and impact of its actions (both in terms of developing competition policy and carrying out enforcement activity) an authority can gain valuable insight into how to improve and maximise its performance. In particular, evaluation allows an authority to determine whether its actions have incentivised pro-competitive behaviour to the benefit of consumers or whether its actions have turned out to be over- or under-inclusive and thus potentially 'chilling'. Evaluation also allows an authority to determine whether the results of its successful actions were obtained in an efficient and effective way from an internal performance perspective.
65. One effective method of evaluating the quality and impact of actions is to engage in *ex post* evaluation exercises to assess the outcome of a project against the original aims of the project, the time taken and the cost incurred in its execution. Another is to engage in ongoing evaluation throughout the life of a project, so that at key stages in the project, the authority can determine if it is on track to deliver the expected outcome. Both of these evaluation mechanisms are within the control of the authority, although it may well decide that in the interests of objectivity *ex post* evaluations are actually carried out by an independent third party.
66. Implementing such an evaluation process (whether during or after the life of a project) provides a strong motivation to the authority's staff to ensure that work is carried out to a high standard, is economically-sound, reasonable and consistent.

Judicial oversight

67. An additional, vital, form of discipline for an authority is the review of its actions by the judiciary. Through the appeal system, an authority's decisions on enforcement and indeed its overall competition policy, are subject to review and evaluation.

68. It may be argued that per se, bright-line rules provide a stronger basis for robust judicial oversight than economic, effects-based rules. However, this underestimates the ability of courts to deal with complex economic issues. Courts in several jurisdictions, including the US and UK, have regularly demonstrated that they are capable of dealing with such issues. There is no reason to assume that they would be unable to do so elsewhere in the world.
69. Aside from the obvious benefits of judicial guidance on the substantive elements of competition policy and law, proper judicial oversight of procedural matters can give valuable guidance to an authority on what is required of it from an administrative perspective. This can enhance the professionalism of the work undertaken at the investigation, case preparation and decision-making phases of a case. This benefits both the parties to the case and the authority in terms of the evidence sought and obtained, the resources involved and the time required to carry out the administrative procedure and take a decision.
70. Both from a substantive and procedural viewpoint, therefore, judicial oversight provides strong motivation to the authority's staff to maintain and improve the quality of their work, to ensure consistency and to maintain a sound and reasonable approach to decision-making.⁴⁸

Clarity of approach

71. In terms of both cost and efficiency, prevention of harm in the first place through compliance is superior to enforcement action after harm has been created. Businesses should have the necessary knowledge of competition law and its attendant obligations to encourage compliance with the competition rules. A competition authority must therefore be consistent in its approach to the law and enforcement and must make its approach sufficiently clear to business.

⁴⁸ However, to ensure that the ability of competition authorities to operate effectively and without undue constraint, appeal bodies should, of course, be cognisant of the requirements for an appropriate institutional balance and wary of taking over the functions of a first-level decision-making body.

72. This will also ensure that the potential risks of competition intervention, in particular the risk of Type I errors in self-assessments, are minimised because businesses have greater knowledge of how their behaviour is likely to be assessed. The risk of unintentional deterrence of otherwise pro-competitive behaviour is thereby reduced.
73. Reasoned decisions are key to creating clarity and certainty for businesses. Decisions that contain the full reasoning behind an authority's decision to act, its assessment of the relevant market, the effect of the conduct at issue and the choice of sanction, provide significant clarity to businesses as to how conduct will be assessed under the competition rules. This increases legal certainty for businesses and gives them the information necessary to assess for themselves the consequences of any intended conduct. In this respect, it is important that an authority issues reasoned decisions, not only in infringement cases, but also in cases where it finds that conduct does not infringe the competition rules or where the authority accepts commitments from businesses to avoid infringement. A recent OECD policy roundtable on guidance to business on monopolisation and abuse of dominance (2007) highlighted that, for business, the reasoning behind a case in which no infringement was found can be as, or more, useful than an infringement decision.
74. Another way for an authority to provide certainty and increase clarity is through the use of guidelines. Guidelines, particularly those that cover both the legal and economic thinking behind an authority's approach to competition policy, provide significant clarity to business on the operation of the competition policy regime. They allow much more effective self-assessment of conduct and provide a reasonable basis for businesses to anticipate how an authority will assess conduct.
75. The advantages of an open and transparent competition policy regime are not limited to the external benefits for businesses but also feed back into the internal incentives for a high quality standard of work on the part of the authority. In particular, by establishing and disseminating guidelines setting out how the competition policy is to be applied, case-teams are sufficiently informed and disciplined to adhere to the

