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COMPETITION ASSESSMENT OF VERTICAL MERGERS AND VERTICAL AGREEMENTS IN THE NEW ECONOMY

Executive Summary

Introduction

New technologies are making our economy global

The growth and ever-increasing sophistication of information technology as well as the convergence of communications devices are changing our society and making our economy global. Businesses use networks ever more extensively to conduct and re-engineer production processes, manage both external and internal operations, streamline procurement processes and reach new customers. As for customers, they now routinely use the Internet to identify sellers, evaluate products and services and compare prices.

This leads to a tendency for companies to integrate vertically and conclude vertical alliances

In such a globalising economy, it is of increasing importance for companies to concentrate their business on core activities in order to improve their competitiveness in widening markets. This leads to a tendency for companies to integrate vertically with other companies active upstream and downstream and to conclude vertical agreements to ensure efficient supply of inputs and sales of output.

Whilst generating efficiencies these vertical operations may also facilitate and encourage anticompetitive practices

Vertical mergers and agreements are generally deemed to yield efficiencies in the companies' way of doing business rather than to lessen competition. However, these transactions can also give rise to competition concerns in that they could, in particular, facilitate foreclosures of competitors. In industries characterized by network effects, such as the telecommunications, electronic communications or media sectors, a dominant standard often emerges in the market. In this context the dominant firm may try to deny rivals' access to its network, thereby preventing interoperability with its products.

Firms have been offered unprecedented opportunities to reduce costs and time in their selling process

Companies of the traditional economy have also integrated the Internet and other new technologies into their business distribution strategies and concluded vertical transactions to ensure exclusive or preferential access to the digital market place. The development of the Internet offers unprecedented possibilities for firms to reduce costs and save time in their sales process as well as great opportunities for new services and products. The new electronic technologies are widely impacting the way firms are conducting their business and how consumers are searching, selecting and purchasing their products, such as giving birth to new intermediaries, like portals and marketplaces. In this respect, opportunities are created for increased competition. However, these technologies can also raise specific competition concerns, notably in the field of vertical agreements, where, for example, exclusionary conduct, tying of sales, price discrimination or control of intellectual property rights can create artificial barriers to entry into the affected markets.

This fast moving environment may give rise to new and complex assessment issues…

…which must take into account the unique characteristics of the New Economy industries

In a fast moving environment characterised by rapid innovation and evolving technologies, vertical integration and alliances in New Economy sectors give rise to the need for complex analysis of a number of competition issues in any given transaction such as the definition of relevant markets, the appraisal of dominance or the assessment of appropriate remedies.

This analysis considers the network effects arising from the interconnection or interoperability of the products in question. It also considers the risk that rivals will not have access to an "essential" facility, and also the level of investments made by companies concerned with the development of new products and services and efficiencies resulting from the transaction benefiting consumers.

The existing instruments and traditional approach to competition assessment may well need to be reassessed in light of the specific characteristics of the New Economy

This raises the question of whether the existing criteria and the traditional approach to vertical mergers and agreements in the New Economy are adequate for these evolving markets and whether a different and more appropriate method, based on a dynamic analysis of the markets, is necessary.

The New Economy encompasses both e-economy infrastructure industries and traditional industries with e-commerce activities.

There has been much debate on whether or not the changes to the economy resulting from the development and sophistication of information technology and communications are so radical as to merit the label "New Economy". Indeed, as underlined by Alan Greenspan[1], *"the economy is changing everyday and, in that sense, is always new."*

In fact, the concept of "New Economy" cannot be reduced to the mere modernisation of what exists already, nor to the straightforward development of a new form of commerce that would take a significant share of the market.

The New Economy describes the transformation of economic activities that is tacking place through the development of new technologies

The concept of "New Economy" tends to describe the transformation of economic activities that is taking place through the development of electronic and communication technologies – such as the Internet – which make accessing, processing and storage of information increasingly cheaper and easier. The emergence of this new type of economy means radical changes in sales practices, in strategies for wining market shares, in relationships between customers and suppliers and in modes of industrial structures.

All sectors of the industry are impacted to a degree by the New Economy which encompasses not only enterprises in the telecommunications, electronic communications, media, software and Internet sectors but also traditional sectors creating opportunities for integration of the Internet and the new information and communications technologies in distribution processes.

For the purpose of the report the "New Economy" is considered as having two primary components with their own specific concerns and opportunities:

The New Economy encompasses both the E-economy infrastructure industries and the traditional industries with E-commerce activities

- ***The E-economy infrastructure*** covers the different communication facilities, information technologies (IT) and services required to support and conduct electronic transactions and to provide transactional services over public-based networks, such as the Internet. As such E-economy infrastructure activities may be divided into three basic conceptual layers: the information/content layer, the network infrastructure layer and the access applications layer.

- ***The E-economy transactions*** – or E-commerce – cover any form of transaction that is conducted electronically using communication networks for the supply of goods and services to customers and businesses at any point in the supply chain.

[1] Remarks by Chairman Alan Greenspan at the Haas Annual Business Faculty Research Dialogue, University of California, Berkeley, California, 4 September 1998, available at http://www.federalreserve.gov/boarddocs/speeches/1998.

Vertical integrations and alliances generally benefit consumers.

As regards new economy infrastructures, content is becoming of central importance in the chain of the e-economy. Interoperability of networks and communications devices, both local and global, provides unique opportunities for the end-user. Global network infrastructure will increasingly provide integrated service networks with more open access for all users. New interactive devices will replace existing technologies.

