Gide Loyrette Nouel **November 2001**

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

Final Report

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INTRODUCTION

The growth, integration and sophistication of information technology and communications is changing our society and economy. Consumers now routinely use computer networks to identify sellers, evaluate product and services and compare prices. Businesses use networks even more extensively to conduct and re-engineer production processes, streamline procurement processes, reach new customers and manage internal operations.

There has been a debate on whether or not these changes 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 modernization of what exists already nor to the straightforward development of a new form of commerce that would take a significant share of the market.

Instead, 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 or media – such as the Internet – which make accessing, processing and storage of information increasingly cheaper and easier.

These new electronic and communication technologies are changing the ways markets operate. In particular, the development of electronic commerce, which may mesh virtual functions and functions that continue to involve physical media, encourages the emergence of a new type of economy based on worldwide communication networks, offering a wide coverage and knowing no frontiers, at a cost that will eventually be nominal.

In this context, it is useful to think about the "New Economy" as having two primary components:

- ***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;

- ***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 time in the supply chain.

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[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.

To meet the increased demand for electronic transactions, consumer electronic companies, media companies, phone companies, computer companies, software firms, satellite builders, Internet Service Providers and television cable companies are investing in the E-economy infrastructure to build out and develop new technologies to allow higher-bandwidth electronic and digital communication networks.

Similarly, the diffusion of these new technologies and the advances of digital electronics open up new commercial opportunities for electronic transactions and constitute a strong driver for an even more profound transformation of industry structures, business models and business relations.

The emergence of this new type of economy means radical change in sale practices, in strategies for winning market shares, in relationships between customers and suppliers and in modes of industrial structures.[2]

The development of the New Economy has indeed introduced a new way for trade that:

- results in more vertical integration between firms into the different layers that enable the flow of information between suppliers and customers (the infrastructure layer, the information content layer and the access applications layer);

- gives rise to a variety of new intermediaries on the virtual markets, such as online marketplaces and portals, when vertical separation is a more efficient structure than vertical integration;

- brings about two parallel markets for the trade of the same goods or services that co-exists in the same space at the same time: the internet-based one and the traditional one;

- is likely to break the traditional patterns of distribution by reducing the traditional role of intermediaries (dealers, distributors or franchisees) and by facilitating the direct distribution of goods from the supplier to customers on the virtual market.

Accordingly, competition strategies in the New Economy are distinct from strategies in other sectors of the Economy, and competition policy must be attuned to some strategies that firms are employing

While certain characteristics of the New Economy might be expected to facilitate entry and reduce certain costs, with the benefit of greater competition being passed on

2 For an overview of the evolution of firms' distribution strategies in the context of the New Economy in five sectors (Car, Retail distribution, Perfumes, Entertainment, Software), see Annex II.

to the consumers, it can also encourage or facilitate certain types of anti-competitive behavior between firms that try to take advantage of the New Economy, notably in the field of vertical agreements, and so reduce competition. Similarly, the current trend towards vertical integration in the supply of infrastructure, terminal equipment (be it PC, TV or mobile), product standards, operating and addressing systems and internet-related services may lead to significant change in the functioning of the market and serious distortion of competition. The strategy of the telecommunication operators which have created spin-off subsidiaries that act as internet providers, offer wide range portal services and also expand in internet-related services is a good illustration of this trend.

New Economy industries, being involved in a fast moving and rapidly changing environment, are particularly susceptible to changes in competition and thus deserve a close and appropriate antitrust scrutiny. The application of antitrust principles should take into account the important ways New Economy industries differ from traditional ones. Particularly, it must reflect the features of these dynamically competitive industries that differentiate them from more statically competitive industries that can be found in large parts of the old economy.

There are three important implications of New Economy features for antitrust economic analysis. First, the rational expectation of significant market power for some period of time is a necessary condition for dynamic competition to exist in high technology industries. Thus if dynamic competition is healthy, the presence of short run market power is not a symptom of a market failure that will harm consumers. Second, given the high level and the cost of investments in the New Economy, one can expect New Economy industries to charge prices well above marginal cost. Therefore high profits cannot be a reliable indicator of market power. Third, a key determinant of the performance of New Economy industries must be the vigour of dynamic competition, an issue underdeveloped under traditional European antitrust analysis.

All traditional schemes of analysis have therefore to be reviewed and a dynamic approach has to be adopted as regards New Economy industries. Competition in high tech industries is fundamentally different from that in more mature and stable industries. Some of the traditional techniques used to define and measure market power in antitrust analysis may not be appropriate. High tech industries are typically characterised by high levels of product differentiation and dramatic shifts in firms' market positions. Thus applying traditional methods yield narrow market definitions and market power may be exaggerated. Some "new" sets of criteria for antitrust analysis of high technology markets concerning the definition of the markets and the evaluation of market power must be considered. A wide-angle lens is needed to assess competition in dynamic markets. This includes the way technology competition occurs and its several dimensions as customer needs and responses to product innovation. This can help improving the way some traditional criteria are used in practice.