principles and practice set out in the guidelines. This improves overall decision-making quality and ensures that individual decisions are correctly geared towards the objective of stimulating pro-competitive behaviour to the benefit of consumers, while minimising the risk of chilling incentives for such behaviour through over- or under-inclusion errors.

D. Independence

76. Political independence is vital for an authority to be able to act consistently in furtherance of pro-competitive conduct without risking the chilling effects of over- or under-inclusion. As discussed above, an optimal competition policy requires a focus on the underlying rationale of maximising consumer welfare. This must be the goal of the competition authority in developing policy and engaging in enforcement action. To the extent that an authority is subjected to other policy aims (for example, government targets on industrial policy development), the possibilities for conflicts with the consumer welfare goal are increased. Independence is therefore vital for ensuring an effective competition policy regime that best stimulates competition to the benefit of consumers and reduces the risks of chilling effects.⁴⁹

III. THE OFT'S APPROACH TO COMPETITION POLICY

77. The OFT's approach to competition policy is designed to meet the requirements set out above for an optimal regime. In particular, recent organisational development has allowed the OFT to put in place four key elements to support its goal of maximising pro-competitive behaviour and minimising the risk of over- or under-deterrence.
78. The first element is the principle that the goal of competition policy is to optimise consumer welfare. This guides all of the OFT's competition policy actions. Second, the OFT actively focuses its resources to avoid

⁴⁹ Independence from government is also key to providing a competition authority with the necessary standing to act effectively as an advocate for competition policy before government departments and other public bodies.

over-stretching its capabilities and to ensure the quality of its decision-making. Third, the OFT engages in rigorous evaluation and actively promotes an open, transparent and clear approach to enforcement, which creates incentives for improved work product quality. Finally the OFT is independent of government in terms of its day-to-day operations and fulfils its mission to make markets work well for consumers by reference to the competition policy framework that it sets rather than wider governmental objectives. These elements are explored further in this section.

A. *Consumer welfare focus*

79. The OFT's mission is to make markets work well for consumers. In carrying out its mission, the OFT benefits from a dual competition and consumer law remit. This 'dual remit' has resulted in strong support for the use of the consumer welfare standard for competition policy at all levels within the agency. In addition, it allows the OFT to adopt a more holistic approach to markets through its wider perspective of how markets function from the viewpoint of consumers as well as businesses. Finally, through its greater understanding of how consumers actually behave, the OFT can frame more effective remedies for competition law problems.
80. The OFT acts only where harm is reasonably likely to be caused to consumers. Therefore, the OFT assesses the likely direct and indirect effect on consumer welfare of action before deciding whether competition intervention in a market is justified.
81. In relation to direct effect, the OFT examines factors such as price, output levels, and quality and has regard to the expected impact of intervention in both static and dynamic terms. In relation to indirect effect, relevant factors include future improvements to consumer welfare that are likely to result from the changes in consumer and business conduct. The OFT also assesses the expected additional economic impact on efficiency and productivity, which are key elements in securing long-term consumer welfare.