The Internet is widely predicted to produce digital convergence, in which computing, telecommunications and broadcasting merge into a single stream of information and services carried on the same network. The same is true of the communications, information/content and information technology sectors.

These technological developments will increase convergence in market infrastructure, through the development of substitutable broadband and interactive digital communication systems. There will also be convergence in content, as the previously separate markets for content services (such as music, newspapers, television, film and Internet publishing) will inevitably overlap and combine into a single world of interactive content.

Vertical integrations and alliances will increase convergence and provide great opportunities for complementarities among high technology products and services

Given the variety and complementarities of the different products and services offered by and through the Internet, vertical integrations and vertical alliances are likely to provide many opportunities to offer packages of sophisticated and high quality products and services to consumers.

Instead of having product and service offers from two or three different sources, such as the separate provision of Internet access, access software and the set top box (with the consequent risk of non-interoperability between these products and services), consumers will benefit from a single final product offered through only one source of supply, with the certainty of high quality.

Vertical integrations and alliances between businesses active at different levels of the delivery chain will undoubtedly contribute towards better compatibility among those products. As technological convergence accelerates between the computing, communications and broadcasting industries, the tendency for vertical and horizontal integration will further increase.

[2] Speech of Jean François Pons, Deputy Director General, DG Competition, European Commission, International Competition Policy Conference 2001, Regulatory Policy Institute, Oxford, Tuesday 26 June.

Concerning e-commerce, new information and communication technologies also offer businesses opportunities for costs reduction with the benefit of greater competition being passed on to consumers.

New technologies offer great opportunities to reduce production and distribution costs

Electronic communications technologies, such as B2B and B2C marketplaces and portals, are widely used by firms to optimise their production and distribution processes and lower costs. They should therefore be taken into account when considering the effect on competition of a vertical merger or alliance. These efficiencies and opportunities generally consist of:

- *Reduction in administrative costs*. The Internet makes it possible to process administrative transactions electronically and thus cut back administrative expenses. For example, "real-time" online transactions can replace expensive phone and fax communications. Similarly, electronic devices can reduce the cost of remedying incorrect transactions, such as inaccurate orders. This reduction in business costs can ultimately lead to immense cost savings for end users.

- *Reductions in search costs*. Buyers can more easily shop for comparisons, which obviously leads to selecting the best prices for them and therefore encourages competition. Another positive aspect is that the Internet can significantly reduce costs incurred by both buyers and suppliers when locating each other in order to do business.

- *Creation of new markets*. An indirect consequence of large costs savings is that new markets could be created, since previously unviable sales channels could become viable.

- *Possibilities of joint purchasing*. Joint purchasing can reduce company costs by leading to economies of scale in purchasing, and by reducing manufacturing costs.

- *Facilitation of supply chain management*. New technologies make possible a greater interaction between buyers and suppliers and thus businesses can avoid being overstocked or understocked, both of which are costly. This enables businesses to focus more accurately on buyer needs.

- *Benefits of collaboration*. Collaboration with other businesses can reduce the time needed to develop, produce and distribute new products.

However, while industries are unanimous about the benefits and efficiencies generated by B2B marketplaces and portals, some businesses from the traditional sectors, interviewed during the course of this study, have expressed reservations about the real benefits and opportunities of B2C as a profitable sales channel.

For example, in the retail distribution sector the sales made through the Internet are insignificant compared to the volume of products sold by the same businesses in their brick and mortar shops. Furthermore, the number of products available on the Internet is limited in comparison to those on offer in shops. Similarly, European car manufacturers express a very cautious attitude toward Internet sales – as they often say, a consumer would always want to "kick the tires" before buying a car.

Vertical integrations and alliances may give rise to foreclosure and leveraging effects

Vertical integrations and alliances may benefit consumers and new information and communication technologies undoubtedly reduce certain costs with the benefit of greater competition being passed on to them. However, they can also encourage or facilitate certain types of anti-competitive behaviour between firms involved either in the E-economy infrastructure or in e-commerce.

With respect to infrastructure industries:

(i) With respect to E-economy infrastructure, there is an increased dependence on a wide-ranging and diversified set of vertically related activities, which notably include the provision of information and content, network infrastructure and access applications.

Interdependency and interoperability between products that result from the convergence of technologies is likely to result in foreclosure practices

In a context of convergence of technologies, vertical integrations and alliances are likely to raise major competition concerns relating to interoperability and interdependence between different products and services. Another concern is the possibility that the holder of key content, key network or key access applications may impose its products or services as a standard.

Therefore, the assessment of New Economy anti-competitive practices must focus in particular on the possibility for holders of essential products or services to raise barriers to entry, thereby foreclosing market access. Moreover, because vertical integration and alliances may impact downstream and upstream levels, opportunities for companies involved in the transaction to leverage their position in related markets should be closely scrutinised.

Vertical integrations and alliances may also have leverage effects at the downstream or upstream level…

Another crucial feature of these industries is their potential to generate positive network externalities (also known as network effects). The risk attached to these externalities is that the first company entering the market may rapidly attain a critical mass and thereby acquire a decisive advantage over its competitors (known as the first mover advantage phenomenon).

…Such as the

To illustrate the typical concerns linked to interoperability and access, which can result from a vertical transaction, one can take the example of an alliance between a major media and entertainment company and a well-known Internet provider whose object is to deliver on-line music. Given the strong position of the companies in their respective markets, they could be tempted to impose their products as standards in the *possibility for parties to impose standards in a nascent market*

emerging on-line music market. In particular, they may format the content in such a way that it is only compatible with their own music player. Thus, they would become the gatekeeper to the on-line music market and could dictate the conditions for the distribution of on-line music.

