Economics at DG Competition, 2008–2009

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Abstract This paper discusses a selection of cases and important policy developments in the enforcement activities of the Directorate General for Competition at the European Commission during the past year (2008–2009).

Keywords Antitrust · Merger control · State aid · Exclusionary conduct · Unilateral effects · Coordinated effects

1 Introduction

This report on EU competition enforcement provides a snapshot of some of the economic analyses undertaken within DGCOMP, both in important cases and in policy development during the past year. In the discussion that follows, we emphasize some of the more interesting and challenging economic issues that arose.

In merger enforcement much economic and empirical analysis has been done to inform decisions regarding “plain vanilla” horizontal mergers—in contrast to last year, when we were more engaged with a number of important vertical mergers. The first case we discuss required extensive analysis of scanner data to assess the potential unilateral effects of a merger leading, in some markets, to possibly virtual monopoly. The second case is the first time in nearly a decade where the Commission has intervened solely on the basis of coordinated effects.

The views expressed in this article are solely those of the authors and do not necessarily reflect those of the European Commission.

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In the next section we discuss a major milestone in the enforcement of “abuse of dominance” in the EU: the adoption in December 2008 of the dryly but accurately called “Guidance Paper on Commission enforcement priorities in applying Article 82 to exclusionary conduct by dominant firms”. Next, we discuss the work done in the interchange fee case involving MasterCard, and then the results of a sector inquiry into the pharmaceutical sector, with special attention to competition from generic drugs. We conclude with an account of DGCOMP’s application of State Aid rules in the context of the recent financial and banking crisis.

2 Mergers

2.1 Campina/Friesland: Estimating Demand to Assess Unilateral Effects

Campina and Friesland Foods were two independent dairy cooperatives at the time of notification. Their activities overlapped in several markets along the dairy food product chain, from the procurement and processing of fresh milk to the production of a variety of dairy and non-dairy products. Both companies were predominantly based in the Netherlands, from where they had expanded internationally. The merged entity would become one of the top three dairy companies in the world. Inevitably, in the Netherlands, the merger would lead to important horizontal overlaps in a number of markets: notably, the procurement of raw milk, fresh basic dairy products (such as fresh milk and yoghurt), and fresh and long-life flavoured dairy drinks, as well as cheese.

2.1.1 Issues in Geographic Market Definition

The case raised an unusually large number of difficult issues, where economic reasoning and economic evidence proved decisive. For example, consider geographic market definition. It was initially far from clear whether the presence of large retailer chains implied that the wholesale market might extend beyond the Netherlands, even if the retail (or end-consumer) market were regarded national in scope. On the other hand, the parties argued that the procurement market would be narrower than national, given the location of the dairy plants, the dispersion of farmers, and other factors that affect transaction costs. In the end, in most cases, markets at all three levels of the supply

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1 Campina in 2007 had 6,885 member-farmers and activities in fresh dairy products, cheese, butter, fresh and long-life flavoured drinks, and emulsions in various countries in Europe, North and South America, and Asia. Friesland Foods counted 9,417 members (2007) with sales of consumer dairy products in Europe, the Middle East, Asia, and Africa as well as sales of dairy ingredients for professional and industrial customers worldwide.

2 Some retailers, notably heavy discounters, that operate under a centralized EU-wide procurement strategy.

3 The merging parties advanced the argument that pre-merger the market for the procurement of raw milk was narrower than national and, in particular, that the boundaries of such markets coincided with the “working area” where each party’s members were concentrated, in such a way that there was arguably no horizontal overlap. However, the parties also argued that post-merger the market would be national, and may be even broader than national, as competitors could then, allegedly, source from Germany and even as far as Denmark. This suspiciously self-serving line of argument was, however, rejected on the grounds,
chain were considered to be national in scope. In large part, this was because of strong evidence indicating that Dutch consumers (and consequently derived demand by retailers) have a very strong preference for Dutch dairy products (customarily packed in 1-l “gable tops” and catering to the taste of consumers as well as to the logistics infrastructure in Holland). Admittedly, this was a surprise to some non-Dutch members of the case team but not to our respondents to the market investigation. They pointed out that the merging parties, both independently and under the umbrella of the Dutch Dairy Organisation, have incurred substantial expenditures over the last decades to promote Dutch dairy products. The success of this strategy is evident from the fact that the merging parties explicitly labelled a large majority of their dairy products as coming from Dutch cows.

2.1.2 Issues in Product Market Definition

The case also raised difficult questions regarding the significance of supply-side substitutability in product market delineation. By definition, raw milk is the primary ingredient in all dairy products, and dairy companies can switch production (or “valorise the milk” in the industry jargon) from one dairy product to another with relative ease. For example, it is hard to think of significant barriers to switching from producing a “young” cheese to producing a relatively more mature cheese.

This case illustrates that the necessary conditions in the Commission’s notice on market definition for a market to be expanded on the grounds of supply-side substitutability are stricter in practice than is generally believed. Indeed, supply-side substitution first requires (i) entry at short notice, (ii) at low cost, and (iii) without incurring irreversible investments—circumstances that hardly apply in most cases, particularly when it is recognized that these conditions apply not only to production but also to distribution and marketing. Moreover, market aggregation—a broadening of market boundaries to include a larger group of products or geographical area—only makes sense when supply-side substitution is found to be technologically feasible and economically viable for most, if not all, firms that sell one or more of the products in question (the so-called “near universality” criterion). Whereas one competitor may be able to shift swiftly from producing and distributing (say) “young cheese” to “mature cheese”, only if all (or nearly all) competitors can do the same would it be possible to include both types of cheese in the same market. However, nothing of substance is lost since the competitive pressure potentially exerted by such rivals will generally be taken into account in the assessment of merger-induced entry.

Footnote 3 continued

inter alia, that much smaller Dutch competitors efficiently procure throughout the Netherlands and very little raw milk is in fact procured from independent farmers abroad.

4 “Notice on the definition of the relevant market for the purposes of Community competition law” (OJ C372, 9.12.97, p. 5).
2.1.3 Issues in the Assessment of Unilateral Effects

All affected markets in this case involved a differentiated retail segment, with all of the usual complications for the competitive assessment. Moreover, each market was unique and raised different analytical and evidentiary challenges.

Take the cheese market, for example: Holland is a net exporter of cheese, to a level hardly matched by any country in the world. The market for certain kinds of Dutch cheese was arguably national. However, in the event of a price increase, one needed to consider the possibility for Dutch cheese suppliers to redirect to the Netherlands cheese that was originally intended for export. On the other hand, the market conditions for fresh basic dairy products were the opposite. Whereas, consumers had also a strong preference for Dutch milk, this had to be fresh, as opposed to long-life. The strength of this preference is remarkable: In the Netherlands fresh basic dairy products represent more than 80% of total basic dairy consumption (i.e., the remaining 20% is long life) compared to less than 5% in neighbouring Belgium and around 30% in Germany. Consequently, fresh milk would not be exported or imported; it generally will be produced and consumed within the Netherlands.

Another, unusually extreme feature of the fresh basic dairy market was the high level of market penetration of private labels (up to 60% in some instances). It is generally argued that private labels increase the bargaining position of large retailers, not least because they reduce switching costs. Hence, one may be tempted to believe that with the four largest retailers in Netherlands accounting for over 80% of purchases, buyer power could offset to a significant extent the unilateral effects arising from even a merger to monopoly. The difficulty, however, is that the merging parties were the primary suppliers of both branded as well as private label dairy drinks, with overall combined market shares between 70 and 80% in fresh milk and even higher in other fresh basic dairy products. In those circumstances, the supplier of a branded good, supplying also a competing private label, would seek to maximize the combined profits and thus set wholesale prices and decide how much to differentiate the brand, taking the pattern of derived demand into account. Indeed, the wholesale supplier may have an incentive to increase brand differentiation so as to ease competitive pressure on the private label and thus allow the supplier to increase prices and margins, and thus enhance its bargaining position vis-à-vis retailers. Indeed, a thorough descriptive analysis of prices showed that not only are private labels often differentiated but also high-end private labels could be—in some instances—consistently more expensive than branded alternatives.

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5 Some market players indicated that competitive harm may result from the emergence of a quasi-monopsony vis-à-vis dairy farmers. This theory of harm was quickly dismissed. Monopsony power can be a genuine and independent source of concern when the resulting allocative inefficiency leads to harm to consumers in the downstream market. However, Friesland and Campina were de facto, vertically integrated in the purchase of raw milk from member-farmers. Hence, there was neither the ability nor the incentive to exert monopsony power vis-à-vis small atomistic farmers.
2.1.4 Analysis of Price Elasticities and Demand Estimation

For the first time, we requested and made extensive use of scanner data on a subset of the affected markets. Even with high quality transaction data, there is a tradeoff between the flexibility of the econometric demand specification to reflect the characteristics of the observed data and the statistical precision of the elasticity estimates. A less flexible specification generally has fewer parameters to estimate and thus may lead to more precise elasticity estimates. On the other hand, being less flexible, the specification may fail to fit the data well, which could induce bias into the elasticity estimates. In other words, the specification may fail to capture important characteristics of the data.6

In this case, we chose a functional specification based on the Almost Ideal Demand System.7 This option—as well as others concerning (i) aggregation over time, packaging or types brands, (ii) the choice of estimator, and (iii) identification8—we justify and explain in detail in an accompanying annex to the decision. We estimated, and reported in the Statement of Objections, the “matrix” of demand elasticities for all major brands and private labels in various product categories, notably, fresh basic dairy (milk, yoghurt, buttermilk, and vla [custard]), fresh flavoured dairy drinks (FFDD), and long-life flavoured dairy drinks (LLFDD).9 Importantly, we used the same baseline specification for all markets.