The objectives of this study are twofold. First it aims at identifying the specific competition issues linked with vertical integration between firms involved in the E-economy infrastructure and with vertical transactions (Title I). With respect to E-economy infrastructure and facilities (Chapter I), this requires analysing the functions of the different layers involved in the electronic infrastructure (the information/content layer, the network layer, the access application layer), the characteristics of these sectors (dynamic competition, network effects) and the evolution towards a great network convergence. Concerning E-commerce transactions and vertical distribution strategies (Chapter II), the study provides an economic presentation and analysis of the characteristics of the prices on the Internet and of the opportunities that e-commerce offers to firms (for example: price discrimination and bundling).

Secondly, the study analyses the adequacy of European competition rules (Title II) to deal with the specific New-Economy concerns and to face the issues of the definition of markets, the calculation of the market shares and the appraisal of dominance (Chapter I). In this respect, the study provides for a comprehensive comparison between the E.U. and the U.S. approach to vertical mergers and agreements, proposes possible methods for improvement of competition assessment, based on a more dynamic approach, and attempts to suggest a series of possible remedies and recommendations[3] (Chapter II).

In order to facilitate the analysis, an illustrative methodology of approach for identification and assessment of competitive concerns in a fast moving and innovative environment is provided in Annex I.

[3] From a competition perspective, it has to be noted that the economic consequences of mergers and agreements between firms are to some extent similar. In both cases, the number of market players acting independently from one another is reduced, and therefore the risk of endangering competition potentially rises (all other things being equal). As the differences between mergers and agreements mainly lie in the realm of legal and institutional consequences, but much less so in the sphere of market implications, this study will treat mergers and agreements as two very closely related economic strategies. Thus, even though some subsequent sections primarily deal with mergers, whereas others focus on agreements, it should be kept in mind that in these cases the thrust of the arguments also applies to the other alternative of organising business relations. However, where there is a genuine difference between the two, this will be clearly mentioned.

TITLE I

MAIN E-ECONOMY CHARACTERISTICS AND POTENTIAL ANTI-COMPETITIVE IMPACTS

CHAPTER I

MAIN ECONOMIC CHARACTERISTICS OF E-ECONOMY FACILITIES AND POTENTIAL ANTI-COMPETITIVE IMPACTS OF VERTICAL INTEGRATION STRATEGIES

CHAPTER 1

MAIN ECONOMIC CHARACTERISTICS OF E-ECONOMY FACILITIES AND POTENTIAL ANTI-COMPETITIVE IMPACTS OF VERTICAL INTEGRATION STRATEGIES

Vertical mergers may raise the ability to foreclose competition

Because vertical mergers typically involve companies operating at different but complementary levels in the supply chain, vertical integration is generally deemed to yield efficiencies in the companies' way of doing business rather than to lessen competition. Vertical mergers may, however, raise competition concerns where the resulting integration gives the merged firm the ability and the incentive to foreclose competition upstream or downstream in the vertical chain (vertical foreclosure effects).[4]

Typically, vertical foreclosure effects are likely to arise where a firm controlling an essential facility or otherwise having sufficient market power at one level of the supply chain can deny or limit market access at another level of the supply process or leverage its market positions into related markets.[5]

Competition issues raised by vertical integration between firms that try to take advantage of the New Economy are not likely to differ fundamentally from issues raised by vertical integration between firms active in traditional markets.

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4 For a review of the economic literature on vertical integration and vertical foreclosure, see Annex II. .

5 For a summary of the European Commission's policy in respect of vertical aspects of mergers and joint ventures, see Michael Reynolds, "*Mergers and joint ventures: the vertical dimension*", p. 153, International Antitrust Law and Policy (1997) and, for more recent developments, the speech by Götz Drauz, "*Recent developments in the assessment of dominance*", EC Merger Control 10th anniversary conference (2000). For a summary of the European Commission's recent decisions involving the media and Internet sectors, see Giuseppe B. Abbamonte and Valérie Rabassa, "*Foreclosure and vertical mergers – The Commission's review of vertical effects in the last wave of media and internet mergers: AOL/Time Warner, Vivendi/Seagream, MCI Worldcom/Sprint*", [2001] E.C.L.R., p. 214.

The proper analysis of vertical mergers may take a special set of complications

However, the proper analysis of potential adverse effects of vertical mergers in the E-economy infrastructure may take on a special set of complications because of the specific economic characteristics of New Economy markets.

Those characteristics, which are important determinants of market structure and competitive behaviour, include dynamic non-price competition, rapid innovation, large uncertainty not only in profit accounting but also in marketplace, strong network effects in demands and multi-product supply conditions.

The application of competition law must deal with specific economic characteristics

As a result, competition in New Economy markets tends to be dynamic and high-tech, with innovation as a key competitive factor. The application of competition law to such innovative industries must therefore deal with those economic conditions by preserving competition – so as to promote efficiency and maximize consumer benefits in the long run - without unreasonably undermining incentives to innovate.

Therefore, before identifying potential foreclosure effects that can result from vertical integration in the different layers of the E-economy infrastructure, it is useful to explore in more detail the economic characteristics of the E-economy infrastructure[6] that are particularly relevant in assessing the impact on competition of vertical integration in this sector.