With respect to the provision of Internet connectivity, which is one of the crucial services in the New Economy sectors, the main anti-competitive practices that may be implemented by a dominant company and requiring careful analysis, may consist of refusing to grant access to its networks, raising its rival's costs, degrading the quality of the connection or pricing selectively to attract customers away from competitors.

With respect to E-commerce:

(ii) With respect to e-commerce, for the trade of certain goods or services, the New Economy has brought about two parallel ways of distribution. Thus, e-commerce constitutes a new sales channel, which competes with and is likely to affect the traditional systems of distribution.

Traditional selective and exclusive distribution networks may be affected by Internet resellers

In particular, this would be the case where a supplier has set up a selective network. The traditional selective distributors may complain that Internet pure players are selling their products without meeting the distributors' selection criteria. In the case of exclusive distribution, traditional retailers may complain that approved retailers on the Internet are selling in their exclusively allocated territories. Problems may also arise when the supplier sells its own products via the Internet to the detriment of its distributors.

Moreover, a variety of new intermediaries on the virtual markets have appeared – such as electronic marketplaces and portals – which generally offer a wide range of products and services to customers or to other businesses (transactions, exchange, auctions, catalogs, negotiations).

With respect to electronic marketplaces, which are owned by a number of major buyers or sellers in a market, there is a risk of small third-party buyers or sellers being denied access to the market, or alternatively being given access only on such unfavourable terms that they would, in effect, not be in a position to compete effectively. This could potentially lead to market foreclosure or provide firms with the ability to raise their rivals' costs.

With respect to portals, content providers may impose their portal as the unique facility to access their content. Depending on the importance of this content, this practice may amount to an abuse as it prevents competing portals from offering access to customers.

Foreclosure is generally deemed to be anti-competitive where nearly all rivals are affected, where their ability to compete is harmed and where they do not have an effective counterstrategy or alternative.

Characteristics of New Economy industries may call for a new assessment of competition issues.

New Economy industries present specific characteristics:

Rapid innovation

Network effects

First mover advantage but fragile leadership

Important costs in R&D

Uncertainty in profit accounting

High product differentiation

Competition in New Economy industries is fundamentally different from that in more mature and stable industries. Accordingly, some of the traditional criteria used to define and measure market power in antitrust analysis may not be appropriate.

New Economy industries are typically characterised by the emergence of new products and services and therefore potential new markets, rapid innovation with important costs in R&D, fragile leadership position, large uncertainty in profit accounting and high levels of product differentiation.

New Economy industries are also characterised by strong network effects (or "network externalities"). These network effects arise when the value of a network increases with the number of its users. In this context, a single firm can rapidly become or threaten to become the only supplier of a given product or service, because it is the "first mover" or because it has a decisive lead over its competitors. In these circumstances, the first company to attain a critical mass can expect to benefit from "snowball effects" that will reinforce its position on the market. Customers are indeed more likely to remain with the established network, and suppliers of complementary products are likely to tailor these products to the established network and be reluctant to prepare products for new entrants. In the face of network externalities, the choice of a technology, especially when this choice is irreversible, is all the more important for the consumer.

Applying traditional methods yields narrow market definitions and this can lead to an exaggerated assessment of market power. Some "new" sets of criteria for antitrust analysis of high technology markets concerning the definition of the markets and the evaluation of market power need to be considered. A "wide-angle lens" is needed to assess competition in dynamic markets. This includes the way technology competition occurs and its various dimensions such as customer needs and responses to product innovation. This can help improve the way some traditional criteria are applied in practice.

Need for new criteria in assessing market definition and market power

For example, with respect to market shares, the current criterion based on the firms' turnover is unlikely to provide a faithful picture of the firms' actual market power. Especially when dealing with Internet connectivity, criteria based on traffic flow or number of end-users may be more reliable.

New technologies enable rival firms to introduce new products and services at the expense of existing ones, which often, by their nature, are not necessarily substitutes or enhancements in the traditional sense but are entirely new advanced products and services. New technologies, particularly in the electronic communications sector have, by their very nature, little or no equivalent in traditional markets (such as enhanced products with more capabilities and functionalities like UMTS telephony as opposed to GSM, or entirely new devices such as Internet connectivity by electricity networks as opposed to fibre optics cables).

Even though the dynamic configuration of the market creates "winner takes most" situations, these situations may constantly be challenged. Indeed, in such a rapidly evolving environment, today's leader in a given technology may be quickly overtaken tomorrow by a new product or technology. Accordingly, market leadership seems to be more fragile in New Economy sectors than in traditional ones. A firm enjoying a dominant position in a nascent market may constitute only a temporary threat for competitors.

These characteristics require a qualified apprehension of markets dynamic

This requires an informed understanding of the underlying technologies and in-depth appreciation of market dynamics. Quoting Jean François Pons, Deputy Director General, DG Competition *"applying Competition law in new economy cases is very difficult. The judgements that have to be made are often fine ones – allowing an operation to go through could close a new market completely, whilst prohibiting or imposing conditions on another could stifle innovation and prevent technical progress".*[2]

The adequacy of the current competition rules to limit anti-competitive effects of vertical agreements and vertical mergers will vary considerably depending on what segment of the New Economy is involved. This dynamic approach is particularly relevant for the competition analysis of electronic networks. When addressing e-commerce, i.e. B2C and B2B, it may not be so relevant as it merely acts as an additional way of selling or distributing the same products. The question is therefore open on whether it constitutes a distinct market at all.

Methods for improvement of competition analysis: towards a more dynamic approach - <u>See flowcharts attached</u>.