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6 Moreover, “flexibility” is often expensive: The number of price elasticities (own and cross) that must be estimated is equal to the square of the number of products considered. Even with several years of data, it can become difficult to estimate with acceptable precision the demand elasticities for a large number of products. Also, there is no guarantee that cross elasticities have the “right” or expected signs. Consequently in interpreting and assessing the robustness of the results we paid special attention at the overall consistency of the elasticity matrix with the expectation that cross-price elasticities would be positive and own price elasticities negative.

7 The Almost Ideal Demand System (popularly termed the “AIDS” model), first proposed by Deaton and Muellbauer (1980), is advocated by many as a basis for empirical merger analysis and is well documented in the literature—for example, Hausman (1994) or Cotterill and Haller (1996). Importantly, it has been extensively used in empirical work. In the AIDS model, expenditure shares of each product are regressed on the logarithms of the prices of the different goods and the log of total expenditure (deflated by a price index).

8 We chose to do nothing under the reasonably credible assumption that prices are unlikely to be endogenous, but instead are set by retailers prior to consumers’ making their purchase decisions (at least on a weekly basis—and we had weekly data). In any event, we test the validity of the no-endogeneity in prices assumption using a Hausman test. This test compares the instrumental and non-instrumental variables estimates. In most cases the test did not find statistically significant differences. This implies that the non-instrumental variables estimates are unbiased and are preferred to the instrumental variables estimates, as the former are more efficient.

9 We also estimated elasticities at a higher level of aggregation, with a view to informing market definition: For example, we estimated the elasticity matrix across the four fresh basic dairy categories: fresh milk, fresh yoghurt, buttermilk and vla, to determine whether each category constitutes a distinct product market from a demand-side perspective or, on the contrary, whether they form part of a wider “fresh basic dairy” market. When assessing the boundaries of the market the interest is more on the own-price elasticity than the cross-price elasticities. It is quite possible to find that the cross-price elasticities for all possible substitutes are positive but very low. That does not necessarily mean that the relevant market is confined to the candidate product and the hypothetical monopolist has market power. On the contrary, the own-price elasticity could be quite high in this case, because many weak substitutes could jointly defeat any price increase of the candidate product. The own-price elasticity is more relevant for market definition purposes as it summarises information regarding all cross-price elasticities. Only if the own-price elasticity is low does the hypothetical monopolist have market power and can increase prices profitably.
The following patterns or “stylized facts” emerged from the elasticity structures: (i) Concerning fresh basic dairy—for example, fresh milk—high cross-price elasticities between the parties’ brands suggested they were each other’s closest competitors. A similar conclusion could be maintained regarding natural yoghurt and vla. (ii) For FFDD, again the parties’ products appeared to be each other’s closest competitors and the private label products exerted on them a less strong competitive constraint. (iii) As regards LLFDD, once more, the parties’ products are each other’s closest competitors, and private label alternatives exerted on them a lesser competitive constraint. In sum, our econometric analysis supported the argument that for all three categories of considered markets (fresh milk, FFDD, and LLFDD) the parties exerted on each other a stronger competitive constraint than did other competitors or private label suppliers.

However, it also appeared that consumers actually behave quite differently over time across the three markets. As pointed out by the parties in their response to the Statement of Objections, long-life dairy products can be hoarded, and it is possible—and in fact likely—that consumers would choose to buy significantly more when the price is discounted than they plan to consume on that particular week.10 Our simple econometric model was static. It implicitly assumed that every consumer that enters the store on a given week checks and compares the prices of all of the available choices and makes his decision to purchase to satisfy his needs for 1 week, and 1 week only.11 However, the data show that this is not how consumers behave in general in the Netherlands. A simple descriptive analysis of the price and sales data for LLFDD revealed that the market is highly cyclical, with prices at rather predictable intervals falling noticeably and sales for the promoted brand increasing dramatically (mostly due to the market expansion effect, rather than to business stealing). Unfortunately, it is complex to account for inventory behaviour in a dynamic econometric model of demand, and even more so in the limited time available in a merger investigation.12 Consequently, econometric results advanced as complementary evidence of unilateral effects in the Statement of Objections were dropped and were assigned no weight in the final decision.

Nevertheless, inventory behaviour is not likely in the case of fresh basic dairy (e.g., fresh milk) or FFDD. This is for two reasons: First, fresh dairy products are perishable and have expiry dates that are often shorter than 1 or 2 weeks. This makes it difficult to purchase large quantities to keep in stock. Second brands of fresh basic dairy products—in particular, fresh milk—do not experience any significant promotions, price or otherwise, comparable to those observed for LLFDD. However, a detailed descriptive analysis of the data also revealed that as regards fresh basic dairy products consumers may experience habit persistence.13 Fortunately, econometrically accounting for habit

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10 The parties pointed out that a sales surge in response to a promotion could be due not only to stocking behaviour but also as a result of (i) impulse purchases and (ii) the particular design of the promotion.

11 Subject to other considerations: in particular, what share of the budget to allocate to LLFDD.

12 Failure to account for inventory replenishment by customers is likely to produce underestimates of the true post-merger price effects (see, for example, Hosken et al. 2002; Hendel and Nevo 2006).

13 Habit persistence refers to the case where the consumer is accustomed to the purchase and consumption of a given brand and, eventually, his/her consumption pattern of the brand becomes less sensitive to changes in its price.
persistence is far less complex than accounting for inventory behaviour. We introduced habit persistence by allowing present decisions to be influenced by past decisions. Past decisions are observed in the data, in contrast with expectations concerning future hoarding.

Our dynamic specification accounted better for how consumers really make their purchasing decisions of fresh basic dairy products such as milk and yoghurt. A more realistic specification was also reflected in increased robustness as measured by a number of econometric tests. As regards FFDD, the results of the dynamic specification were in line with those of the static specification, thus allowing us to argue that for this category of products the merging parties were the closest substitutes. However, as regards fresh basic dairy products (including fresh milk) it could no longer be argued that the merging parties’ brands exerted on each other a stronger competitive constraint than private label suppliers. Instead, the degree of influence was similar.

In conclusion, econometric results were presented in the Statement of Objections with respect to the unilateral effects of the merger across a number of markets. Of these, only the analysis of FFDD survived further scrutiny. An improved specification led to more economically and statistically robust results as regards fresh flavoured dairy drinks, but for the purposes of assessing the likelihood of unilateral effects such results were in fact inconclusive. Finally, as regards LLDD the econometric model was deemed inadequate, and the results were thus considered irrelevant for the final decision.

Nonetheless on the basis of descriptive data analysis and other extensive qualitative evidence the Commission concluded that the merger would lead to unilateral effects in most fresh basic dairy markets (milk, buttermilk and yoghurt), branded non-health FFDD, and a number of LLFDD. Appropriate remedies were submitted, and the merger was conditionally cleared.

2.1.5 Final Outcome

The merger was ultimately approved subject to commitments. The merging parties offered to divest the entire fresh dairy business of Friesland Foods situated in Nijkerk (the Netherlands), covering largely fresh basic dairy products. Furthermore, among other brands they granted an exclusive, renewable 5-year licence to use the Friesche Vlag brand name in the Netherlands for the current Friesland Foods Fresh product portfolio, followed by a black-out period. Finally the divested Campina’s Dutch-type cheese production facility at Bleskensgraaf (the Netherlands) and offered to carve out a sales team and other employees for R&D, planning and logistics and general support from the sales organisation of the merged entity.

The Commission also concluded that the merger would in its initial form also have led to a significant impediment of effective competition in the market for procurement of conventional raw milk by bringing together the two main purchasers of raw milk in the Netherlands, given the market power that they would have on downstream markets. These competition concerns in the market for procurement of conventional raw milk had therefore to be solved through commitments in the downstream markets and had to include access to raw milk for the divested businesses on a lasting basis. In this respect, the merging parties offered transitional supply agreements for the buyers of
the divestment businesses in fresh dairy products and cheese. Also they committed to set up a “Milk Fund” and to provide incentives for farmers to leave the merged entity and join/form competing cooperatives.

2.2 ABF/GBI: Economic Analysis of Coordinated Effects

The ABF/GBI case was the first merger in almost a decade, since Airtours/First Choice, where the Commission intervened solely on the basis of coordinated effects. Importantly, economic reasoning and economic evidence played a key role in bringing this case, just as it directly influenced, if not shaped, the guidance on coordinated effects offered by the European Court of Justice (ECJ) in Sony/BMG v. Impala, a ruling that came less than two months before the ABF/GBI decision.

The case involves the acquisition of the yeast business of GBI in continental Europe by Associated British Foods (ABF). ABF is a diversified food company, and one of the two worldwide leaders in the yeast industry. GBI was one of the main European yeast producers, owned by Gilde, a Dutch private equity firm. Gilde, the seller, was disposing of its yeast operations worldwide.

After an in-depth investigation, the Commission identified competition concerns in the Spanish and Portuguese national markets for compressed yeast. The decision elaborates in detail the coordinated effects, which would likely emerge on these two markets, yet it cleared the transaction after having accepted appropriate remedies offered by the parties.

The products concerned are quite familiar: Yeast is an essential ingredient in the production of bread and other bakery products, enabling the dough to expand. While three separate product markets for yeast (dry, liquid, and compressed yeast) were identified, the focus of the investigation was on compressed yeast. This compressed yeast is perishable with a 3–4 week lifetime when refrigerated, and it is used in Spain and Portugal primarily by artisan bakers. The in-depth investigation supported the conclusion that the markets for compressed yeast were national in scope for the countries analysed.

The basic market structure was as follows: In Spain, ABF held pre-merger market share of about 30–40% in the compressed yeast market, while GBI had 10–20%, and the remaining large seller Lesaffre held 40–50%. In Portugal, GBI was the traditional leader with 40–50%, ABF had 20–30%, and Lesaffre had 20–30%. Fringe players existed in both markets, but their presence was quite limited.