6 A detailed presentation of the infrastructure and access mechanisms necessary for delivery of e-commerce services is provided in "*Competition in e-commerce: a joint OFTEL and OFT study, consultation document*" (April 2000) and "*The role of telecommunications and information infrastructures in advancing electronic commerce*", OECD, Paris, 4 May 1999. Technical descriptions of the Internet can also be found on *http://info.iso.org/home.html* and *http://www.iec.org*.

Section I.

Main economic characteristics of the E-economy facilities

1. The vertical structure of the E-economy infrastructure

E-Economy infrastructure increasingly depends on vertically related activities

As indicated above, the E-economy facilities include the different facilities and services necessary to support and conduct electronic transactions. The essential feature of the E-economy facilities is its increased dependence on a wide and diversified set of vertically related activities, which must be combined efficiently if the yield of the ultimate products or services is to be maximised. These activities can be divided into three basic different conceptual layers: the information/content layer, the network infrastructure layer and the access applications layer.

1.1 The information/content layer

The content layer contains the information and services of direct value to the user such as communication services, all types of information, be it voice, text (newspapers, magazines, books, etc…), images, audio (music, radio), video (movies) and data as well as evolving content, including on-line games and interactive shopping.

Content is becoming of central importance in the chain of the E-economy infrastructure.

Content can either be "*real-time*" or "*downloadable*". Real time content is data that can be accessed as if it were communicated at the same time as the user who is accessing it. By contrast, '*downloadable*" content consists of data stored for retrieval. It generally takes the form of a file that can be copied from the Internet to the user's own PC. The user may then exit the Internet and use his own applications to read or view the file.

With information technology moving towards electronics and digitalisation, content is becoming of central importance in the value chain of the E-economy infrastructure.[7] Networks will evolve to deliver increasingly rich content and eventually full broadband multimedia. Similarly, terminal devices and network infrastructures will advance to display content in colour, full video and high fidelity stereo.

[7] For an opposite view, see "*Content is not king*", Andrew Odlysko, AT&T Labs – Research, January 3, 2001, available at http://www.research.att.com.

The flexibility of digital information creates greater possibilities.

As underlined by the EU Commission, the flexibility of digital information therefore creates the possibility for more and enriched conventional services (such as digital television and radio) as well as a range of new services and applications. "*These new services are as varied as electronic newspapers, on-line supermarkets, marketplaces and catalogues, home-banking and the use of multimedia web sites*".[8]

The holding of right over key content may give particular market power

Against this framework, it is foreseen that content companies will converge into the digitised content business. Indeed, content becomes increasingly valuable once digitised, as it can be reproduced perfectly and transmitted instantaneously to almost any point of the planet. This convergence of content businesses, which has already been ongoing for some time, is likely to lead to the creation of large content entities, such as Time-Warner, which owns magazine and book production, television programming, movies, music labels, sports teams and cartoons. Most importantly, from a competition point of view, is that possession of rights over key content - or '*Premium content*" - may give market players particular commercial power**.**

Interoperability of networks and communication is essential

1.2 The network infrastructure layer. The Internet constitutes the dominant core network used for electronic transactions.[9] It is usually defined as a packet-switched network of interconnected and overlapping networks designed for data transfer, delivery and retrieval, which use standardized protocols, among which the TCP/IP protocol is the most important, to exchange traffic. The success of the Internet therefore lies in the interoperability of networks via gateways and communication via a standard protocol.

ISPs connect to both local and global networks

Internet Service Providers (ISPs) provide the link ("*internet connectivity*") between the Internet infrastructure and end-users, whether independent computer networks or individual end-users. To this purpose, they are usually connected to both local access networks (local networks) to provide local access and through packet-switched networks (global networks) to process traffic and provide connectivity to the Internet at large.

Most customers still connect using a PC and a modem Alternative local

1.2.1 Local access networks. The first and last link in the chain is the connection between the end-users and the nearest point of presence (POP) of the ISP. Physically, POPs are modem pools or racks with routers, to which the end user can connect via local access networks (local loop[10]).

8 Commission Green paper on "*the Convergence of the Telecommunications, Media and Information Technology sectors and the implications for Regulation – Towards an Information Society Approach*", COM(97)623, p. 11.

9 Some electronic commerce activities may also take place on proprietary or other networks that are not technically part of the Internet.

10 The local loop is defined as referring to the "*physical circuit between the customer's premises and the telecommunications operator's local switch or equivalent facility*", page 3, Communication from the Commission "*Unbundled Access to the Local Loop: Enabling the*

connection are being deployed, using a variety of new higher bandwidth technologies

In Europe, most customers still connect with their ISP over the PTSN (known as "*dial-up access*", typically using a computer and modem over the telephone network). Alternative local connections[11] are being deployed using a variety of new higher bandwidth technologies (broadband access link).

These include access via digital subscriber line systems (ADSL), cable modems, leased lines, broadband fixed wireless, mobile, radio[12] and satellite.[13]

These developments in broadband technologies will, over time, make access to the Internet faster. In particular, broadband local connections, which function at speeds hundreds of times faster than today's dial-up telephone connections, will allow users to send and receive text, images, audio, and video with virtually no delay. Additionally, broadband will offer the benefit of an "*always on*" connection, eliminating the need to log on and off.