Competition authorities should focus on the vigour of the dynamic competition by taking a longer-term view

Competition in New Economy markets tends to be dynamic with innovation as a key competitive factor. Therefore, in order to assess the competitive forces of the market, it becomes essential to focus on the vigour of dynamic competition by taking a longer-term view. This requires looking beyond current market figures.

Actual and potential innovative threats should be systematically examined

The leader in a given market constantly has to face the threat that another firm will come up with a better version or an entirely different product that eliminates the demand for the leader's product. These threats force New Economy businesses to invest heavily in R&D and to bring out new versions of their products, including versions that lead to the demise of their older versions. In this context, an essential element of market power assessment in New Economy industries is the examination of actual and potential innovative threats to leading firms. This generally involves the assessment of the likelihood of future races for market dominance and the consideration of competitive threats based on new technologies that differ radically from those used by the incumbent.

More consideration should be given to efficiencies

As innovation contributes to technical and economic progress and consumer benefit, a dynamic approach suggests giving more consideration to the efficiencies generated by the transaction.

In comparison with the E.U., the U.S. competition authorities are more prepared to make a balance between efficiencies and anti-competitive effects. The approach to vertical mergers and agreements seems to put more weight on expected efficiencies which seems to be better suited to meet the characteristics of the New Economy.

Recommendations

The existing instruments should be applied through a more dynamic approach

The objective of antitrust policy in the New Economy must not discourage innovation while deterring anti-competitive and injurious behaviour.

In this respect, one can argue that the existing instruments, while not preventing a dynamic analysis, are not specifically designed to address this kind of approach, especially the Merger Control Regulation, which is arguably driven essentially by asserting the creation or strengthening of dominance.

Concentrations:

A comprehensive rule of reason approach should be applied

As regards concentrations, the dominance test applied under the Merger Control Regulation may not be sufficient. The well-established principle by which efficiencies are assumed up to the limit of dominance should not be applied as such. It should be understood, indeed, that dominance seems inherent to the New Economy, as it often involves emerging markets where little or no competition yet exists and that dominance is, in most of these sectors, fragile and temporary. Hence, even though the proposed merger creates or strengthens a dominant position, this should not automatically mean that effective competition would be significantly impeded in the common market.

Article 2§1 and Article 2§2 ECMR should be treated on an equal footing

Existing tools could be relied on but must be adapted in order to take into account efficiencies and the evolving nature of markets. In particular Article 2 (1) of the Merger Control Regulation referring to the development of technical and economic progress should be treated on an equal footing with Article 2 (2), which translates the classical dominance test, thus allowing a dynamic rule of reason test. The adoption of the Green Paper aimed at launching a broad public debate on the functioning of the merger control law is the perfect opportunity to suggest clarification of the wording of Article 2 and possible amendments to the Merger Regulation.

Agreements:

There is a clearly need for a new set of guidelines specifically addressing issues raised by portals, B2B and B2C marketplaces and infrastructure

In the field of agreements, a dynamic approach is already entrenched in Article 81 (3) in relation to the granting of exemptions. With respect to portals, B2B and B2C marketplaces, the new issues involved in the New Economy call for innovative and evolving case law. The new block exemptions Regulation and the guidelines on vertical restraints may not be sufficient.

With respect to infrastructure, the proposed new regulatory framework for electronic communications networks and services and the Draft Guidelines on market analysis and the calculation of significant market power are far from addressing all potential issues, as they are entirely based on traditional criteria. The objective of a new set of rules would be to prevent the refusal of access, the raising of rivals' costs, the degradation of the quality of the connection offered by competitors and price discrimination to attract customers away from competitors.

Complex commitments of structural and behavioural remedies are often inherent to New Economy cases

Concerning remedies, whilst divestiture is traditionally seen as the most efficient measure to solve problems of dominance and the less demanding one for competition authorities, it is however often very complex, costly and usually requires a long period of time. These disadvantages are even more problematic in New Economy industries, which often have complex intertwined activities and where time is of the essence. Competition authorities must be prepared to deal with more and more sophisticated packages of commitments, which include both structural and behavioural remedies. Even though such packages may cast doubts on the efficiency of the measures, it must be understood that this complexity is often inherent to New Economy industries.

The Commission should be prepared to deal with sophisticated packages of commitments

Sophisticated packages of behavioural and structural remedies should not be rejected on the mere basis of their complexity. As a result, further consideration should be given to systematically appointing an independent trustee, acting on behalf of the Commission, in charge of monitoring and enforcing remedies on an ongoing basis. This offers more guarantee of effectiveness.

In examining remedies, any suggestion that would at first seem acceptable should be weighed against its inherent potential adverse effects on the incumbents. Remedies should in no circumstance unreasonably favour competitors to the detriment of first entrant and consumers. In the long term, it is generally pro-competitive and in the interest of consumers to allow a company to retain for its use, at least for a period of time, facilities which it had developed for its own business. Particular care is required where the goods, services or facilities to which access is demanded represent the fruit of substantial investment. That may be true, particularly in relation to the refusal to license intellectual property rights.

The global nature of the Internet

A better international consistency of approach is required. Given the global and pervasive nature of the Internet, which in many cases will void national market definitions of real meaning, coordination in investigation and enforcement of antitrust will be vital. Developing common principles *calls for a better international consistency of approach*

in international antitrust in dealing with the effects of the New Economy should become a top priority. Concerning mergers in particular, they should be dealt with simultaneously by European and American authorities and decided upon within the same time frame. A forum focused especially on the substantive issues surrounding international antitrust enforcement is required. In that regard, the Global Competition initiative, supported from the beginning by the Commission, could be a suitable framework.