2.2.1 The Economics of Tacit Collusion

The goal of merger control is to prevent the accumulation of excessive market power, which would give firms the discretion to raise prices above the competitive level with

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14 Case C-413/06 P Bertelsmann and Sony Corporation of America v. Impala [2008], OJ C 223 of 30.08.2008.

15 Gilde also divested the remaining part of GBI to the other leading yeast producer—the French company Lesaffre. This other transaction was notified under M.5020 Lesaffre/GBI UK and cleared subject to commitments after a first-phase investigation.
a negative impact on consumer welfare in the absence of any relevant efficiencies. Economic theory shows that mergers may reduce consumer welfare by facilitating collusion (coordinated behaviour) in oligopolistic markets, as sellers may reach a tacit (or explicit) understanding of how to coordinate their actions so as to eliminate or reduce the competitive pressure that they exert on each other.

Collusive arrangements, however, may be difficult to enforce, given that explicit cartelisation by means of legally enforceable contracts is prohibited. In addition, the participating firms face a dilemma between adherence to the terms of coordination, thus collectively maximising profits, and deviation, which entails reaping high individual short-term profits at the expense of the other sellers but obtaining less profits in future periods as a result of targeted punishment by other firms or simply the breakdown of the coordination. A voluminous literature on the necessary and sufficient conditions for rational collusive firm behaviour has developed in industrial economics. The more that the post-merger situation presents these characteristics, the higher is the likelihood of a post-merger equilibrium where the companies will engage in tacit collusion. However, the focus should not be on the feasibility of tacit collusion, but rather on the merger-specific effects on the potential for tacit collusion to arise.

In earlier years, the Commission dealt with the potential collusive effects of mergers in narrow oligopolies, drawing on the notion of a dominant position “by one or more undertakings” (see, for example, Nestlé/Perrier (1992), Kali+Salz/MDK/Treuhand (1993) or Gencor/Lonrho (1996). A substantial evolution in the assessment of tacit collusion took place when, in a landmark judgment in 2002, the Court of First Instance (CFI) in Airtours v. Commission annulled for the first time a prohibition decision under the European Community Merger Regulation (ECMR). In 1999 the Commission had prohibited the merger of two UK suppliers of foreign package holidays, because it expected the creation of a collective dominant position. On this occasion, the CFI clarified the standard for finding collective dominance by rejecting a routine application of a “checklist” approach (analyzing the market characteristics conducive to coordination) but setting out three cumulative conditions, reflecting a more dynamic approach and looking at the sustainability mechanism of tacit collusion: First, the market must be transparent enough to allow for the monitoring of other firms’ market conduct. Second, coordination must be sustainable, which means that the participants must be deterred from defection by fear of retaliation. Third, the benefits of coordination must not be jeopardised by the actions of current or future competitors or customers. The CFI also made clear that these conditions require a “prospective analysis” of the specific circumstances.

The Airtours judgment influenced the adoption of the Horizontal Merger Guidelines, in which the Commission opted for a more economic approach. The Guidelines indicate that to assess the likelihood of coordinated effects it is first necessary to identify a plausible mechanism for coordination. The mechanical application of the check

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16 Four cumulative elements are considered necessary for coordination to emerge and be sustainable: the ability to reach an understanding on the terms of coordination, the ability to monitor deviations, the existence of deterrent mechanisms, and the absence of the ability or incentive for outsiders to destabilise the coordination.
list was thus put aside, and the facilitating factors would thus have to be discussed in
the context of a particular mechanism of coordination based on the above-noted four
building blocks. That paved the way for the most important first steps from collective
dominance toward the concept of coordinated effects.

2.2.2 Implications of the ECJ’s Impala Judgment: Coordinated Effects as a Matter
of Degree

When the CFI in Impala v. Commission annulled the European Commission’s
Sony/BMG Decision, this was a remarkable and somewhat surprising development
for many observers. The core of the judgment is the detailed review of the Commis-
sion’s assessment of the strengthening of an existing collective dominant position by
the major record companies. On 10 July 2008, the CFI judgment was overturned by
the ECJ. In the context of this judgment the ECJ fully endorsed the economic model
of tacit coordination, elaborating on its most important aspects.

The Impala decision of the ECJ, in particular, highlights several elements that the
Commission should examine in detail and analyze consistently. The ECJ recognizes
that by its very nature and in contrast to cartel agreements, tacit coordination can rarely
be proved by relying on hard evidence. Price-fixing or market sharing agreements in
violation of Article 81 EC Treaty can generally be proved by way of hard evidence
(generally, written documents). In contrast, tacit coordination, “is likely to emerge
if competitors can easily arrive at a common perception as to how the coordination
should work”.17 Tacit coordination can thus only be inferred indirectly from observing
and adequately interpreting the actual conduct of market players in light of existing
market conditions, which affect their ability and incentives tacitly to coordinate their
actions.

Reaching an agreement, however, is not sufficient. The agreement should be sustain-
able over time: “having regard to the temptation which may exist for each participant
in a tacit coordination to depart from it in order to increase its short-term profit, it
is necessary to determine whether such coordination is sustainable”.18 The ECJ also
refers to the need for identification of a sufficient degree of sustainability. Monitoring
to a sufficient degree, a credible deterrence mechanism, and a limited reaction by out-
siders are the elements that the ECJ points to: “the coordinating undertakings must be
able to monitor to a sufficient degree whether the terms of the coordination are being
adhered to ... Furthermore, discipline requires that there be some form of credible
deterrent mechanism that can come into play if deviation is detected. ... the reactions
of outsiders, such as current or future competitors, and also, the reactions of customers,
should not be such as to jeopardize the results expected from the coordination”.

Indeed, the ECJ also requires the Commission to link these aspects to the effects
that the merger brings about. Thus, the Commission should further show, on the basis
of a prospective analysis, the extent to which “the alteration in the [relevant market]

17 Paragraph 123 of the judgment in Case C-413/06 P Bertelsmann and Sony Corporation of America v
18 Paragraph 123 of the judgment in Case C-413/06 P Bertelsmann and Sony Corporation of America v
structure that the transaction would entail, significantly impedes effective competition by making coordination easier, more stable or more effective for the three firms concerned either by making the coordination more robust or by permitting firms to coordinate on even higher prices”.19

The ABF/GBI case is the first instance in which the change in the Merger Regulation and the very clear recent guidance from the ECJ on how to assess the coordinated effects are given full effect.

2.2.3 Facts of the Case and Assessment

We structured the assessment of the coordinated effects of the proposed merger into three parts:

In the first part of the analysis, a number of structural market conditions likely to facilitate the emergence and sustainability of tacit coordination are identified. These factors are common to both the Portuguese and the Spanish markets. Following the Court of Justice in Sony/BMG v. Impala, “it is necessary to avoid a mechanical approach involving the separate verification of each of those criteria taken in isolation, while taking no account of the overall economic mechanism of a hypothetical tacit coordination”.

In the second part, for each relevant market, an assessment was made of the extent to which market conditions facilitate a tacit understanding among Lesaffre, ABF, and GBI and possible terms of coordination, the monitoring of deviations, deterrence of deviations, and the reasons why outsiders have no ability to undermine the resulting degree of tacit coordination.

Finally, on the basis of a prospective analysis, we show the extent to which the “the alteration in the [relevant market] structure that the transaction would entail significantly impedes effective competition by making coordination easier, more stable or more effective for the three firms concerned either by making the coordination more robust or by permitting firms to coordinate on even higher prices”.20

2.2.4 Market Conditions Conducive or Facilitating Coordinated Behaviour

The Spanish and Portuguese compressed yeast markets share a number of features typically considered in the economic literature as facilitating coordinated behaviour. There was a small number of active competitors (essentially three being reduced to two post-merger), with a high frequency of repeated interaction of these competitors with no large and bulky orders (predominantly weekly or bi-weekly orders of relatively small amounts of yeast via distributors to artisan bakers). The yeast market is relatively stable or slightly declining and shows a low likelihood of leap-frog innovation. Several qualitative indicators suggest that demand elasticity is comparatively low and that the product is relatively homogenous (a few brands of yeast in standard packaging for each competitor). There is a high degree of market transparency in

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competitors’ prices, volumes, and capacities. The markets in question are protected from outside reactions or the expansion of fringe competitors\(^{21}\) by high barriers to entry and expansion. Customers have very limited countervailing buyer power, being typically smaller local distributors of bakery products for artisan bakers. In addition, extensive multi-market contacts among the companies involved, that meet in a number of neighbouring product and geographic markets, exacerbate the problem.

2.2.5 Assessing the Coordination Mechanism

We then investigated alternative hypotheses on how coordination would actually work in practice. We used a range of investigative techniques, all of which contributed in important ways to offer a complete understanding of the ability and the incentive of market players to collude and how the merger would influence them. We interviewed potential competitors and rivals in other geographic markets seeking to learn “how the market works” and, guided by the criteria in the merger guidelines, how coordination could be achieved and sustained. We also contacted other competition authorities that had uncovered or suspected a cartel in yeast markets in their jurisdiction. We made a number of field visits, and we also held extensive interviews with distributors and with customers, large and small. in addition, we attended a major trade fair, which offered extensive opportunities not only to have direct contact with the product under analysis, but also to experience first hand how firms actually compete in practice, how they differentiate, how much effort (if any) they put in attracting rivals’ customers, and more generally how they form beliefs and what these are with respect to competitor conduct. The amounts of “soft” information that sales representatives or procurement managers are willing to share with anybody that comes along, even a competition official, during a quiet day at a trade fair are quite remarkable.