Access providers are getting a greater potential to influence the end-to-end process

In addition to phone and cable lines, communications companies are investing in the full range of technologies that may provide increased broadband availability. As upgrade of local networks is crucial for the delivery of these new services or applications, and as services are not supplied over a switched any-to-any network, the operator owning the local access lines will have greater potential to influence the end-to-end process.

Owning the "*final mile*" of the infrastructure allows companies to offer

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competitive provision of a full range of electronic communication services including broadband multimedia and high-speed internet", COM (2000) 237 final.

11 According to the European Commission, "*none of these alternatives can be considered as an equivalent. (…) While this may over time change, at present none of these alternative networks, nor even their combined use, can for the purpose of delivering retail narrow and large bandwidth telecommunications services be considered as a nation-wide alternative to the incumbents' copper pair*". See Communication from the Commission, "*unbundled Access to the Local loop: enabling the competitive provision of a full range of electronic communication services including broadband multimedia and high-speed Internet*", COM (2000) 237 final, pages 6 and 7.

12 For example, BLR Services, which possesses a local loop radio license in the Rhône-Alpes region of France, has launched an offer of broadband Internet access in Lyon, with technical facilities provided by Lucent Technologies. The company has just connected the first test clients, notably Tele and Infonet, that benefit from broadband services going from 512 kb/s to 2Mb/s. The proposed rates, based on volumes and duration, are 30 to 40% less than the rates usually offered on the market. After the Rhône-Alpes region, BLR Services will extend its offer to the regions of Alsace, PACA and Midi-Pyrénées. The operator intends to cover 17 cities in eight regions by the end of the year.

13 According to a recent Commission study, accessing the Internet over TV Networks using a cable modem or over traditional telephone copper network using the ADSL technology will rapidly become the most popular ways to get on-line at a high speed in the E.U. By 2005, they could together account for more than a half of all Internet connections to homes/SMEs. See the full report, "*The Development of Broadband Access Platforms in Europe*." August 2001, available at http://europa.eu.int/information_society/eeurope.

tailored interactive services and direct traffic toward a portal.

The portal site can in turn be used to generate valuable revenue to support the infrastructure and service provision. As underlined by the joint OFT and OFTEL Report, this means that "*access providers (those providing the local link to customers) are taking a more pivotal role as they gain the ability to control the services and content provided to users*".

1.2.2 Global network infrastructures. The Internet network is a virtual network, usually built on top of facilities and services provided by public telecommunications operators (PTOs), designed to allow data packed traffic to be exchanged between ISPs at large and consisting of switching equipment and routers connected by communication lines.

Global Network infrastructures are designed to provide full connectivity

The underlying physical structure of most Internet networks consists essentially of the same physical configuration of the underlying network used for conventional switched voice telephony. However, Internet data packets are not normally sent over the PSTN but rather over Packet Switched Data Networks (PSDN) engineered to provide point-to-point (i.e, from one Internet exchange point to another) data transmission of so-called packets by using different types of switching technologies (such as X.25, Frame Relay or ATM) and routers.

In order to build their own Internet network, ISPs can either lease lines, which may be combined with their own infrastructure, or buy virtual network such as Frame Relay or ATM from network infrastructure providers, which can serve to some extent the function of leased capacity.

Internet network operated by ISPs may have varying coverage but most ISPs have limited facilities usually only covering a region or even a local area. In order to provide full connectivity to their customers, these operators must either interconnect their networks by peering agreements or buy "*transit*" services to an intermediary carrier for delivery to the network where the addressee is connected.[14] These operators are either referred to as "*secondary peering*" ISPs when they are able to deliver some connectivity on their own (called "*second-tier*" connectivity) but also have to supplement it by buying transit services and resellers ISPs when they only supply resold connectivity from larger ISPs.

Only a small number of large ISPs have nationwide or international networks capable of transporting large volume of data around the world. These are referred to as "*Top-level ISPs*" (or also "*Tier 1*" Internet Backbone Providers).

[14] For more details on this question, see below.

Growth of traffic and new interactive services & applications require higher bandwidth

This market segment is experiencing fundamental changes. First, the explosive growth of Internet traffic and the introduction of new applications which rely upon the transmission of large quantities of data, have made it essential for ISPs to constantly increase the capacity (i.e., bandwidth) of their own networks and of the facilities through which they interconnect with other networks. As mentioned by the Commission in its *WorldCom/MCI* Decision, the increased demand for Internet traffic and capacity has led the industry *"to rely less on facilities originally installed for voice telephony. Newer networks, and upgrades to networks, are increasingly having to be completed with large capacity cable facilities conceived specifically with Internet use in mind".*[15]

In response, operators are investing in new broadband networks

Second, network service providers in today's deregulated telecommunications market have a tremendous opportunity to build competitive network architectures. Whereas in monopoly markets only incumbents could build and operate infrastructure, the opening of markets has attracted a massive amount of investment funds, the demand for fast access being a major driver of network investments.

In response to the growing demand for bandwidth, traditional PTOs and new entrants are constructing broadband networks across both the Atlantic and Pacific. These long distance backbone networks are being integrated on an end-to-end basis with pan-regional networks in North America and Europe as well as, to a lesser degree, on an Asia-Pacific basis.