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FLOWCHARTS

- Flowchart I:

Identification and assessment of competition concerns: content-infrastructure - access providers

- Flowchart II:

Identification and assessment of competition concerns in B2B marketplaces and Portals

Identification of the different layers

♦ Information/content layer
. audio (music, radio)
. video (films), images
. texts (newspapers, books)

♦ Network infrastructure layer
.local access networks
.global network infrastructures
.backbone networks

♦ Access applications layer
.access devices
.access software
.search engines

<u>Convergence</u>

Network and digital convergence of the content layer (broadcasting, entertainment) with the infrastructure layer (telecommunications, electronic communications, ISP) and the access layer (software, browser…)

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Vertical integration may be beneficial to the production of innovative new content and services in the Internet industry. However, vertical integration involving either bottleneck holders or firms with strong positions in one of the converging sectors may also give rise to serious foreclosure effects

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1) <u>Assessment of market definitions, market shares and dominance in an innovative and</u> fast moving environment: relevance of short term substitutability, consideration for products innovation and functionality or other dynamic test, relevance of global impact of new technologies for geographic market definition.

2) Assessment of dominance in an innovative and fast moving environment: "Fragile monopolist", "winner takes most", permanent threat from innovative competitors, potential innovator entry imposes effective competitive constraints on dominant conduct.

3) Assessment of the impact of exclusionary practices: foreclosure can result from a refusal to deal, license or provide access to an essential or bottleneck facility, undue preferences and discriminatory practices (degradation of connectivity, raise of rival's costs), cross-subsidisation and predatory pricing.

4) Foreclosure harms competition if: (i) Nearly all affected rival's are affected, (ii) Their ability to compete is harmed, (iii) The foreclosed rivals do not have counterstrategies (such as the development of new products), (iv) Excluding rivals is profitable in view of the dynamic customer lock-in and network effects

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In order to assess foreclosure, market share and dominance, consideration should be given to the characteristics of the New Economy

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Specific characteristics of the New Economy

Fragile and challengeable leadership leading to temporary dominance; Innovation as a series of Winner-Take-All Races; High fixed costs and low marginal production costs; Network effects; First mover advantage; High risks for all; High rewards only for winners

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Whilst traditional competitive concerns are identified and assessed under a static analysis, these specific characteristics call for a more dynamic approach

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<u>Need for a dynamic approach</u>

Current tools should be used with a more prospective approach.
Efficiencies should be balanced with anti-competitive effects on an equal footing .

Timely remedies should be a balance between R&D investments of integrating firms and risks for competitors linked to network effects and first mover advantage.

Identification of the different intermediaries

♦ B2B Marketplaces
- Aircraft components (Myaircraft.com)
- Industrial automotive products (Covisint)
- Chemical industry (chememplorer)

♦ E-commerce
- Auction sales
- Retail sales
- Car sales
- Selective/exclusive distribution
- New intermediaries

♦ Portals
- Music, films (Vizzavi)
- horizontal portal (yahoo)
- Sport (Sportline)

New e-commerce intermediaries can generate efficiencies such as lower administrative costs, search costs, inventory costs, and allow cooperative buying or selling. However, due to first movers advantage these new intermediary can become dominant, which would lead to several anticompetitive effects such as market foreclosure and raise of rival's costs.

Competitive concerns

Risk of Dominance which can lead to monopsony power
Market foreclosure (upstream and downstream)
Raise of rival's costs (Undue preferences and discriminatory practices)
Refusal to access
Joint selling
Risk of free riding of traditional retailers

<u>Assessment of market shares and dominance in an innovative and fast moving environment.</u>

In order to assess foreclosure, market share and dominance, consideration should be given to the characteristics of the New Economy

<u>Specific characteristics of the New Economy</u>

Network effects; First mover advantage; sunk costs; markets can be tippy

Whilst traditional competitive concerns are identified and assessed under a static analysis, these specific characteristics call for a more dynamic approach

Need for a dynamic approach

Current tools should be used with a more prospective approach

Consideration should be given to the drafting of new notices or guidelines to deal with the specific concerns raised by portals and marketplaces

<u>ANNEX I</u>

COMPETITION ISSUES IN THE NEW ECONOMY
HIGHLIGHTS

COMPETITION IN THE NEW ECONOMY

Network effects. Network effects benefit customers, as they gain more value from a product or service in a networked environment. As a consequence, prices are lower but offers are standardized.

Furthermore, leadership by one or a few firms will tend to be the norm on a market with network effects.

Therefore, trying to prevent or counter network effects means reducing benefit to customers.

Soft durable goods. Digital products are useful for a long time, even though they may become obsolete.

Consequently, New Economy firms will have to compete for their installed customer base to buy their latest products. Innovation is therefore encouraged, as well as the need for firms to constantly "re-invent" themselves.

Series of contests. Competition in the New Economy often takes place for the market rather than on the market. Therefore, the most innovative firm can challenge very strong existing dominant firms, and win.

Competing on the Internet means that a category leader must continue to innovate and keep prices low.

High risks, high rewards. Since the flip side of leadership on the Internet markets is huge sunk costs, returns on investment would be expected to be higher to account for the risk of failure.

The traditional analysis about rates of profit in "perfect" competition is therefore inapplicable, as successful innovators must charge above their marginal costs to recoup their high fixed costs and risk.

Dynamic competition. In the domain of the Internet, competition is always a step ahead. Indeed, today's market leader can tomorrow be challenged by the next product or service; therefore, market power is temporary and fragile.