82. The benefits to consumers of the OFT's consumer welfare focus are borne out by economic studies on the effect of OFT action. The OFT estimates that the direct effect of its competition enforcement work over the period 2005-08 was an annual average of £192m of savings for consumers.⁵⁰ Independent research commissioned by the OFT suggests that the scale of the deterrent effect of UK enforcement is likely to imply total consumer savings of at least six times this figure; around £1.15 billion. This compares to a total annual OFT budget of about £70 million.⁵¹
83. Where the likely impact on consumer welfare from OFT action is unlikely to be substantial, the OFT will usually decline to act. For example, in the mergers field, the OFT has applied in several recent cases⁵² its revised guidance on 'markets of insufficient importance'.⁵³ The revised guidance provides that the OFT generally will not consider mergers affecting markets worth less than £10 million as capable of justifying a reference to the Competition Commission, save where factors suggest that the consumer harm from the merger will be particularly significant. This reflects the economic reality that investigating mergers in small markets may result in disproportionate burdens on businesses where there are only limited consumer benefits that could be expected to be achieved. In determining whether consumer harm in an individual case will be significant, the OFT triangulates the size of the affected markets with its belief as to the probability of consumer harm materialising and its assessment of the magnitude of that potential harm. It also considers the future deterrent effect of not intervening in a given case and whether the parties can

⁵⁰ OFT1007, Positive Impact 07/08, July 2008.

⁵¹ See OFT963, The deterrent effect of competition enforcement by the OFT, Executive Summary, November 2007. We note that the total annual budget of the OFT is used for activities extending beyond competition law enforcement.

⁵² See, for example, *Anticipated acquisition by FMC corporation of the alginates business of ISP Holdings (U.K.) Limited 30 July 2008* and *Completed acquisition by Stagecoach Group plc of the East Midlands Franchise 4 February 2008*.

⁵³ OFT516b Revision to Mergers – substantive assessment guidance - Exception to the duty to refer: markets of insufficient importance, November 2007.

reasonably provide proportionate remedies to prevent harm occurring at all.⁵⁴

84. In terms of its 'portfolio' of competition cases, in recent years the OFT has focused more enforcement activities on national and international cartel behaviour than other matters. This reflects the general consensus that such behaviour is anti-competitive, harmful to consumers, and not prone to errors of over-inclusion or Type I errors.
85. In contrast, the OFT has undertaken relatively few Chapter II (abuse of dominance) decisions. This is, in part, a reflection of the use of the consumer welfare filter described above. However three other factors have played an important role in this respect. First, in the UK, network industries (such as telecommunications, postal services, energy, and water) were liberalised earlier and cases in these sectors fall to the relevant regulator. Second, the existence of the Market Investigation Regime⁵⁵ offers an alternative approach to deal with certain structural monopoly issues. Finally, in common with other EU member states, cases involving EU wide abuse of dominance are generally taken by DG Comp.

B. Institutional ability

Effective resourcing

86. The OFT is aware of the need not to spread its resources too thinly to avoid potentially reducing the quality of its decision-making and increasing the risk of over- or under-inclusion errors in its policy or its enforcement activities. When the Competition Act came into force in 2000, the OFT adopted a relatively broad approach to taking on cases

⁵⁴ Where such remedies are available, the OFT is likely to intervene. See *Completed acquisition by Dunfermline Press Limited of the Berkshire Regional Newspapers business from Trinity Mirror plc* 4 February 2008.

⁵⁵ The OFT has the power to refer a market to the Competition Commission under section 131 of the Enterprise Act 2002 where it has reasonable grounds for suspecting that any feature, or combination of features, of a market in the UK for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of goods or services in the UK or part of the UK. See further OFT511 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', June 2003

and opened cases on the basis of no more than a 'reasonable suspicion' of competition law breaches. This resulted in a large number of cases being investigated at the same time and consequently stretched the OFT's resources significantly. In the light of this experience, OFT moved away from this approach to a more focused one.

87. Starting in 2004, in order to better target its resources, the OFT strengthened its internal approach to deciding which work it takes forward. This approach is built into the OFT's annual business planning and Effective Project Delivery Framework.⁵⁶ The strengthened approach requires the OFT to consider the timing and resource requirements of projects within the context of its overall workload and to assess the resources required going forward to deliver the projects considered. The assessment is carried out throughout the life of a given project. Only projects that will deliver sufficient benefits and impact in view of the time and resources necessary for their execution are taken forward. This allows the OFT to focus its resources on fewer projects and to ensure that it consistently delivers high quality work and minimises the risk of action that has the unintended consequence of chilling incentives for pro-competitive behaviour.