The corollary of this increased amount of capacity is that the market is developing new ways for users to buy and purchase capacity at wholesale rates, which are coming to resemble those of traditional commodity markets.[16]

Technological developments will allow the emergence of integrated services networks

Finally, technological developments – in particular advances in fibre optic technologies, broadband transmission technologies and switching technologies – are enabling networks, on the one hand, to be installed with huge increases in capacity allowing transmission of large quantities of information and, on the other hand to be run with less complexity and more flexibility.

15 Case IV/M.1069, *WorldCom/MCI*, Decision of the Commission of 8 July 1998, paragraph 21, O.J. L 116 of 04 May 1999, p. 1.

16 On this issue, see "*Building infrastructure for electronic commerce – leased line development and pricing*" OECD Report of 14 June 1999, Paris, DSTI/ICCP/TISP(99)4/FINAL.

The development of these technologies will eventually allow the emergence of integrated services networks that, unlike existing networks (which are restricted as to the type of information), can provide a range of multimedia services, offer high speeds and process data, voice and image on a unified network that can be operated and managed cohesively with unprecedented flexibility, simplicity and manageability.

The emergence of such a new multiplayer infrastructure therefore presents the potential to revolutionize the way networks are built. Service providers who embrace this new technology and construct the new converged network have the opportunity to build unprecedented competitive advantages into their networks and to achieve market leadership.

The level of investment required provides an incentive to enter into applications

In addition, the convergence of network infrastructure allowed by digital technologies and the significant expansion in the range of services, which can be carried on these networks will result in important economies of scope and scale. This factor is already resulting in a large number of mergers, joint ventures and other types of co-operative agreements between firms in the telecommunication and content industries. The high level of financing required for building broadband network infrastructures provides an incentive for large network operators to enter into application areas, i.e. interactive services and content, in order to generate additional revenue sources.[17]

ISPs strongly depend on accessing to all or the majority of the networks

1.2.3 Internet traffic exchange between networks. Packeted traffic sent by end-users to their ISPs is either terminated on the same network, when it is intended for another subscriber connected to this network ("internal traffic"), or exchanged between ISP networks in order to be delivered to the network of the intended customer ("external traffic").

When packeted traffic needs to be exchanged between ISP networks ("external traffic"), it either goes via direct interconnection between these networks (in this case, the traffic can be exchanged directly between the two networks) or via a public or private Internet exchange point[18] which provides access to regional networks and/or backbone networks[19] through which access to the desired ISP network can ultimately be reached.

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17 "*Information infrastructures: their impact and regulatory requirements*", OECD Report, Paris 1997, OCDE/GD(97)18.

18 Interconnections between backbones were initially made at National Access Points (NAPs). A NAP consists of a building or space within a building containing switching and routing equipment to which operators can connect their networks and thereby interconnect to other networks also present at the NAP. These original NAPs were quickly supplemented by other interconnection points conceived at the initiative of backbone providers. This second generation of interconnection points is not technically NAPs, in the strict sense of the term, but fulfill essentially the same function as NAP.

Until recently, there were only a small number of Internet exchange points. However, the commercialisation of the Internet, and the rapidly growing traffic it has generated, has provided tremendous incentives for ISPs, in particular small ISPs, to increase the number of Internet exchange points in order, on the one hand, to bring content closer to customers and, on the other hand, to reduce as much as possible transit agreements with larger ISPs. In the same time, a number of large ISPs are also interconnecting directly rather than through exchange points.

Peering still accounts for a large part of traffic exchange...

Traditionally, ISPs have exchanged traffic among themselves via interconnection (known as "peering" agreements) or via access payments (known as "transit agreements"). A peering agreement means that two ISPs exchange necessary routing information so that traffic can be exchanged between their networks at no charge. Although peering still accounts for a large part of traffic exchange, some large ISPs have been unwilling to use the peering model with smaller ISPs and payment is increasingly being demanded for interconnection.[20]

…payment is increasingly demanded for connection

As underlined by the Fischer and Lorenz Report and illustrated by the *MCI WorldCom/Sprint*[21] and *WorldCom/MCI*[22] cases, the increasing dominance in the provision of Internet services by a few large ISPs, with their own Internet networks, *"may be an emerging trend that might evolve into abuse of dominant position of certain operators who could enforce settlement based interconnect agreements with smaller players".*[23]

Indeed, the different characteristics of ISPs imply that they do not necessarily enter interconnection negotiations with equal bargaining strength. Large ISPs may have customers providing highly demanded contents and services or a customer base that customers of other ISPs want to access.

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19 A backbone is an overarching network to which multiple regional networks connect and which, generally, does not serve directly any local networks or end-users.

20 On this question of traffic exchange, see the OECD Report, "*Internet Traffic Exchange: developments and policy*", Paris 1998, DSTI/ICCP/TISP(98)1/FINAL.

21 Case COMP/M.1741, *MCI-WorldCom/Sprint*, Decision of 28 June 2000.

22 Case IV/M.1069, *WorldCom/MCI*, Decision of 8 July 1998, OJ L. 116 of 4 May 1999, p. 1.

23 "*Study on the development of new telecommunications services, in particular those exploiting Internet, and their impact on the European Union regulatory and policy framework for telecommunications*", a report for the European Commission prepared by Fischer & Lorenz, 31 January 2000, page 71.