When investigating coordinated effects it is also critical to communicate effectively and widely that the merger is under investigation to facilitate interested parties, large and small, to come forward with evidence. Also, flexibility and an open mind with regard to previously held hypotheses are important. It is often necessary to guide the interviewee\(^{22}\) towards key issues, such as a possible “meeting of the minds”, detection of deviations, retaliation, etc. However, it is critical that we allow the respondent to tell “his story”, even if, at first, and in the absence of more evidence, it is difficult to see how it relates (and may even contradict) the prevailing view as to the likelihood of coordination.

In addition to such qualitative evidence we obtained data from the merging parties, as well as from Lesaffre, on average prices (net of discounts) and costs, and information on sales flows from each plant’s customers accounting for up to 80% of the market. It cannot be over-emphasised how decisive an in-depth analysis of market data often turns out to be, both to dismiss plausible but incorrect theories regarding how coordination could work and to make sense of the qualitative evidence obtained from

\(^{21}\) Fringe competitors have no local distribution networks which tend to be very traditional and hard to establish, are relatively far away from the region and have little spare capacity and very limited incentives to enter/expand in Spain and Portugal.

\(^{22}\) (the most useful evidence usually comes from oral interviews when assessing coordinated effects).
interviews. Furthermore, facts referred to by respondents should always be checked against market data. Conversely, looking only at data on market outcomes can help guide the search for evidence on the coordination mechanism but often does not help in identifying whether coordination has taken place, let alone if it likely will; or if it has, whether it would be strengthened.

Finally, evidence regarding how rivals form views about the terms of any mutually beneficial coordination can be obtained by reviewing their internal documents. Our interest is to understand how decisions have been made and which criteria were decisive at any given time. Whereas hard evidence of illegal collusion can potentially be destroyed, it is virtually impossible to eliminate all traces of how past decisions were made, even in the most centralised of organisations. Employees in any large firms are essentially agents of the firm’s shareholders, and both the agent and the principal have an interest in documenting how decisions were taken in the past. Indeed, in this case, a number of interviews and internal documents uncovered a great deal of market transparency and showed how competitors would be able to arrive at a common perception of each others’ behaviour. For example, some documents showed how price increases of competitors were often correctly anticipated.

Ultimately, all of the evidence gathered, quantitative and qualitative, when put together suggested that price—and more precisely price increases applied more or less simultaneously—was found to be the core focal point of the likely (tacit) collusion between the Lesaffre and the merging parties. This would also be in line with some past cases of alleged cartel behaviour in the yeast industry in other countries. Holding a significant excess capacity, all three main players would likely be in a position to react in timely fashion to punish deviations from the collusive behaviour. As it turned out, however, distributors, often ignored as a neutral layer in the supply chain, played an important and decisive role in ensuring the sustainability of any coordination in the market.

In both Portugal and Spain the compressed yeast market is essentially made up of artisan bakers; most of the final customers of the compressed yeast producers are small, traditional, family enterprises, and they are present in large numbers. These businesses are in some cases so small that it is not economic for them to own their own refrigeration systems to keep the compressed yeast in a usable condition for any significant period of time. Consequently, they have to be served on a nearly continuous basis by local/regional distributors that operate refrigerated transport facilities. These factors mean that over the years the producers that actively sell in Portugal and Spain have relied on a capillary network of distributors to make the rounds to serve these customers. One of the surprising aspects revealed by the investigation was the importance of the interpersonal relationship between the distributors and their customers, in certain cases extending beyond one generation. It was therefore very clear that distributors played a fundamental role in the market.

Yeast producers and distributors were very “loyal” to one another, as shown also by quantitative data on stable and durable relationships. This was complemented by the analysis of some written contracts (in Portugal in particular), many dating back many years or even decades. This stability is explained by the arrangements that are in place: Distributors proved to be in the vast majority of cases, either de facto or de jure, exclusive for one supplier and for a set “attributed” region. This makes the
whole distribution system a relatively simple one, with few changes possible since all of the relevant producers are already “locked-in” in all of the regions in both Portugal and Spain. Distributors also collected information for the suppliers on any switching and, through well established relationships with even the smallest of buyers, even on the prices offered and paid to competitors. As part of their commercial obligations with the suppliers or through carefully designed contractual incentives, distributors would regularly report this information back to the suppliers, thereby facilitating the monitoring of any deviation in prices or conditions.

2.2.6 The Coordinated Effects of the Merger

To bring a coordinated effects case it is not sufficient to identify a list of factors and market conditions that facilitate coordination or to assess the existence and sustainability of a plausible coordination mechanism in the light of such facilitating factors. It is also necessary to show further that the change in the relevant market structure that the transaction would entail would lead to a significant impediment of effective competition. While the investigation indicated that a certain degree of coordinated behaviour was already observable pre-merger in the markets concerned, we also concluded that the merger would make the coordination more effective and more stable.

Indeed, a three-to-two merger would significantly change the market interaction. For each of the remaining duopoly members, there would only be one competitor (tacitly) to agree on the terms of coordination. Transparency would be enhanced, as each firm would face only one competitor to be monitored, and hence discovering the deviator would be easier. Also punishing deviations would be more effective, as there would be no doubt as to who should be the one to take the retaliatory measures, and against whom. The fact of having only two players instead of three would also reduce the incentives to deviate, as there would be proportionally less to gain. Consequently, the merger would lead to “more stable” coordination.

The merger would also lead to “more effective” coordination. The investigation also showed that by removing GBI from the market, one would eliminate a potentially destabilizing factor in the collusive game. GBI showed a number of asymmetries in comparison to the two other suppliers, which the merger would remove. Contrary to ABF and Lesaffre, which had local production plants in the region, GBI was serving Spain and Portugal from its Italian facility, which was farther away. The different size of the Italian plant and its different location meant not only higher transport costs, but it may have caused GBI to react differently to, for example, unanticipated supply developments in Italy or demand changes in all other regions that it was serving. Also, by eliminating GBI, spare capacities would become extremely symmetric between the two remaining players, making coordination between them more sustainable. An aspect which weakened the retaliation potential against GBI (and hence increased GBI’s potential incentives to deviate) was that GBI was not present in some related product markets in Spain and Portugal (in particular liquid yeast), where retaliation could effectively occur. GBI would thus be immune from counter-attacks in that related market, whereas the two remaining players were also the only ones active there.

During Phase I of the proceedings, the notifying party already submitted commitments. It proposed to divest GBI’s current activities in relation to the sale and
distribution of yeast products in Spain and Portugal. However, the remedy proposal did not include a production plant, but a supply toll-manufacturing agreement to last for at least 3 years for the supply of yeast from GBI’s plant in Casteggio, Italy. Without a production plant, the potential suitable purchaser of the divested business would have to rely largely on supplies from Casteggio with the risk of production problems and interruptions which could weaken his position. It could thus not be expected that that such a new entrant would have the ability or incentive to destabilise the coordination between the merged entity and Lesaffre on a long term basis.

2.2.7 Final Outcome

To resolve fully the competition concerns ABF ultimately committed either to sell the current GBI distribution businesses in Spain and Portugal to a suitable purchaser who will possess dedicated production capacity in Felixstowe (UK) for supplying GBI businesses in Spain and Portugal or, as an alternative remedy, to sell the distribution businesses in Spain and Portugal together with GBI’s production facility in Setúbal. The second alternative was necessary as one condition of the first alternative remedy—the acquisition of the Felixstowe plant in parallel by the suitable purchaser—depended on a third party’s decision. Ultimately the second alternative was implemented within the deadline when Lallemand, a competitor with limited presence in Spain or Portugal, acquired the distribution business and the plant in Setubal.

3 Other Antitrust Issues

3.1 DG COMP’s Guidance Paper on the Application of Article 82 to Exclusionary Conduct

On December 3, 2008, the European Commission issued its guidance paper on enforcement priorities in applying Article 82 (the Guidance Paper). The Guidance Paper marks a departure from the past approach to enforcing Article 82, which had been often criticized as exceedingly formalistic. It outlines an effects-based approach for the application of Article 82 to exclusionary conduct by dominant firms. Such conduct aims to exclude actual competitors from expanding or would-be competitors from entering a market, thereby potentially depriving customers of more choice, more innovative goods or services, and/or lower prices.

The Guidance Paper sets out the Commission’s determination to prioritise those cases where the exclusionary conduct of a dominant undertaking is liable to have harmful effects on consumers. It starts by providing the general approach to assessing whether or not a company is in a dominant position. It then describes the general analytical framework that the Commission will apply to determine if the dominant firm has infringed Article 82. The first step is for the Commission to explain on the

23 An effects-based approach had already been formulated and implemented in the area of Article 81 since the late 1990s and mergers since the adoption of a revised merger regulation and horizontal merger guidelines in early 2004 and more recently non-horizontal merger guidelines.
basis of cogent and convincing evidence how the allegedly abusive conduct is likely
to restrict competition and thereby harm consumers. The second step is for the firm to
rebut this finding of a likely negative effect by showing that it likely creates efficiencies
that leave the consumers overall better off. If persuaded that such efficiencies meet the
conditions laid out in the Guidance Paper, the Commission shall consider the firm’s
conduct as legal under Article 82. The general framework is subsequently applied in
the Paper to the most common types of exclusionary conduct: exclusive dealing, tying
and bundling, predatory practices, and refusal to supply.

The Court of First Instance (CFI) has implicitly already endorsed an effects-based
approach under Article 81, and there is no reason why this would not extend to Article
82. In the recent O2/T-Mobile case\(^{24}\) the CFI partially annulled the Commission’s
finding of an infringement of Art. 81(1) on the basis that it “specifically failed to
analyse objectively the competition situation in the absence of the agreement”.\(^{25}\) This
logically imposes a requirement to delineate an appropriate counterfactual against
which to compare the competitive effects of the agreement or analogously a particular
practice. The Guidance Paper explicitly adopts this obligation to assess the effects of a
practice by comparing the actual or likely future situation in the relevant market (with
the dominant undertaking’s conduct in place) with an appropriate counterfactual.