88. In addition to focusing the use of its resources, the OFT is pro-active in ensuring that it has the right mix of adequately trained and skilled staff. As such the OFT has an almost equal mix of lawyers and economists working on competition matters. In addition it has an active 'revolving-door' policy'; as a result, an estimated 50% of the authority's staff has had experience in the private sector. This developing policy has been effective for the OFT in achieving a good balance of highly qualified, trained and specialist staff. This balance is key for ensuring that the work of the OFT is economically-sound and legally consistent, thereby increasing the likelihood that it achieves its aim of stimulating pro-competitive behaviour and reducing the risk of chilling competition.

⁵⁶ This is a set of project management principles, processes and tools aimed at improving the OFT's ability to deliver high quality and timely outputs through well run projects.

C. Institutional motivation

Clarity of approach

89. The OFT's policy is to provide as much greatest guidance and legal certainty to business as possible, by ensuring that its approach to competition policy and enforcement is consistent and clear.
90. A key tool for ensuring consistency and clarity of approach is the publication of reasoned decisions. This includes not only infringement but also, in appropriate cases, non-infringement decisions. Finally, when the OFT accepts commitments from businesses, it attaches those commitments to its final, reasoned decision. All of the OFT's Competition Act decisions are published on its website to allow effective dissemination of the guidance to be obtained from them.
91. The OFT also has a policy of wide dissemination of guidance and advice to business. In terms of the legal rules, the OFT has issued a series of guidelines on the UK competition rules, including the cartel provisions and leniency programme, ensuring compliance with the competition rules, dominance assessments, and vertical agreements. The OFT also publishes guidance on how it enforces the competition rules, for example involving third parties in Competition Act investigations, the assessment of penalties for infringements and how the OFT interprets the services of general economic interest exception. Detailed guidance in the field of mergers, both substantive and jurisdictional, has also been published. Aside from guidance on competition legislation, the OFT regularly publishes economic studies and reports on the economic considerations applicable to certain markets and factors relevant to the consumer welfare standard. The OFT also engages in widespread awareness raising and engagement with business via appropriate proactive media relations and interviews, speaker opportunities, and engagement with business representative organisations and trade associations. By providing both legal and economic substantive guidance to business, the OFT ensures that companies have a complete picture of the competition policy regime in the UK and can gauge for

themselves how best to ensure that they remain in compliance with that regime.

92. Finally, the OFT engages in public consultation whenever it proposes changes to or developments in its competition policy activities (for example, when developing its principles for assessing the appropriate penalty for competition act infringements). By so doing, the OFT ensures, not only that business is engaged with and aware of important competition policy developments, but also that any areas in which further clarity is needed are highlighted early and can be addressed before the guidance is finalised. This increases the guidance and legal certainty obtained by business from the OFT's publications. The costs of self-assessment and compliance are thereby significantly reduced for businesses, as are the risks of Type I errors in self-assessments.
93. The effectiveness of the OFT's efforts to provide information, education and guidance to businesses on the UK's competition policy regime can be seen from independent research which showed that by June 2006 more than half of businesses in the UK were aware of the Competition Act. This figure rose to sixty per cent for businesses with ten or more employees.
94. The OFT recognises that an open and transparent approach also has a feed-back effect on internal decision-making and can help to strengthen the OFT's internal checks and balances. To this end, the OFT is engaging with stakeholders to further improve how it communicates and engages with them in the future. With OFT policy and decision-making increasingly subject to wide scrutiny (and critique) by stakeholders, the OFT's staff have the impetus to ensure that all decisions and actions are high-quality, consistent and reasonable. In addition, the creation and dissemination of guidance, in particular, has a disciplining effect on decisions and supports the development of a sufficient knowledge base within the OFT to ensure the necessary institutional capability for it to meet its objectives and reduce the potential for unnecessarily deterrent action.