Legal framework & innovation. The consequence of these characteristics is that innovation must be protected at all costs.

To this end, taking a long-term view is essential, both for firms and for policy makers. Although, New Economy industries are intensely competitive, their competition dynamics are fundamentally different from traditional static competition models. Therefore, risks of (governmental) intervention causing harm to the competitive process and consumers are greater with short-term analysis.

These concepts must be borne in mind when assessing the competition concerns raised by vertical agreements and mergers in the New Economy.

Vertical integration may be beneficial to the production of innovative new content and services in the Internet industry. However, vertical integration involving either bottleneck holders or firms with strong positions in one of the converging sectors may also give rise to serious foreclosure effects.

THE DIFFERENT LAYERS OF THE INFRASTRUCTURE OF THE INTERNET

The structure of the Internet is organized around three separate elements:

- Information or content (audio, video, text, etc.);

- Network infrastructure (local access networks, global infrastructures, backbone networks);

- Access applications (access devices, software).

Internet infrastructure is based on separate but complementary elements

At first sight, these three elements can, and indeed do, stand on their own. Nevertheless, all three rely on one another to make the Internet what it is.

For example, special software is needed to access video content through the network, while access applications are useless if they do not allow the user to get the kind of content he wants. Similarly, the network by itself is useless unless it provides access to desired content.

This inter-dependence of all three layers of the Internet is widely predicted to lead to *"digital convergence"*, where content, network and access applications will tend to adopt common standards, so that they can perform the same functions from anywhere regardless of the type of user.

Digital convergence might be reduced due to the dynamic nature of the Internet

This digital convergence could lead to the creation or strengthening of dominant positions held by those firms setting the standards, or those whose activity (be it content, network or access applications) stands as a "must".

Still, the dynamic nature of the Internet markets is deemed to have a *"self correcting"* effect on this standardization.

A dominant firm cannot rest or capitalize on past successes, as its position can be threatened by a more innovative firm, which will change the standard for its own.

Innovative firms benefit from a competitive advantage

A firm's market position is therefore closely linked to innovation, which requires heavy investments in R&D.

These sunk costs will only be recovered by a firm if it benefits from *"positive network externalities"*, i.e. if its activity attracts more and more users and surpasses the previously existing standard.

Nevertheless, in view of the huge amount of sunk costs borne by firms present at a given layer of the infrastructure, they will try to maintain their advantage through anti-competitive behavior, for example limiting interoperability or interconnectivity to lock consumers in their service.

Competition policy must take into account the risk of innovation

Such behavior is considered, at least in economic terms, to be the reward for the high risk taken by the firms in innovating.

Therefore, the challenge for competition policy is to seek a balance between the positive effects of innovation (enhanced competition in prices and R&D) and its adverse effects (*"winner takes most"*).

ASSESSMENT OF COMPETITION ISSUES LINKED TO VERTICAL INTEGRATION IN THE INFRASTRUCTURE OF THE INTERNET

The main competition issues raised by vertical integration in the infrastructure of the Internet concern market definition criteria and impact of practices on such a dynamic market.

- ***Market definition***

Emphasis must be put on the impact of (future) innovation

Product market. The current approach to market definition is in large part static, and pays little attention to innovation. This is shown by the particular importance attached to price elasticity and short-term substitutability in the Commission's notice on the definition of the relevant market. It is also aggravated by the fact that technical characteristics are only taken into account to assess barriers to entry.

In contrast, the dynamic nature of the Internet requires that product innovation and functionality be considered not only as barriers to entry, but as part of a product's characteristics.

Geographic market. Similar concerns are raised by the geographic definition of the market.

Does a global network environment imply a global market?

Where the core of the business in the infrastructure of the Internet is access and interconnection, the balance between a (too) narrow or (too) wide definition of the market will in a great respect depend on the firms behaviour and incentive to develop.

Market shares. The current criteria for definition of the market share in turnover may be inapplicable in many situations linked generally to the Internet.

Calculation of market share in turnover may be irrelevant

As far as Internet infrastructure is concerned, a firm's turnover may not reflect its importance on the market, while traffic or number of users may be more significant.

With respect to market share calculation, it might be advisable to establish criteria different from those currently applicable.

- ***Dominance and foreclosure***

Dominance. In the fast moving environment of Internet infrastructure, it should be kept in mind that New Economy monopolies are fragile, as they are under constant threat from innovative competitors.

Dominance is never definitely established over the market

Even if it is true that the dynamic configuration of the market creates "winner take most" situations, these can still be challenged.

As a consequence, a dominant position on the market does not automatically lead to reduced competition, and may in fact enhance competition.

Foreclosure. When a firm can exercise a decisive advantage on the market (be it through holding a bottleneck facility or important market power), foreclosure can appear.
However, as stated above, foreclosure will only be deemed to exist where it has obvious negative effects, such as:

Foreclosure affects rivals where no alternative exists

- Nearly all rivals are affected,
- Their ability to compete is harmed,
- They do not have an effective counterstrategy or alternative,
- Excluding rivals is profitable in view of lock in and network effects.

- ***Typology of anti-competitive behavior linked to foreclosure in Internet infrastructure***

Foreclosure may appear in two types of situations:

Exclusionary practices and leveraging are likely to appear

Exclusionary practices. A non-exhaustive list of these practices includes refusal to deal, license or provide access to an essential or bottleneck facility, undue preference, discriminatory practices (degradation of connectivity), cross-subsidization and predatory pricing. The main point is that access to the market will be reduced.