Although the Guidance Paper is not a traditional interpretative notice/guideline on
the application of the competition rules, but is a commitment of the Commission to
adopt a certain course of action. In this sense it has a binding effect on the Commis-
sion. In particular, the adoption of the Guidance paper entails that a complaint should
be rejected where the conduct complained of is unlikely to result in anticompetitive
foreclosure—i.e., to have a harmful effect on consumers. Further, there is no priority
to pursue cases in which effects cannot be assessed. A theory of harm and a proper
validation is necessary for every practice.

3.1.1 Role of Dominance

It is important to recall the context in which the Article 82 review has taken place,
culminating in the Guidance Paper. A source of much confusion relates to the meaning
and role of dominance in Article 82 enforcement. The legal definition of dominance
has two elements:\(^{26}\) (i) the ability to behave independently to an appreciable extent

\(^{24}\) Judgment of the Court of First Instance in Case T-328/03 O2 (Germany) GmbH & Co. OHG v. Com-
mision of the European Communities.

\(^{25}\) The CFI then examined whether the counterfactual examination had been properly carried out: It con-
cluded: “… the Decision … suffers from insufficient analysis, first, in that it contains no objective discussion
of what the competition situation would have been in the absence of the agreement, which distorts the
assessment of the actual and potential effects of the agreement on competition and, second, in that it does
not demonstrate, in concrete terms, in the context of the relevant emerging market, that the provisions of
the agreement on roaming have restrictive effects on competition, but is confined, in this respect, to a petitio
principii and to broad and general statements”.

\(^{26}\) “The dominant position relates to a position of economic strength enjoyed by an undertaking, which
enables it to prevent effective competition being maintained on the relevant market by affording it the
power to behave to an appreciable extent independently of its competitors, its customers and ultimately of
the consumers” Case 27/76, United Brands v. Commission.
of other market participants and (ii) the ability to prevent effective competition from being maintained in the relevant market.

Taking this definition out of context has contributed to the misguided belief among some practitioners that “dominance” is a stigma and virtually illegal since practically any exclusionary action undertaken by a dominant firm would constitute an abuse. Briefly, the reasoning is as follows: First, the definition is purely a legal construct and has no meaning in economic terms. The concept of “acting independently” does not provide a basis for discriminating between dominant firms and non-dominant firms. No firm can set price independently of its customers or consumers: In general, increasing price causes a loss of revenue, either because consumers turn to rival firms or because they drop out of the market. Even a textbook monopolist faces a downward sloping demand curve. Second and more importantly, by definition a dominant firm is in a position that “enables it to prevent effective competition being maintained”. To some this equates “dominance” with “abuse”. A more refined argument is that this second element implies that some practices have the capability to foreclose, whereas others simply increase sales through an expansion of the market. Since the “capability to foreclose” is a feature or characteristic of the practice, this boils down to a form-based analysis, where the practice is assessed in abstract terms without regard for its actual effects in the market, let alone on consumer welfare. Having established that a firm is dominant, it has a special responsibility not to engage in any form of conduct that has such capability to foreclose, irrespective of its actual effects. 27

The Guidance Paper seeks to dispel the misconception, derived from the above line of reasoning, that there is no place for an effects-based analysis under Article 82. First, the notion of independence in the legal definition of dominance is related to the level of competitive constraints facing the firm. The independence requirement is not absolute; it is a question of degree. This means that its decisions should be fairly insensitive to actions and reactions of competitors, customers and, ultimately, consumers. A firm that faces a low demand elasticity and low rivals’ price and quantity elasticities can behave independently of competitors and consumers to an appreciable extent. This is reflected in its ability to maintain prices that are significantly above competitive levels over an extended period. Thus, dominance means that the firm in question is only

27 Many practitioners consider that this form-based approach was ultimately endorsed by the CFI in its Michelin decision, in particular in the following sentence: “For the purposes of establishing an infringement of Article 82 EC, it is sufficient to show that the abusive conduct of the undertaking in a dominant position tends to restrict competition or, in other words, that the conduct is capable of having that effect” (Michelin II, p. 239).

We do not share this view. Indeed, we offer the opposite interpretation: First, the Court does not refer to mere foreclosure but to the restriction of competition, indicating that it is not concerned with the foreclosure of particular competitors but rather the impact of the conduct on the competitive process. Second, the Court properly recognizes that the effects of a conduct are not static, but of a dynamic and continuous nature. Thus in some cases one should not wait until the conduct has already restricted competition, but one can intervene either if it is shown (i.e., demonstrated) (i) that it tends to restrict competition, or (ii) where the anticompetitive effects have not materialized yet, that it is capable (i.e., likely) of having that effect. If by conduct that “restricts competition” the Court means conduct that interferes with the competitive process to the detriment of consumers, then “restriction of competition” and “anticompetitive foreclosure” are essentially synonymous. Analogously, the substantive test in merger control considers a merger anticompetitive where it “significantly impedes effective competition”.

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to a limited extent constrained by effective competitive forces and therefore enjoys substantial and durable market power.

Second, it is not illegal to hold a dominant position. This implies there is a presumption that the source of the significant market power that the firm enjoys is not only legitimate but also likely to derive from the firm’s superior performance, evidently to the benefit of consumers. Hence a dominant firm is one that is able to “prevent effective competition being maintained” because it is able to offer a better quality, greater choice, and/or a lower price or is simply more successful at innovating than its rivals. There is thus no stigma in being dominant. The fact that a dominant firm legitimately is able to prevent effective competition does not imply that any action it takes with the capability to foreclose rivals will constitute an abuse. On the contrary, even an already dominant firm is free to compete fiercely and foreclose all its rivals provided that, in the end, consumers are not harmed. Only if the foreclosure of rivals eliminates a source of competitive pressure such that the dominant firm is able to raise prices or reduce quality and choice (hence, to the detriment of consumers) can its conduct be considered abusive. The whole point of the Guidance Paper is to explain how this might come about and what elements the Commission needs to bring forward to prove it. A finding that a firm is dominant in a relevant market, in itself, does not inform whether conduct that further increases market power in that or a related market is abusive or legitimate.  

However, dominance obviously plays a pivotal role in Article 82 enforcement: It is presumed that firms not holding a dominant position cannot possibly engage in conduct such that it would harm consumers and thus qualify as an infringement of Article 82. The dominance assessment functions as an initial screen to disregard market conduct that in all likelihood will never be harmful. Indeed, the Guidance Paper establishes a new “soft safe harbour” for companies with a market share below 40%. Above 40%, the Guidance Paper expresses an increased openness to accept that high market shares do not necessarily indicate dominance. Market shares provide a useful first indication of the overall market structure. But more important for the assessment of dominance are (i) constraints imposed by a credible threat of future expansion by actual competitors, or (ii) entry by potential competitors, as well as (iii) the bargaining strength of the firm’s customers.

Some commentators have argued the 40% threshold is too low, suggesting it should be at 50%. Others insist that the safe harbour should be a hard one; that is, there should be no exceptions to the rule, in order to generate the desired legal certainty. In response, it is worth stressing that market shares are highly sensitive to market definition generally. Moreover, in the context of Article 82 enforcement it is often difficult fully to account for the “cellophane fallacy.” Where it is not possible to correct the resulting bias towards broader markets, market shares may seriously underestimate

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28 It is for this reason that the Guidance Paper, contrary to what many commentators have argued, does not invoke the notion of “special responsibility” to restrict the type of actions that a dominant firm can take—by declaring them per-se illegal for a dominant firm. On the contrary, it clarifies that “depending on the specific circumstances of each case” the actions of a dominant firm may or not constitute an abuse.

29 Various alternatives have been proposed to address, if not resolve the cellophane fallacy. It is clear this is a difficult and controversial issue. This, however, is better addressed in the context of a future review of the EU Notice on Market Definition.
the level of market power enjoyed by the firm. In these circumstances a hard safe
harbour at 50% is not appropriate.

### 3.1.2 Consumer Harm as the Cornerstone of an Effects-Based Analysis

In line with modern antitrust thinking, the Guidance Paper sets out consumer welfare
as the principle on which the Commission should base enforcement policy with respect
to exclusionary abuses (para. 5). The Guidance Paper makes it clear that “the Com-
mision will focus on those types of conduct that are most harmful to consumers” and
that “this may well mean that competitors who deliver less to consumers in terms of
price, choice, quality and innovation will leave the market”. Effective competition on
the merits, and not simply competitors, should be protected. Therefore, a dominant
position is lawful unless accompanied by conduct leading to consumer harm (paras.
6 and 19). The CFI, in the 2006 *Glaxo* decision, has recently endorsed the focus on
consumer welfare under Article 81, and this should extend to Article 82. The CFI held
that the objective of article 81(1) was to prevent firms from reducing the welfare of
the final consumers of the products in question.

Giving such a clear signal about a focus on consumer welfare is already an impor-
tant achievement and cannot be overstated. First, and most important, it provides a
benchmark against which to assess whether a conduct is or not abusive. Following the
Guidance Paper, conduct that harms consumers is abusive; otherwise, it will not be
challenged. In other words, we have to look beyond the form of a particular conduct
into its likely or potential effects. Second, it provides content to the notion of an effects-
based analysis. It is the effects of the conduct on consumer welfare that is the focus of
attention, not other kinds of effects. Third, it is the basis for extending the assessment
of the competitive effects of the conduct to account for efficiencies. Efficiencies are
relevant since they affect the net impact on consumer welfare of the practice.