Regular evaluation

95. The OFT has an ongoing and rigorous internal evaluation programme. First, most large projects now have impact estimation plans which outline the intended outcome or impact of the project, the key indicators of success and how to monitor those indicators. These impact estimation plans are now embedded across the OFT. The use of these plans provides an added impetus to OFT staff to improve the quality of their analysis and decision-making as they carry out projects. They also allow the OFT to estimate its overall impact in terms of consumer savings.⁵⁷
96. In addition, for completed projects, such as market investigations or competition act investigations, the OFT often commissions an independent evaluation of the impact of those projects on the market and on consumer welfare. These can offer positive feedback, but they can also include significant learning points for the OFT. For example, in October 2007, the OFT published Europe Economics' independent evaluation of the impact of the OFT's recommendations to resolve competition problems in the taxi industry resulting from restrictions on the number of licences and regulated fare structures. The evaluation found that, following those recommendations, the removal of licence restrictions by local authorities increased taxi availability and resulted in time savings for consumers and increased demand. However, the failure to adjust regulated fares downwards led to over-supply and a loss of productive efficiency. This evaluation has provided valuable guidance to the OFT and lessons to carry forward into future market studies. Similar evaluations of other projects provide equivalent benefits going forward.
97. Aside from evaluation mechanisms, the OFT benefits from a number of internal checks and balances such as a supervisory Board which is responsible for ensuring that the OFT meets its statutory obligations in an efficient and cost-effective way.

⁵⁷ For example, see OFT1007, Positive Impact 07/08, July 2008.

98. In addition there are numerous important external oversight mechanisms. Most obviously, the OFT is subject to judicial oversight from the courts and from the specialist Competition Appeal Tribunal; indeed many of its formal, and some of its informal, decisions have been appealed to the Competition Appeal Tribunal for a full-merits review, thus further increasing the legal certainty and clarity provided by those decisions. Furthermore, as a publicly-funded body, the OFT is ultimately accountable to parliament, for example through parliamentary review of its annual plans and reports and the potential for parliamentary select committee scrutiny where needed. In addition, the OFT is subject to valuable oversight and evaluation from the National Audit Office, which scrutinises the OFT's efficiency and the effectiveness with which it uses its resources, and reports to Parliament on its findings. Finally, the OFT operates within the Better Regulation framework established to ensure that UK government departments design and implement their regulatory actions in a manner that ensures transparency, consistency, accountability, proportionality and a targeted approach. These checks and balances are key to ensuring that the OFT operates effectively and efficiently in promoting its goal of enhancing consumer welfare and minimising action that could have a detrimental impact on the incentives of business to engage in pro-competitive behaviour.

D. Independence

99. The OFT is a non-ministerial government department established by statute. Although it works closely with other government departments, such as the Department for Business, Enterprise and Regulatory Reform, the OFT is independent of government in terms of its day-to-day operations. Its mission is to make markets work well for consumers and it fulfils that mission by reference to the competition policy framework that it sets rather than wider governmental objectives. As a result, the OFT is able to focus on the maximisation of consumer welfare through the stimulation of competition and the minimisation of potential chilling effects.

IV. INTERNATIONAL COOPERATION AND STANDARDS

100. With globalisation, competition enforcement in an international context is increasingly important. Many businesses with a presence in the UK also operate in other jurisdictions and their conduct may well be affected by the competition regimes in those jurisdictions. The likelihood of this happening is, if anything, increasing. One aspect of globalisation has been the proliferation of competition law regimes internationally, as can be seen from the fact that the International Competition Network, which was launched in 2001 with 14 Member countries, now has 91 Member countries.⁵⁸ Most competition law regimes will have rules dealing with cartels, mergers and unilateral conduct. The consequences of this for international businesses, particularly in terms of the cost of compliance with, and/or sanctions for breach of, these different rules may well be significant and have serious implications for how those businesses compete.

International differences in chilling risks and competition enforcement

101. To avoid chilling effects on the incentives of businesses to engage in potentially pro-competitive behaviour, competition authorities, as discussed above, should be aware of and mitigate the risk of Type I and Type II errors, both in terms of setting their competition rules (potential *ex ante* errors) and enforcing those rules (potential *ex post* errors).