Leveraging. Leverage practices are likely to appear when a firm takes advantage of its position at one level of the chain to reduce competition on either the upstream or downstream market. Bundling and the imposition of technological standards are the most common leverage practices.

When assessing all of these concerns, specific consideration should be given to the characteristics of the New Economy, which leads us to a more dynamic approach to the market.

With respect to infrastructure:

- The current tools should be used with a more prospective approach;
- Efficiencies should be balanced with anti-competitive effects on an equal footing;
- Timely remedies should involve a balance between R&D investments of integrating firms and risks for competitors linked to network effects and first mover advantage.

2 COMPETITION ISSUES IN E-COMMERCE

New e-commerce intermediaries can generate efficiencies such as lower administrative costs, search costs, inventory costs and allow cooperative buying or selling.

However, due to first mover advantage, these new intermediaries can become dominant on their market, which would lead to several anti-competitive effects such as market foreclosure or the raising of rivals' costs.

THE NEW INTERMEDIARIES OF THE INTERNET

The development of e-commerce has introduced new trading patterns that create two parallel markets for trade of the same goods or services, and give rise to a variety of new intermediaries.

Some aspects of e-commerce are expected to facilitate trading by reducing certain costs, while anti-competitive effects may be aggravated by the new dimension given to trading practices.

E-commerce aims at reducing costs, for both firms and consumers

E-commerce relies on three main categories of intermediaries:

- Marketplaces (B2B and B2C);
- Portals;
- Commercial websites.

Each and every type can be combined, in order to gain efficiency and to reach more customers. For instance, *Yahoo!* was originally intended primarily as a portal, but it now has an e-commerce section, and offers B2B services to enterprises.

ASSESSMENT OF COMPETITION CONCERNS LINKED TO VERTICAL INTEGRATION IN E-COMMERCE

- ***Market definition***

Innovation & dynamic approach

Dynamic approach. The same basic concerns are raised by the market definition for e-commerce as for infrastructure.
Here again, innovation plays a significant role when assessing substitutability between goods and services. In the same way, technological requirements are important as regards market participation.
In addition, the geographic scope of the market will tend to enlarge, as goods and services can be accessed and ordered in any

part of the world (even though language may restrict market definition.)

Specific concerns linked to the product market. One characteristic of the market for e-commerce lies in the fact that goods or services sold over the Internet may have no equivalent or no exact substitute on the traditional market.

The typical situation is that of e-mail and other digital services.

Specificity of the product market for goods with "Internet added value"

More complex is the situation of a real good sold over the Internet with an "added value." This added value will result from the "opportunity cost" for the customer. As in most instances the customer does not only buy a product but also a service (delivery, insurance, etc.), it may be considered that the actual good he buys differs from the one he could buy on the traditional market.

It could thus be argued that there is a separate product market for goods sold with "Internet added value".

- ***Assessment of dominance and foreclosure***

While the same practices are likely to be implemented in both commercial websites and e-marketplaces (*see infra 2.3*), the assessment of dominance and foreclosure must distinguish between the two situations.

Commercial websites. The main issues related to commercial websites are linked to the existence of distribution networks.

The main issue is linked to distribution networks

A free rider problem can occur when a distributor or supplier takes advantage of the promotion efforts of another distributor to sell his own products. Free riding can affect both traditional retailers and "e-retailers" by infringing on their territories.
Such a risk is partially taken into account by the Commission's Guidelines, but uncertainties remain as to the criteria a distributor may use when setting up a distribution network.

In a *refusal to supply*, a distributor may prohibit the sale of his products on the Internet, provided that he does so in accordance with transparent selection criteria.

Definition of active and passive sales is a key question

Nevertheless, the question of the definition of active and passive sales is likely to be a point of controversy between the supplier and his distributors.

Marketplaces. When an online marketplace is owned by a number of major buyers or sellers in a market, there is a risk of second-tier or small third-party buyers or sellers being denied access to the market, or alternatively being given access only on such unfavorable terms that they would not be in a position to compete effectively. This could lead to market foreclosure or raising of rivals' costs.

Private marketplaces are likely to be "tippy"

Dominance can occur when the owner of a marketplace is the most important buyer and/or seller on the market. Indeed, as a result of network effects, the more buyers a marketplace attracts, the more likely any seller will be able to find a buyer; this also holds true for buyers.

Foreclosure, dominance and monopsony power are enhanced by exclusive dealing agreements

Foreclosure will be enhanced where exclusive dealing agreements are concluded in the marketplace, be it through the ownership of the marketplace or through agreements with suppliers. In this situation, foreclosure will be apparent not only on the downstream market, but also on the upstream market.

The risk of monopsony or buyer power might also occur when a marketplace attracts the most important actors on a market.

The assessment of dominance will depend on whether or not the market definition includes goods traded on the traditional market.

- ***Typology of anti competitive behavior in e-commerce***

Price discrimination. The possibility to personalize the product offer, combined with the capacity to obtain information about a given customer and his buying behavior makes price discrimination possible.

Advanced technology allows discrimination

Such discrimination can take different forms, from price matching policy to different degrees of convenience on a website.

Bundling. A producer can increase his profits by selling several goods together under certain conditions. In information goods, bundling over the Internet occurs where a customer cannot always purchase *à la carte*, but must buy the entire group of bundled products.

Bundling may deter market entry

This strategy may deter market entry and encourage predatory practices.

Lock in. The cost faced by a customer when he is willing to switch from one technology to another may lock him in to the former. Lock in may result in switching costs for customers, both in loss of money and in loss of time.