In addition, as mentioned above, ISPs having such a large customer and content base may also act, in the same time, as a gateway to the rest of the Internet given the reach and breadth of their network.

Large ISPs stand in a critical position

Given the strong dependencies for ISPs to access to all or at least the vast majority of the networks connected to the Internet, larger ISPs stand in a critical position as providers of capacity services to other ISPs and might be able to charge supra-competitive fees for interconnection with their backbone networks and/or favour their own operations at the expense of third parties.

As next generation communications services will increasingly rely on broadband integrated networks for the delivery of multimedia services, the issue of interconnection to these networks may become much more significant.[24]

1.3 The access applications layer. The access applications layer includes the devices, operating systems and applications software used to access content and provide services on the Internet.

As the initial interface, access devices may constitute an important bottleneck

1.3.1 Access devices. As the initial interface by end-users to access the Internet, access devices may constitute an important bottleneck. High-speed local loops and sophisticated electronic commerce applications are of little value to customers if they have no means of access or if the technical capacity of their access devices is less than required by applications.

New interactive devices will overtake the PC to deliver interactive services

Today, the dominant terminal device for Internet access is the PC. The PC has undergone significant technological change in the last few years in terms of speed and new features. While the PC will undoubtedly continue to be a valuable route for accessing the Internet, more particularly for business, it has been suggested that other interactive devices[25] will become more widespread and will ultimately overtake the PC as mechanisms for mass-market delivery of interactive services.

[24] See the EU Commission's proposal for a Directive of the European Parliament and of the Council on "*access to, and interconnection of, electronic communications networks and associated facilities*", COM(2000)384, 12 July 2000. See also, Herbet Ungerer, "*access issues under EU Regulation and anti-trust law – the case of telecommunications and internet markets*", Conference, June 23-24, 2000, Washington D.C.

[25] These include WebTV Set top boxes (which combine Internet and digital TV reception with facilities allowing storage and manipulation of video content, enabling applications as diverse as downloading of films and sending of E.mails), video game consoles and mobile phones (through WAP, GPRS and EDGE technologies).

This may be explained by the fact that, as pointed out by the Report prepared by Fischer and Lorenz for the European Commission on "*Internet and the future policy framework for Telecommunications*"[26] (hereafter, the Fischer and Lorenz Report), "*today's personal computers and Internet software require far too much technical knowledge of the users and that the interface to Internet content and services is too complicated*".

In this respect, the joint OFTEL and OFT study[27] indicates that "*access using the TV with the advent of digital broadcast (via set top box) and games consoles and through mobile phones, promises to become an important mechanism for broadening access to the information society*". Similarly, the market study undertaken by Fisher and Lorenz suggests that these new devices will undoubtedly play a key role in bringing online services to end-users: "*television and the Internet will converge into one on-line medium and Internet access by set-top boxes will become normal. Another candidate for making access easier is a slimmed down version of the PC with smaller operating systems and simpler computing. Also, access by telephones, mobile terminals and equipment with a more narrow range of functionality than a traditional PC is expected to be widespread*".

Unbundling access technology and content is likely to be a key issue

Against this framework, unbundling of access technology and content is likely to be a key for a truly open and competitive Internet environment. Especially related to broadcasters and cable-TV providers, the *Fischer and Lorenz* Report underlines the concerns raised by interview respondents according to which "*the control of the access device to cable-TV (set top boxes) may be dominated by a few organizations which can bundle other services, such as telecommunications and internet services, into their basic set-top box offering*". Indeed, access through a set top box is typically to a selected "*walled garden*" of sites. Such operational restrictions, although they might be justified by practical, financial and technical reasons, can lead to market foreclosure if used to restrict access of competing operators to the market place or to discriminate against competitors.

[26] "*Study on the development of new telecommunications services, in particular those exploiting Internet, and their impact on the European Union regulatory and policy framework for telecommunications*", a report for the European Commission prepared by Fischer & Lorenz, 31 January 2000.

[27] "*Competition in e-commerce: a joint OFTEL and OFT study, consultation document*" (April 2000), paragraph 2.31.

Another concern with these devices is that proprietary rights over set top box components[28] can be used as limiting factors, giving network operators or manufacturers of terminal devices the opportunity to control the gateways between the content provider and the end-user.

Proprietary rights over access technology may be used to leverage market position

From a technical point of view, a set-top box is nothing more than a computer system with the main purpose of decoding digital into analogue signals and equipped with a conditional access system, an electronic program guide and application program interface allowing the supply of interactive services.
As illustrated by the Microsoft antitrust case in the United States, control over this technology could be used by dominant operators to stifle innovation or to leverage their market position in related markets.

1.3.2 Access software and search engines. In addition to an access device, access software will generally be necessary to allow a user to interact with the Internet.

Concerning set top boxes (i.e. WebTV), because the access software will generally be an inherent part of the set top box, the potential competition issues will not be separable from those relating to the set top box itself.