102. The balance between Type I and Type II errors will depend on the conditions in domestic markets. In particular, where there is a history of state ownership of enterprises, protected monopolies, concentrated markets or closed economies, the risks (and potentially significant consequences) of Type II errors are high. There is a lower likelihood that self-correcting market forces will, absent intervention, erode market power. In such countries, even when markets are subject to liberalisation and/or privatisation, they are often still characterised by the presence of high entry barriers and incumbent operators with

⁵⁸ See speech given by Sheridan Scott, Chair of ICN Steering Group to the Federation of the Industries of São Paulo State, Brazil, 12 May 2008.

significant market power. A lack of incentives and/or ability for potential competitors to enter the market often results in the erstwhile monopoly operators being able to consolidate their control of critical markets and further reduce the possibility for the markets to self correct in the short to medium term. This can result in markets characterised by 'uncontested firms in incontestable markets'.⁵⁹ In such situations, with limited possibilities for market forces to address the potentially negative economic effects of conduct by operators with market power, the consequences of under-intervention can be severe and long-lasting. Competition authorities, when faced with these types of market situations, would therefore be justified in applying a more interventionist approach to competition policy to avoid Type II errors.

103. Put another way, it can be argued with some force that differing economic conditions may require different levels of intervention and thus different *ex post* enforcement of the competition rules. Conversely, factors such as active engaged consumers, dynamic business, government policy that supports enterprise, and efficient capital markets would make it likely that, absent intervention, market power would be eroded more quickly.

104. This does not mean however that the *ex ante* rules should be significantly different as between jurisdictions. The benefits of a consumer-welfare focussed competition policy are clear and, in the authors' view, overwhelming. Despite this, differences still exist between authorities in relation to the objectives of competition policy, as highlighted by the recent ICN report on unilateral conduct. Many jurisdictions surveyed by the ICN have, in addition to the consumer welfare objective, other competition policy objectives, such as promoting market integration, assisting SMEs, ensuring fairness or protecting inefficient 'national champions. Taking into account these wider considerations can result in Type I or Type II errors, which not

⁵⁹ See speech given by David Lewis, Chairperson of the Competition Tribunal of South Africa on Competition and Development, given at the 6th Annual ICN Conference, Moscow, 2007.

only reduces consumer welfare but also harms business and the wider economy more generally.⁶⁰

Impact of different intervention policies on multinational businesses

105. For businesses that operate internationally, different levels and standards of intervention in different jurisdictions are most likely to be experienced in the areas of mergers and unilateral conduct.⁶¹ Thus, for multinational businesses, the direct costs and effects on incentives that enforcement has in relation to these areas can be significantly different across jurisdictions.

Mergers

106. In terms of mergers, businesses engaging in international mergers and acquisitions can face both jurisdictional and substantive differences between jurisdictions. As a result, they may incur significant additional costs.

107. In terms of jurisdictional matters, some competition authorities operate compulsory notification regimes with low thresholds for intervention, which means that businesses may face disproportionate costs in dealing with those authorities even if the merger is unlikely to raise competition concerns in the market in question.⁶² This problem is largely avoided as regards the UK because the UK merger regime is voluntary and thus does not mandate notification. Generally, however, the possibility of divergent mandatory notification thresholds can cause significant problems for businesses and much work has been done internationally to attempt to address this issue. In 2008, the ICN working group on mergers published a paper on setting notification thresholds for merger

⁶⁰ For a more detailed discussion, see Fingleton, *Competing interests*, Global Agenda (2005) at 164.

⁶¹ As discussed in section I, for cartels (particularly hardcore cartels), there is increasing recognition worldwide of the need for rigorous enforcement, due to the harmful economic effects of cartel behaviour. Businesses therefore face relatively consistent enforcement messages across jurisdictions.

⁶² Equally, the authorities may find that their time and resources are diverted dealing with mergers that have little competitive impact in their jurisdiction.

review, which highlights the need for notification to be required only for transactions with a material nexus to the reviewing jurisdiction and for thresholds to be set by reference to objective criteria (such as sales or asset values) in order to reduce the risk of inappropriate merger reviews.