The Internet favours such practices in response to fierce competition motivated by reduced search costs (through search engines and shop bots).

Consumers may be locked in by a service

Lock in practices can result in increased market power, and cross subsidizing (financing the acquisition of old consumers by imposing higher prices on new ones, which is rendered possible by network externalities).

Brand name and confidence. Online purchasing does not always offer the possibility of judging all the qualities of a good and thus requires a certain confidence in the website on the part of the consumer.

Brand recognition is a key to success

Consequently, the building of a brand may constitute a barrier to entry, in particular for Internet pure players.

3 THE NEED FOR A DYNAMIC APPROACH

The context of the New Economy requires competition authorities to shift their focus towards a more dynamic view of competition. Unlike price/output decisions, analysis of dynamic competition requires evidence about, among other things, the pattern of investment in developing new products, the control of critical assets (particularly intellectual property and distribution channels) and the beliefs of market participants and informed observers about the nature and pace of innovation. In particular, one must consider the vulnerability of leading firms to potential new entrants as a result of drastic innovation.

A NEW APPLICATION OF EXISTING TOOLS IS REQUIRED

The EC Merger Regulation. In our view, the dominance test is far too narrow in the context of the New Economy, and Article 2§1 referring to the development of technical and economic progress should be given more consideration in such an innovative environment.

Agreements. As regards agreements, a dynamic approach is already central to Article 81§3 in relation to the granting of exemptions. In its assessments under this clause, the Commission systematically balances anti-competitive harms with pro-competitive efficiencies.

Innovative case law. A dynamic rule of reason test should be applied.

CLARIFICATION OF EXISTING INSTRUMENTS & ESTABLISHMENT OF NEW GUIDELINES

- ***With respect to concentrations***

As stated above, clauses 1 and 2 of Article 2 of the ECMR should be treated on an equal footing, therefore reversing the current principle by which *"efficiencies are assumed for all mergers up to the limit of dominance."*

Dominance is fragile and temporary

Dominance can be considered as inherent to the New Economy, as it involves emerging markets with little or no competition. Dominance is thus fragile and temporary in an innovative environment.

Market power

Dominance therefore does not necessarily lead to reduced

must be prospectively approached

competition on a market.

As a consequence, the traditional monopoly test used to appraise market power should be applied with a prospective approach. In particular, the lack of information relating to historical price fluctuations and movements should be put in phase with the functionality of the products.

- ***With respect to agreements***

The new BER and guidelines on vertical restraints, far from dealing with all New Economy issues, seem to have been designed to provide guidance for traditional sectors, with limited consideration to the Internet when included in their distribution networks.

The BER and guidelines deal only with distribution network issues

In the same manner, the issues raised by marketplaces, be they B2B or B2C, are not dealt with.

It thus appears necessary to establish specific guidelines addressing the issues raised by the broad distribution of goods on the Internet, rather than trying to adapt existing guidelines that were not designed for this purpose.

The review should also pay attention to market definition and dominance, in a more dynamic way.

The rules should be clarified for *portals*, as they involve a very specific activity.

These rules should ensure that customers can choose their content provider independently of their access provider, and that they are allowed access to competing portals.

Competition rules must have "non discriminatory access" as their motto

For marketplaces, the new guidelines should ensure that the marketplace is opened on a non-discriminatory basis, and does not allow undue exchange of information between competitors.

As regards infrastructure, the new or proposed guidelines are far from addressing all the issues, as they are based on traditional criteria. They should take into account all the special problems linked to network access.

REMEDIES

As shown by the Commission's case law concerning telecommunication networks, the key concern is that of access.

This holds true for both infrastructure (access to the local loop, to the POP, etc.) and e-commerce (access to portals and marketplaces).

- ***Behavioral and structural remedies in the New Economy***

Although the Commission has broad discretion to impose remedies, it is still reluctant to impose behavioral remedies, as it considers them inefficient.

Remedies must not only sanction, but also protect customers

Nevertheless, as the US competition authorities are well aware, structural remedies are not always a solution, as the divested activity often cannot stand alone.

Therefore, what should be kept in mind is whether or not the proposed undertakings by the firms are appropriate to solve the competition concerns. This is particularly true in a fast moving environment such as the New Economy where divestiture can deprive a firm of its core components.

Remedies must not be imposed as a sanction for dominance over a market, but must take into account efficiencies for customers.

- ***Towards sophisticated packages of remedies***

With this in mind, packages of remedies, including both structural and behavioral remedies, should be the norm.

This trend is shown in the latest decisions taken by competition authorities on both sides of the Atlantic.

Complex undertakings will tend to be the norm

The Commission should not be put off by the complexity of the task, which could, for example, involve the nomination of a trustee or the setting up of a specific "task force".

Moreover, the Commission should not reject complex commitments made by firms for the sole reason that they are complex.

NEED FOR INTERNATIONAL CONSISTENCY OF APPROACH

International cooperation in the field of competition policy is required now more than ever due to the special characteristics of the New Economy.

Indeed, as not all markets around the world have reached the same maturity, a decision taken by one national authority may harm competition on another national market.

Given the global and pervasive nature of the Internet, which in many cases will make national market definitions impossible, coordination in investigation and enforcement will be vital.

New Economy issues extend beyond the limits of a national competition territory

Antitrust decisions of the future will have more and more global implications and will increasingly raise complex global enforcement issues.

Developing common principles in international antitrust in dealing with the effects of the New Economy will become a top priority issue.

In this regard, the Global Competition Initiative must be even more fully supported and endorsed by competition authorities than it is today, as it could prevent national authorities from taking conflicting decisions.