However, when traditional access mechanisms are used, the user will generally have a choice as to the access software – or browser - that is used. Such browser software can be distributed in various ways. First, it can be made available for downloading from web sites of ISPs or of third parties. Secondly, it can be provided as part of the set up package of an ISP through agreements with those ISPs. Thirdly, it can be pre-installed on new PCs through agreements with PCs manufacturers. Finally, it can be distributed through retails channels either in its own right or on magazine cover disks.

2. Network convergence

Internet is predicted to produce "digital convergence"

The Internet is widely predicted to produce '*digital convergence*", in which computing, telecommunications and broadcasting all merge into a single stream of discrete bits carried on the same ubiquitous network.[29]
As means of communication are becoming increasingly digital, smooth

[28] There are three essential components of a set top box that govern the conditions of access: conditional access systems, electronic program guides and application programming interfaces. As these components are generally based on proprietary technology, new entrants are dependent on the existing competitor to access the set top box and, as a consequence, the marketplace.

[29] See the EU Commission Green Paper on "*the convergence of the telecommunications, media and information technology sectors and the implications for regulation*", COM(97)623, 3 December 1997.

development and integration of generic networks able to provide and support all types of applications, including entertainment, voice telephony, and electronic commerce will be essential to allow expansion of network capacity.

Technological convergence is making boundaries less clear cut

Against this framework, technological convergence[30] is making less clear cut the traditionally defined industry boundaries within the communication sector (telecommunication, cable television, broadcasting satellite and cellular mobile). The same is true for boundaries between the communications industry, information/content industry and information technology industry

Technological developments provide the basis for convergence in market infrastructure

These technological developments may have important effects. The first, which can be defined as <u>convergence in market infrastructure</u>, is the tendency towards the development of substitutable broadband and interactive digital communication systems.

Despite differences in network topology, bandwidth, performance and reliability, telecommunication infrastructures, broadcasting infrastructures and mobile infrastructures (both cellular as well as satellite networks) provide the basis for the high speed local loop and backbone infrastructures which customers and service suppliers will rely on for access to electronic commerce services and applications.

Content services are combining into a single market for interactive content

The second important effect of these technological developments relates to what might be called <u>convergence in content</u>. The previously separate markets for content services (such as music, newspapers, television, film and Internet publishing) are overlapping and, to a certain extent, combining into a single market for interactive content.

Technological convergence increases the tendency for vertical and

As technological convergence accelerates between the computing industry, communications and broadcasting industries, the tendency for vertical and horizontal integration may further increase[31], as underlined above.

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30 The concept of convergence may be defined as relating to "*the changes in the underlying economies of scope, leading to the joint production of goods and services which were previously produced in separate industries*"; see "*Regulation and Competition issues in Broadcasting in the light of convergence*", OECD, Paris, 26 April 1999.

31 Convergence has already had a very significant impact on the broadcasting and telecommunications industries over the past decade, as can be seen in the large number of mergers and alliances, both horizontally (among telecommunication operators, broadcasting and Internet firms) and vertically (between combinations of telecommunication operators, broadcasting and internet firms and content providers) as well as new entry and new investment by incumbent firms. It is anticipated that this trend will continue.

For a detailed explanation on the driving forces behind the growing mergers and acquisition trend, see "*Mergers and acquisitions trends in the information and communications industries*", Christian Micas, Telecommunications Consultancy, Brussels.

horizontal integration

Higher bandwidth network architectures, including high-speed local loops, will further provide the means for network owners to develop or form alliances with content services and offer vertically integrated package combining network access services, Internet services and content services. This is occurring as network owners and operators try to increase their value-added services by moving into new applications and services and try to extend their network capacity. Likewise, content service providers are investing in networks as a means of obtaining market access.

Vertical integration may be beneficial but may also give rise to serious foreclosure effects

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

As explained above, a major consequence of convergence is likely to be that "*new types of service providers will require new types of resources and access to new types of bottlenecks and bottleneck holders, ranging from sophisticated network resources to access to set-top boxes, conditional access systems, navigator software, Application Program Interfaces and content rights*".[32]

A close examination of vertical integration effects is necessary

Therefore, a close examination of the effects of vertical integration into the other converging sectors will be necessary in order to make sure that it does not raise barriers to entry, thereby foreclosing access to these new types of resources and markets. As pointed out by the EU Commission, competitive issues which could also arise "*include bundling of content and services, or of network capacity and services, predatory pricing, cross-subsidization of services or equipment and discrimination in favour of own activities*".[33]

Against this framework, what needs to be avoided is that firms with bottleneck facilities - or a position of economic strength - foreclose market access or otherwise leverage their position to gain unfair advantage when operating in other upstream or downstream markets.

32 "*Ensuring efficient access to bottleneck network facilities. The case of telecommunications in the European Union*", Herbert Hungerer, available at http://www.europa.eu.int/comm/competition/speeches.

33 EU Commission Green Paper on "*the convergence of the telecommunications, media and information technology sectors and the implications for regulation*", COM(97)623, 3 December 1997, page 23.