108. In terms of substantive merger review, the costs to businesses of multi-jurisdictional reviews can be reduced through greater consensus on the economics behind merger reviews and the standards to which mergers will be held. For example, the similarities between the significant/substantial lessening of competition standards in the UK and the US and the significant impediment to effective competition standard at EC level means that businesses whose mergers are reviewed in these jurisdictions can formulate their arguments for each in a consistent manner. To the extent that other jurisdictions converge along similar economically sound standards, the costs of international mergers for businesses will be reduced. Again, the OECD and ICN have made significant progress in this regard.

Unilateral conduct

109. The likelihood of different standards of intervention by competition authorities is most high in the area of unilateral conduct, where there may be divergence both between the law and economic theory and between the approaches of competition law regimes in various jurisdictions. Businesses can therefore face potentially significant consequences in terms of chilling effects, diseconomies of scale and scope, and compliance burdens. For businesses operating internationally, and particularly those with a uniform product or service offering, this can have a highly negative effect on their ability to organise operations across borders and to engage in pro-competitive behaviour in different markets.

110. In particular, there is a significant risk that competition authorities may set different *ex ante* rules, taking into account objectives other than consumer-welfare which they consider desirable from the perspective of their national economic development (different *ex ante* rules). An

example might be an abuse of dominance law that simply seeks to protect small firms from large ones. Equally, even where competition authorities in different jurisdictions seek to apply a broadly consumer-welfare based economic approach to competition rules (and therefore apply the correct *ex ante* rule), there may be different views of the need for intervention (different *ex post* application of the rules).

111. Where local markets are insufficiently dynamic, the agency may reasonably want to intervene because markets are less likely to self-correct. If that is the prevalent domestic market situation then, faced with limited enforcement resources, it could be efficient to set presumptions, including market share thresholds, that make it easier for the agency to bring cases. This could be an efficient way of stimulating greater competition in the domestic economy on a faster timescale. It is interesting to note in this regard, that historic transatlantic differences in unilateral conduct enforcement may, at least in part, be explained by the fact that many policymakers in Europe believed that markets in the EU were less integrated and flexible than the US and, as such, less likely to self-correct. In addition, many of the most powerful firms that operate in the EU were previously state-owned monopolies; as such they did not gain the market position they enjoyed through superior performance and efficiencies. Indeed, economies with a history of state-ownership may be less likely to have the market-oriented conditions necessary to drive self-correction, as compared to economies where firms have a history of vigorous competition on efficiency.⁶³

112. For multinational businesses, this may lead to a need to adjust behaviour to the 'highest common denominator' of permitted conduct and thus forego potentially efficiency-enhancing conduct that would be permitted in some jurisdictions but not in others. As Campbell and

⁶³ It is also important to note, in considering differences between the US and other jurisdictions, that private 'treble damages' actions are an important feature of US anti-trust law. The potentially punitive nature of treble damages, coupled with the fact that anti-trust cases are heard by (non-specialist) juries means that the risks of over-deterrence and 'chilling' effects are substantial. As a result, the US courts have in recent years tended to establish robust limitations on anti-trust liability and constrain private actions, so that unilateral conduct actions are brought only where significant harm is demonstrably likely to occur as a result of the conduct. We have perhaps yet to see the European Courts act to limit liability in this way, at least in relation to unilateral conduct.

Rowley point out, 'the highest common denominator is not necessarily desirable, nor is the lowest common denominator necessarily undesirable. Unless the jurisdiction with the most demanding requirement has a law that closely approximates a sound economic standard, the result will be less than optimal.'⁶⁴

Reducing the impact of international divergence on competition policy

113. To the extent possible, the solution to divergence between competition authorities is to encourage convergence towards sound economic principles as the standard for review of conduct (whether unilateral or otherwise). Providing consistent and reasonable economically-based standards for businesses that operate in the international context would be a significant way to reduce both the costs associated with doing business in multiple jurisdictions and the risks of pro-competitive behaviour being deterred. In particular, an effects-based approach under the consumer welfare standard would increase legal certainty because it makes it more likely that similar outcomes will prevail, even across differing legal systems.
114. However, as noted above, even with significant convergence as regards the *ex ante* rules for competition policy, the extent to which *ex post* enforcement can converge will depend to a large degree on the domestic economic conditions prevailing in various jurisdictions.
115. The need for varying levels of intervention in the *ex post* enforcement of the competition rules may be addressed, at least to some degree, through mechanisms such as the use of soft presumptions and safe harbours as well as shifting the burden and altering the standard of proof. For example, in open and vibrant economies where markets are likely to self-correct, the burden of proving likely harm rests correctly with the enforcing authority. It may be appropriate in less open economies, where it is far less likely that the market will avoid potential harm through self-correction, for the burden of proving the non-