The Commission will normally intervene under Article 82 where, on the basis of
cogent and convincing evidence, the allegedly abusive conduct is likely to lead to anti-
competitive foreclosure. This notion contains two operative elements: (i) foreclosure,
which occurs when the dominant company makes access to customers more difficult
or impossible for actual or potential rivals; and (ii) consumer harm resulting from this
foreclosure. The Guidance Paper then outlines general considerations that are rele-
vant for the assessment of anticompetitive foreclosure. It addresses issues such as the
conditions in the market, including the relevance of entry barriers, the position of and
counterstrategies available to competitors, the part of the market that is affected by
the conduct, and possible evidence of actual foreclosure and implementation of an
exclusionary strategy. This framework is then applied to the most common types of

30 Judgment of the Court of First Instance in Case T-168/01, *GlaxoSmithKline v. EU Commission*.
31 Specifically, the CFI departs from the Commission’s customary approach that limitations on paral-
lel trade should be considered as a de facto per-se restriction of competition for which there exist no
possible justifications. The CFI argued that parallel trade is not an end in itself and deserves protection
only when it “gives final consumers the advantages of effective competition in terms of supply or price”
(paragraph 121).
exclusionary conduct: exclusive dealing, tying and bundling, predatory practices and refusal to supply.\textsuperscript{32}

The Guidance Paper identifies the “as efficient competitor” test as a useful analytical tool for price-based conduct. Failing the test, in the sense that the effective price is below the average avoidable cost (AAC)\textsuperscript{33} for a range of output that cannot be contested by competitors, is neither a necessary nor a sufficient condition for finding that a rebate is harmful for consumers. In particular, if the effective price is above average avoidable cost, existing competitors may still be unable to match the offer from the dominant firm. That is, competitors may need time to invest and develop their capabilities. One should thus take a dynamic view of the constraint exercised by seemingly less efficient competitors. No conclusion should hinge on a knife-edge result for the “as efficient competitor” test. Only if the result of the test is robust in terms of a reasonable sensitivity analysis should one draw inferences. These considerations apply to all instances in which the “as efficient competitor test” is endorsed in the Guidance Paper.

This highlights that, ultimately, to show anticompetitive foreclosure we must provide evidence that the conduct in question has led, or is likely to lead, to greater price increases, reduced quality, less consumer choice, or less innovation than would occur in the absence of the practice. But more generally, the analytical framework set out in the Guidance Paper imposes the obligation to offer a coherent narrative that explains how the allegedly abusive conduct is liable to result in consumer harm. Conduct, which has been \textit{prima facie} labelled “abusive” when engaged in by a dominant firm, such as granting conditional rebates, may in reality not frustrate the competitive process. Depending on the concrete circumstances, it may actually enhance competition and benefit consumers.

Economic models can help us construct this narrative and point to relevant evidence. In general, the assessment will be based on various factors: for example (i) the capability of competitors, customers, and suppliers to counter the conduct of the dominant firm; (ii) the extent of the conduct (in general the larger is the extent of the conduct in scope or duration, the greater is the likelihood of foreclosure); (iii) possible evidence of actual effects where the conduct has been in place for a sufficient period.

\textsuperscript{32} For instance, in an instance of alleged tying, the Commission will investigate whether the dominant firm is indeed tying two distinct products and how this practice is leading to anticompetitive foreclosure on the tied and/or tying market—for example, by making entry in these markets more difficult. The dominant firm can subsequently explain whether and how its conduct allows it to provide customers with a better product in a more cost effective way, thereby benefiting customers overall.

\textsuperscript{33} To apply the “as efficient competitor” test requires defining an appropriate cost benchmark, which may differ depending on the type of conduct or market situation concerned. The two cost benchmarks used in the Guidance Paper are either average avoidable cost (AAC) or long-run average incremental cost (LRAIC). Average avoidable cost is the average of the costs that could have been avoided if the company had not produced a discrete amount of (extra) output, in this case usually the amount allegedly subject to abusive conduct. Long-run average incremental cost is the average of all the (variable and fixed) costs that a company incurs to produce a particular product. The LRAIC will usually be above AAC because LRAIC takes into account all product-specific fixed costs, including product-specific fixed costs made before the period of abusive pricing, whereas AAC only takes product-specific fixed costs into account that are incurred during the relevant period of time, for example costs incurred to foreclose.

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of time; and (iv) possible direct evidence from internal documents of an exclusionary strategy by the dominant company.

Notwithstanding the above, the use of an effects-based approach does not imply that it is necessary to apply very complex economic or econometric analysis. Actual or likely negative effects can in general be shown by carefully analysing the conduct and factual developments and the ways in which the conduct is likely to affect the market. Nevertheless, economic and econometric modelling can be a tool, and sometimes a very useful tool, in such an analysis.

3.1.3 Efficiencies

Even if it is proved that a firm (i) is dominant and (ii) its conduct has, or is likely to foreclose rivals, and (iii) this is likely to result in consumer harm (i.e., its conduct led to anti-competitive foreclosure), the Guidance Paper recognizes that, with a consumer welfare standard in mind, this assessment may not be complete. The dominant firm can put forward efficiency justifications for its conduct. Thus, even if the foreclosure is anticompetitive, it is possible that the conduct brings with it efficiencies that result in benefits to consumers that more than offset the harm from the foreclosure. In such a case, the conduct will not be deemed abusive.

The Guidance Paper establishes a four pronged test whereby the undertaking must prove: (i) its conduct results in efficiencies; (ii) the conduct is indispensable to achieving such efficiencies; (iii) the efficiencies outweigh any anticompetitive effects of its conduct; and (iv) that effective competition is not fully eliminated.

The question of the burden of proof requires some clarification: The Guidance Paper indicates that the dominant firm “will generally be expected to demonstrate, with a sufficient degree of probability, and on the basis of verifiable evidence, that the following cumulative conditions are fulfilled.” As the wording suggests, this is not an absolute requirement. There may be circumstances where demonstration of one or more criteria requires information that only the Commission can obtain. Moreover the Guidance Paper also makes it clear that the Commission bears the ultimately responsibility for balancing “any apparent anticompetitive effects against any advanced and substantiated efficiencies” to determine whether the conduct “is likely to result in consumer harm.”

In what follows we provide a short summary of the key elements in the assessment of particular categories of conduct.

3.1.4 Predatory Pricing

The Guidance Paper establishes a modern test for predation. Conduct is viewed as abusive where: (i) “a dominant undertaking engages in predatory conduct by deliberately incurring losses or foregoing profits in the short term (referred to hereafter as “sacrifice”) (ii) so as to foreclose or be likely to foreclose one or more of its actual or potential competitors (iii) with a view to strengthening or maintaining its market power, thereby causing consumer harm.”
Only if these three cumulative conditions are met (sacrifice, foreclosure, and consumer harm) can aggressive conduct on the part of the dominant firm be considered as predatory and thus as resulting in anticompetitive foreclosure.

A price/cost test can be helpful in establishing the first of these conditions (sacrifice). Pricing below AAC will in most cases be viewed as a clear indication of sacrifice. However, below cost pricing is not necessary to establish sacrifice. In some cases sacrifice can be shown “if the allegedly predatory conduct led in the short term to net revenues lower than could have been expected from a reasonable alternative conduct”. Also note that price below AAC, while sufficient to establish sacrifice, is not sufficient to establish that the conduct is predatory. For this it is also necessary to show that the below-cost pricing results in foreclosure and consumer harm (that is, anticompetitive foreclosure).

The assessment of foreclosure is arguably the most complex component, but it is also where economic analysis provides extensive insight, as is reflected in the Guidance Paper. First note that what may appear as a sacrifice is not in fact part of a rational predatory strategy. Indeed, predation is costly, and the cost increases with the market share of the predator; conversely, the victim’s losses are smaller when its market share is smaller. Further, according to “Chicago School” thinking, since predation can only be temporary, the prey will not exit. Not even a dominant firm can successfully predate on equally or more efficient rivals since the predator would ultimately raise prices or behave less aggressively to recoup initial loses. Further, if the industry is profitable in the long term, lenders should be prepared to back the prey through any period of temporary losses. In sum, predation could not possibly lead to permanent exclusion of an equally efficient rival. Even if the prey ceased operations during the predatory phase, either it or a successor would re-enter during the recoupment phase, making use of the prey’s original assets.

However, recent advances in economic theory have led to a fair consensus that under certain circumstances the prey may indeed decide to exit the market if a dominant incumbent engages in aggressive competition, even if the prey understands that it is subject to a predatory attack. These circumstances are identified explicitly in the Guidance Paper:

- If the targeted competitor is dependent on external financing, substantial price decreases or other predatory conduct by the dominant undertaking could adversely affect the competitor’s performance so that its access to further financing may be seriously undermined.
- If the dominant undertaking is better informed about cost or other market conditions, or can distort market signals about profitability, it may engage in predatory conduct so as to influence the expectations of potential entrants and thereby deter entry.
- If the conduct and its likely effects are felt in multiple markets and/or in successive periods of possible entry, the dominant undertaking may be shown to be seeking a reputation for predatory conduct.

Finally, likely consumer harm may be demonstrated by assessing a variety of structural conditions that contribute to the likelihood that a predatory pricing strategy will be successful. An analogy with mergers is useful. A merger eliminates the competitive
constraint that the parties exert on each other. Whether this results in increased prices
to the detriment of consumers depends, for example, on whether the goods of the
merging parties are close substitutes or whether remaining competitors are capacity
constrained, as well as on entry barriers and other structural market conditions. Similar
ideas apply when assessing the effects of predatory behaviour on consumer welfare.
To establish likely consumer harm we need to identify the foreclosed rivals and assess
the extent of the competitive constraint that the prey (or preys) would have exerted on
the dominant firm in the absence of predation, As well as which (if any) rivals (actual
or potential) remain in the market to compete with the dominant firm, or whether buy-
ers can exert any degree of countervailing buyer power. If the alleged predator cannot
increase significantly its market power as a result of the exclusion of the prey, there is
no consumer harm. This also means that a real sacrifice would have been in vain, as
recoupment would not be possible. Hence what appears as predatory conduct is just
aggressive competition and does not infringe Article 82.