⁶⁴ Neil Campbell and William Rowley QC, *Climbing the competition policy Everest: the evolution of unilateral conduct*, Global Competition Review (2006), Nov, 31-34.

likelihood of harm to rest with the allegedly infringing companies. Equally, safe harbours for conduct, which depend on the health and vigour of the economy as whole, may well be appropriately modulated (for example, higher thresholds may be appropriate in more open and competitive markets). While this solution is not optimal, in that it may still result in potentially significant differences in the *ex post* application of the competition rules across jurisdictions (and thus still result in increased costs for international business), it nonetheless ensures that jurisdictions adopt the correct *ex ante* rules and an economically sound approach to their enforcement based on relatively uncontroversial assumptions as to likely harm under different economic conditions.

116. An additional, and important, element in addressing international differences (both *ex ante* and *ex post*) is privatisation. In many jurisdictions, state-created monopolies are present in various key industries or are only now in the process of being privatised.⁶⁵ In some jurisdictions, state-created monopolies that participate in commercial activities are subject to competition law in the same way as private companies. In others, however, state action defences protect state-created monopolies from the rigours of competition law.⁶⁶ This reduces the possibilities for pro-competitive competition enforcement to take place across all sectors of the economy. Reducing the number of state-created monopolies active in industries or bringing them within the sphere of the competition rules would be an important step forward. Indeed, many jurisdictions recognise that privatisation is necessary to improve competition and consumer choice. The ICN working group on unilateral conduct has published recommendations to this effect.⁶⁷

117. Finally, to address properly the impact of the competition rules on multinational business and on the international economy, competition

⁶⁵ Aside from historical reasons, there may be strategic or public-policy reasons why countries prefer to have state-created monopolies in certain sectors. Some industries that possess state-created monopolies include commodity sectors (Australia, Canada, Turkey), social and insurance sectors (Germany), and defence and high technology sectors (Russia).

⁶⁶ Report of the ICN Unilateral Conduct Working Group on the Objectives of Unilateral Conduct Laws, Assessment of Dominance/Substantial Market Power, and State-Created Monopolies, May 2007.

⁶⁷ ICN unilateral conduct working group, State-Created Monopolies analysis pursuant to unilateral conduct laws: Recommended Practices (2008).

authorities could be encouraged to take a more 'comity-based' approach to the question of consumer welfare. Adopting a purely national approach can cause problems in today's increasingly global economy. For example, an export cartel may not directly damage its host country but its activities will have a clear negative impact on consumer welfare in foreign jurisdictions. An approach based purely on the national interest could favour no action by the authority of the host jurisdiction. However this could trigger intervention by foreign authorities, which could not only be inefficient and costly from an enforcement perspective but could also have wider political repercussions. A 'comity-based' approach would allow the more efficient, and arguably fairer, outcome of action on the part of the authority where the cartel is located. Similar concerns may be of particular importance in relation to issues such as IP enforcement in the coming years. While such a 'comity-based' approach is certainly something that can only be encouraged (rather than mandated), continuing engagement in international competition fora may well offer the way forward in this respect.

118. Indeed, knowledge-sharing bodies such as the ICN, the OECD and the ECN are the best way to further international competition policy development. In particular, they are key to ensuring convergence towards an economically sound, effects-based approach to competition policy that promotes consumer welfare. The OFT is heavily involved in these bodies and participates regularly in, and often leads, discussions on competition law issues. Through its participation, the OFT can disseminate the lessons it has learned from its competition policy activities and can learn from the experiences of other competition authorities. This type of engagement is vital for meeting the challenge to develop competition policy internationally on an economically sound, consumer-welfare basis while recognising the impact that domestic economic conditions will necessarily have on competition policy objectives and enforcement.