3.1.5 Tying and Bundling

The Guidance Paper first states emphatically that tying and bundling are marketing
strategies that often have consumer welfare-enhancing effects. However, tying would
be considered abusive where: (i) the firm is dominant in the tying market; (ii) the tying
and tied products, based on consumer demand, are distinct products; and (iii) the tying
is likely to lead to anticompetitive foreclosure.

Technological ties are liable to greater anticompetitive foreclosure because they
contribute to making the commitment to the tie credible. Also, theories of harm for
pure tying (or pure bundling) that may be a source of concern will naturally involve
complements, a dynamic element, and often the aim of protecting the tying good (for
which there is dominant position)—for instance, where the provision of the tied good
is necessary to develop a alternative to the tying good.

As for multiproduct bundling, the Guidance Paper recommends applying an “as
efficient competitor test” by comparing the incremental price that customers pay for
each of the dominant firm’s product in the bundle to the dominant firm’s long-run aver-
age incremental cost (LRAIC). An incremental price below LRAIC generally warrants
Commission intervention as it may lead to foreclosure of an “as efficient competitor”.
However, in the case of bundle-to-bundle competition, the relevant test is whether the
price of the bundle as a whole is predatory.

3.1.6 Exclusive Dealing and Rebates

Exclusive dealing is a concern (i) when competitors are not present when the contract
between the dominant firm and the buyer is concluded, or in the case of rebates when
there is a significant range of output that the competitor cannot contest; and (ii) when
there are asymmetries that favour incumbents over entrants, for instance so that a
competitor needs to contract with a number of buyers.

Theories of harm for conditional rebates are also best considered in terms of
exclusive dealing or possibly tying between substitutes (which creates a commit-
ment to fight for the contestable part of demand because it is the only way to sell
the non-contestable part — on the assumption that tying is credible). Hence, it is worth asking why the buyers, while accepting the retroactive rebate, forgo the benefit of inducing competition between suppliers (knowing that if the dominant firm is less efficient, it should not be in a position to compensate buyers sufficiently).

Importantly, the Guidance Paper abandons the past formalistic approach in favour of an “as efficient competitor” analysis, already implemented in recent cases such as Intel. When assessing foreclosure the Commission will look not only to the loyalty-enhancing effect of a rebate with respect to the last individual unit but also to the rebate system as a whole and its capacity to prevent the expansion or entry of rivals. The Commission will seek to determine what price a rival would have to offer a customer as a compensation for the loss of a conditional rebate if the latter would switch part of its demand (relevant range) from the dominant firm.

Comparing this hypothetical “effective price” to the benchmarks of the AAC and long run average incremental cost (LRAIC) of the dominant firm, the Guidance Paper sets out three enforcement thresholds. According to these thresholds, an effective price consistently above the dominant firm’s LRAIC is not capable of anticompetitive foreclosure, whereas an effective price between the dominant firm’s AAC and LRAIC where rivals do not have at their disposal any realistic counterstrategies is considered anticompetitive, as is an effective price below AAC. The rationale for these thresholds is that the lower the estimated effective price over the relevant range is compared to the average price of the dominant supplier, the stronger the loyalty-enhancing effect. However, as long as the effective price remains consistently above the LRAIC of the dominant undertaking, this would normally allow an equally efficient competitor to compete profitably notwithstanding the rebate. In those circumstances the rebate is normally not capable of foreclosing in an anti-competitive way.

The empirical implementation of the test may be more sensitive to the evaluation of the contestable share (the range of output that can be contested by competitors) than the evaluation of average avoidable costs (the effective price is a steep function of the range of output over which it is computed — it converges to infinity as the output converges to zero). However, dominant firms will often have a good understanding of the range of output that can be contested by their competitors. It will be the subject of the discussion with buyers (who will want to exaggerate the contestable share to obtain higher rebates, so that the dominant has a strong incentive to gather market intelligence). More generally, the dominant firm will need to calibrate properly the rebates; rebates that are much in excess of what is required to hamper competitors or (at the opposite end) short of what is required will be very costly.

3.1.7 Refusal to Supply and Margin Squeeze

Upfront, the Guidance Paper stresses that even dominant firms should have the freedom to choose with whom they can deal. The Commission will consider a dominant firm’s refusal to deal as abusive only in exceptional circumstances and only if: (i) it relates to a product or service that is objectively necessary to be able to compete in the downstream market; (ii) it is likely to eliminate effective competition in the
 downstream market; and (iii) its anticompetitive effects outweigh the consequences of imposing an obligation to deal on the dominant firm. As to margin squeeze, the Commission will compare the price of the input against the LRAIC of the downstream division of the dominant undertaking.

It is a major achievement that the Guidance Paper focuses on the elimination of effective competition—and not just the elimination of a single competitor. Also, again, it is of great significance that the effect on consumer welfare (generally in the long run) is the ultimate yardstick for whether a refusal to supply is abusive or not. It is also an improvement that margin squeezes are considered as a category of refusals to supply and that there is no sharp distinction made between ending an existing supply relationship and refusing de novo.

3.1.8 Final Remarks

The Guidance Paper constitutes a shift towards an economics-based approach to abusive conduct under Article 82. The stated goal is to make sure that we are protecting competition and consumer welfare, not (individual) competitors. Also dominant companies should be free to compete aggressively as long as this competition is ultimately for the benefit of consumers. The effects-based approach thus means that the Commission will carefully distinguish competition on the merits, which has beneficial effects for consumers and should therefore be promoted, from competition that is liable to lead to anticompetitive foreclosure, i.e., foreclosure that is likely to harm consumers. Since the focus of the Commission’s policy is on the effects on consumers, it should be prepared to examine claims that are put forward by a dominant firm that its conduct is justified on efficiency grounds. There is no reason why the Commission’s approach to efficiency defences under Article 82 should be different from that applicable to restrictive business practices and mergers.

In sum, the Guidance Paper reflects the current state of economic thinking and, as such, presents a solid and sound base for enforcement, and thereby provides greater clarity and predictability as to the circumstances that are liable to prompt an intervention by the Commission. The Commission will continue to pursue vigorously exclusionary conduct by dominant companies that is likely to harm competition and thereby consumers. By establishing its enforcement priorities, it seeks to make its intervention as effective as possible. Also, the Guidance Paper should help dominant undertakings to refrain from engaging in abusive conduct in the first place.

3.2 MasterCard’s Interchange Fees

The multilateral interchange fee (MIF) is a fee paid by the merchant’s bank (the acquiring bank) to the cardholder’s bank (the issuing bank) for every payment card transaction that is undertaken at a merchant’s premises. Because payment schemes have been characterized as associations of undertakings, their MIFs have come under antitrust scrutiny in a number of jurisdictions, including the European Commission. In 2007, the Commission rejected MasterCard’s efficiency defence (which held that
MasterCard should be expected to set MIFs that do not restrict competition and benefit consumers), and prohibited MasterCard’s prevailing European cross-border MIF. In the economic analysis of interchange fees, network externalities play an important role. Payment card associations often argue that by allocating the costs of card payments in an appropriate way between merchants and cardholders, they increase the efficiency of payment markets (Baxter 1983). Such frameworks typically assume that card payments are more efficient for merchants than are non-card payments. Without a MIF, final consumers would then hold and use too few cards, because they do not take into account the efficiency benefit that they generate for merchants. This positive usage externality is internalized via a MIF, which increases costs for merchants, but decreases costs for cardholders and thereby induces efficient consumer choices.

However, as the subsequent literature on payment cards has shown (e.g., Rochet and Tirole 2002, 2008), payment card associations often have an incentive to set excessive MIFs precisely because payment card markets are two-sided. As it is difficult for merchants to turn down cards (especially when card acceptance is a means of competing with other merchants), merchant demand for card acceptance is very inelastic. This may allow MIFs that significantly exceed the level at which usage externalities are internalized. Payment card associations and banks could benefit from such elevated MIFs for two reasons:

First, higher MIFs may allow banks to increase profit margins on card payments. If issuing banks pass the MIF through to cardholders to a lesser extent than acquiring banks pass it on to merchants, then MIFs allow banks to shift revenues to the side where they can be more easily retained (issuing) and to shift costs to the side where they are passed through (acquiring). Such asymmetric pass-through can be observed empirically (see for instance Chang et al. (2005)). It is also plausible on theoretical grounds. Indeed, retail banking competition is likely to be characterized by larger switching costs than is true for acquiring competition, which may generate asymmetric pass-through, with the result that the MIF becomes an instrument to transfer rents from merchants and final consumers to banks.

Second, excessive MIFs can be a means to promote expensive cards at the expense of cheaper cards. For instance, premium credit cards are issued at relatively moderate prices to final consumers. This low issuing fee conveys the impression that these cards are “cheap” given that they offer functionalities that simple debit cards (which operate with lower MIFs or no MIF at all) do not offer. However, the MIF masks the true costs of those cards, as most of the cost are borne by merchants. Since consumers typically face retail prices that are not contingent on the payment instrument used, each such card payment exerts a negative externality on the merchant and its customers. Unrestricted MIFs may therefore allow the introduction of hidden costs into the system that distort the competition between payment instruments.

For these reasons, the MasterCard decision had made clear that in order to fulfil the criteria of Article 81(3) EC, MasterCard would have to go beyond general claims that some MIF may be able to balance the two sides of the payment card industry. In discussions following the decision, the Commission suggested that MasterCard should...
use the available data on the costs and benefits of payment cards actually to calibrate which fees would be appropriate in light of the arguments on which MasterCard’s efficiency claims had explicitly or implicitly rested. MasterCard and the Commission subsequently discussed possible efficiency justifications and calibrated at which level MIFs internalize network externalities. In order to do so, data on the costs of different payment instruments from several European national banks studies and from the Commission’s Sector Inquiry on retail banking were used. MasterCard and the Commission also discussed several contractual restrictions to which the decision had pointed, which had been found to compound the restrictive effects of the MIF.

In March 2009, MasterCard provided three undertakings in order to avoid a conflict with competition law. First, it applied reduced cross-border MIF averages of 0.3% for consumer credit cards (which previously ranged from 0.8 to 1.9%) and 0.2% for consumer debit cards (which previously ranged from more than 0.4% to about 0.75%). These averages were calculated along the lines of what Rochet and Tirole (2008) have coined the “tourist test” interchange fee level. The “tourist test” or “avoided cost test” caps MIFs at the level of transactional benefits of card payments for merchants (direct cost savings of card payments relative to non-card payments). It therefore aims at internalizing usage externalities between the two sides by setting MIFs at the level where merchants are on average indifferent between card and cash payments (see Farrell 2006; Wright 2003).

Second, MasterCard repealed a number of scheme fee increases it had announced in October 2008, apparently in response to the decision. Finally, MasterCard committed to adopt certain measures to enhance the transparency of its scheme, which will allow consumers and merchants to make better informed choices about the means of payment that they use and accept. For example, MasterCard’s rules were changed so that merchants are offered the possibility of receiving unblended rates. Merchants will also receive more freedom in deciding to accept only a subset of MasterCard branded cards and in deciding whether or not to surcharge or rebate a subset of payment instruments.

3.3 Sector Inquiry into Pharmaceuticals

On 8 July 2009 the Commission adopted the Final Report on its competition inquiry into the pharmaceutical sector. The aim of competition inquiries is to allow the Commission to gain a more complete understanding of sectors where it believes that wider competition problems may be present. Inquiries of this kind may be viewed as ‘upstream’ of any antitrust proceedings in specific antitrust cases.

The main aim of the inquiry was to examine the reasons for observed delays in the entry of generic medicines to the market. The inquiry concentrated on those practices that incumbent companies may use to block or delay such entry: e.g., concluding settlement agreements with potential generic entrants (“pay-to-delay”), using the patent system unduly to extend protection on the product, and intervening at the level of national marketing authorisation bodies and pricing and reimbursement bodies with a view to delay entry after the product’s loss of exclusivity. The Commission collected and analysed a great deal of information for this purpose, including internal strategy documents of companies, to gain a better insight into the companies’ market behaviour.
In view of the high level of regulation of the sector, the inquiry also analysed the role of the regulatory framework in this regard.

The Chief Economist Team (CET) conducted an empirical analysis of the impact of generic entry, both in terms of extent (what proportion of medicines faces generic entry, what time does it take for entry to occur, how many generics typically enter) and in terms of effect (the effect on prices in the market, volumes, market shares). Using regression analysis, the CET explored a number of (regulatory) factors that might explain the pattern of entry and competition by generics.

The analysis was based on a sample of medicines representing the (vast) majority of medicines that faced loss of exclusivity in the period 2000–2007 in the EU. Two main data sources were used: data obtained from pharmaceutical companies in the course of the sector inquiry and data requested from industry information provider IMS Health. The resulting dataset contained monthly sales and price data and other types of information for hundreds of products per Member State (counting the various individual formulations and originator and generic products separately). The Commission also compiled a dataset containing other factors that may play a role in the pattern of generic entry and competition, including, in particular, the main characteristics of the regulatory framework in each Member State.

The results of the econometric analysis indicate that a number of regulatory variables play an important role. The first is whether pharmacists are required to dispense the cheapest available product from those covered by the doctor’s prescription. In countries where such compulsory generic substitution exists, the degree of price competition and the level of generic penetration appears to be greater. The same holds for policies involving reimbursement of medicines at the level of the lowest priced product and a frequent adjustment of reimbursement levels to take account of price developments in the market. Likewise, differential co-payment for patients further appears to favour price competition. By contrast, regulatory environments where generics are subject to a price cap or mandatory discount (in comparison to the pre-existing originator price) when they enter appear less favourable to generic entry and competition.

4 State Aid

Member States naturally tend to ignore the consequences of state support that will take place outside their jurisdiction. In that context, the main purpose of state aid control in the EU is to avoid a “support” race among Member States that would lead to an excessive amount of aid (Member States’ being caught in a prisoner’s dilemma) and more generally to achieve benefits from coordination in the provision of support. EU state aid control thus allows Member States to intervene when pursuing well defined objectives of common interest while avoiding excessive distortions of competition, in particular when these distortions occur in other Member States. In the context of the current financial and economic crisis, the EU is actively applying this framework, in particular towards banks in distress and towards companies that suffer from the credit squeeze.
4.1 Banks in Distress

The EU has developed a set of rules on rescue and restructuring aid for firms in difficulty. These rules recognize that rescue may pursue an objective of common interest, in particular when bankruptcy involves negative external effects that would not be taken into account by firms in distress. However, these benefits have to be balanced against distortions of competition. A potentially significant distortion is associated with distorted incentives to compete by healthy firms which, as a result of rescue, face more competition.

Thus, aid to rescue or restructure a company can only be granted once, in order to avoid repeated interventions to keep a particular firm in the market. Furthermore, restructuring aid is conditional upon implementation of a restructuring plan and efforts to restore the long-term viability of the company. The beneficiary of the aid must make a contribution toward the cost of its restructuring. In order to limit the distortions of competition, the Commission also imposes compensatory measures in the form of asset divestitures, capacity reductions, or reductions of entry barriers.

The failure of financial institutions might involve significant systemic effects associated with negative externalities, so that the social cost of a bank failure much exceeds its private cost. The negative externalities of a bank failure (or the anticipation of it) arise through various channels. First, as banks have extensive exposures to one another, losses of one bank will be borne by other banks (in case of failure or through a reduction in the value of their debt), the position of these banks may in turn be weakened and trigger losses for their own creditor banks. Losses can spread directly through inter-bank exposures or indirectly through guarantees, credit lines, or insurance against credit risks (credit default swaps, or CDS) that are being drawn and called. Second, pure informational contagion can arise such that the failure of one bank leads to an adjustment in the expectations regarding the viability of other banks perceived to be similar (even in a simplistic sense).

Hence, targeted support for banks in difficulty might be attractive as a way of alleviating market failures and achieving financial stability. However, these benefits have to be balanced against distortions of competition, in particular moral hazard. Indeed, the rescue of banks (or more generally the support of banks in difficulty) might have the effect of protecting the providers of funds (owners and creditors) and the bank managers from the consequences of past (excessive) risk taking. The rescue measures might strengthen the expectation that insurance will be provided in future cases of distress and provide renewed incentives for excessive risk taking. Measures aimed at financial stability should thus be designed so as to mitigate problems of moral hazard. The rescue (or support given to banks in difficulty) also affects competitors directly and distorts their own incentives to compete. Indeed, if banks that were not in distress observe that their competitors are bailed out, incentives for appropriate risk taking will be further impaired.

The Commission has thus drawn a distinction among distressed banks between those that are in distress because of a defective business model and those that happened to be distressed because of the systemic effects, while pursuing a fundamentally sound business model. Mandatory restructuring is imposed on the former, and the restructuring plans can potentially be designed in such a way as to address problems of moral
hazard and distortions in the incentives to compete for competitors. Restructuring plans are based on three dimensions: private (“own”) contribution to the coverage of the restructuring costs (aid to the minimum), compensatory measures, and long-term viability (to avoid repeated support).

In principle, the first requirement, which involves a restructuring of liabilities, could ensure that restructuring costs are borne by the owners, creditors, and managers of the entity receiving support. This would allow for an ex-post implementation of standard features of “special resolution regimes”: the conversion of unsecured debt/hybrid capital into common equity and/or the write-down of (part of) the unsecured debt, and efforts to address concerns of moral hazard.

Compensatory measures are aimed at reducing competition distortions. For non-financial institutions, compensatory measures typically consist of asset disposals and/or capacity reductions that “compensate” competitors for the survival of the distressed firm. For financial institutions, the disappearance or downsizing of a bank may actually hurt competitors. There is an added dimension during a systemic crisis: Sellers are numerous, while buyers are few, thus putting an additional downward pressure on asset prices. For that reason, compensatory measures have to be tailored to the specifics of the industry.

4.2 Credit Squeeze

As a consequence of the crisis in financial markets, banks have become much more risk averse than in previous years, and as a result much less willing to provide financing. This tightening of credit conditions not only affects weak companies, it can also affect healthy companies that find themselves facing a sudden shortage or even unavailability of private funding, whether loans or risk capital. These heightened perceptions of risk by financial institutions are all the more problematic since these perceptions may become self-fulfilling: Lending evaporates because the risk of default is perceived to be higher, which in turn leads to actual bankruptcy of initially sound undertakings and a higher perception of risks. Given what can be seen a temporary mispricing of risk and potential coordination failure, State support addressing these market failures may thus be appropriate.

Consequently the Commission adopted in December 2008 a “temporary framework for State aid measures to support access to finance in the current financial and economic crisis” (the “temporary framework” or TF) in response to the growing effects of the crisis on the real economy.35 The adaptation of rules contained in the TF target the specificities and the expected temporary nature of credit tightening. More specifically, the temporary framework allows Member States to provide the following types of aid in the form of subsidized loans and guarantees. Importantly, the Commission has also consciously acted “passively” as safe harbours for the credit risk premia that the governments are allowed to charge have not been adapted. Therefore, members states are allowed to provide loans and guarantees at prices that reflect current credit risk but pre-crisis risk premia. Hence, government support is targeted at what is

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currently perceived as market failure and as credit risk premia return to lower levels, the support that governments are allowed to grant will vanish.

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References