The competitive impact of such practices depends upon the relative magnitudes of barriers to entry into each of the converging sectors following vertical mergers. When barriers to entry in each of the converging sectors are low, vertical integration is not likely to affect the overall level of competition, as firms in each of the previously separate sectors are potential entrants into the other sectors. However, where there are high barriers to entry and limited competition in one of the converging sectors, vertical integration may reduce the overall level of competition in the more-competitive sector. In this case, vertical integration may indeed allow firms in the sector with high barriers to entry to leverage their installed base into the more competitive sector.

3. Dynamic nature of competition and speed of market transition

E-economy markets are characterised by rapid innovation, which results in frequent new products or generations of products, more efficient production processes and rapid improvement in the cost-effectiveness and quality of existing products.

Competition issues are said to be self-correcting through rapid and perpetual introduction of new products

As new generations of products appear more frequently in E-economy markets that in mature industries, competitive issues that may occur are said to be "*self-correcting*" through the rapid and perpetual introduction of new products.[34]

Experience teaches that normal operation of economic incentives in such dynamic and high-tech markets will generally result in entry of new technologies and firms, which can completely leapfrog the market positions of incumbents and quickly attract customers and suppliers.

[34] See "*Competition Policy in the New Economy: Is European Competition Law Up to the Challenge*", Chritian Ahlborn, David S. Evans and Atilano Jorge Padilla, [2001] ECLR p. 156.

It is important to focus on dynamic competition for the market of the future

As a result, established operators are under the constant threat from innovating operators, unless entry of such new technologies or operators in the market is impeded in some way by arrangements, exclusionary practices or restrictions on access to input that are critical for competition. It is therefore important to focus not only on static competition within the market as it is currently constituted but also on dynamic competition for the market of the future, i.e. competition to develop new products or to replace an existing product through drastic innovation.

In this respect, it should be noted that firms that try to profit from innovation to enter markets and challenge incumbent's position have to commit to large scale and irreversible investments in research and development. Because such R&D necessarily involves sizable financial commitments before product's introduction and first sale revenues and because R&D is an uncertain investment, the ultimate profitability of individual projects is difficult to calculate. Innovation based upon R&D creates uncertainty not only in profit accounting but also in the marketplace.

Some form of temporary market power may appear necessary to achieve efficiencies

These characteristics are relevant to competition analysis in two specific ways. On the one hand, application of competition law should also take properly into account the fact that, in the E-economy, some form of temporary market power may appear necessary, in some situations, to achieve efficiencies connected with innovation. Indeed, potential prospects for high profits – or temporary monopoly profits – may also act as strong incentives to innovate in such markets.[35] Products and services in the E-economy are usually characterised by substantial fixed costs[36] and low variable costs. As a result, production in E-economy industries often demonstrates increasing returns to cumulative production. Such returns must be sufficiently high to reward the typically large fixed costs associated with high risk inherent in investments in R&D.[37]

35 The Austrian School (von Mises, Schumpeter and, more recently Demsetz, Shackle and Kirzner) suggests that industries with low barriers to entry should be left to operate without constraints since temporary monopoly profits constitute the legitimate reward for innovative activities. They conclude that government's intervention to reduce profits of the winners reduce the incentives of existing firms and prospective entrants to engage in competitive innovation. This opinion is partly shared by the Chicago School and its *laissez faire* advocated approach to regulation, supported by the contestable markets theory. For further details, see Question III.

36 Firms in New Economy often have to invest a great deal to develop their products, either because they must make substantial investments in R&D or because they must invest in a physical or virtual network to create and deliver their products.

37 See "*Competition Policy in the New Economy: Is European Competition Law Up to the Challenge*", Chritian Ahlborn, David S. Evans and Atilano Jorge Padilla, [2001] ECLR p. 156.

This may have important implications on market structure as well as on firms' practices. In particular, ex post "*excess*" profits (for the winners) are likely to be the norm in innovative industries and does not necessarily mean that competition is failing provided there was an effective competition to innovate initially.[38]

Competitors' incentives and opportunities to innovate should also be protected and preserved

On the other hand, it may be particularly important, in order to protect and preserve competitors' incentives and opportunities to innovate, to ensure that incumbents with market power do not impede the ability of new technologies to enter markets. The fact is that rapid technological progress does not automatically adequate to low entry barriers, especially if users find it costly to switch to new brands or products that are incompatible with the established technology. Potential competitors recognising the enormous difficulties of entering markets as a result of exclusionary or foreclosing practices from incumbents enjoying market power may indeed lose incentives to compete.

The assessment of vertical integration may therefore raise complex trade offs

As a consequence, the assessment of vertical integration in such dynamic industries, driven by changing technologies and innovation, may raise many complex trade offs between on the one hand, efficiencies and, on the other hand, competitive problems that do not have an easy policy resolution.

Competition occurs along several dimensions

Finally, it should be recognised that competition in such innovative markets occurs along several dimensions, of which price is not the most important. Given these various forms of dynamic non-price competition, defining relevant market on the basis of conventional market definition methods, which are primarily based on price responsiveness and fail to recognize other dimensions of competition, will often provide little guidance.

38 In its "*Guidelines on Market Influence determinations*" (March 2000), the OFTEL indicates that it "*recognizes the role of profit in stimulating innovation and encouraging market entry, from which customers benefit*" and further adds that "*high profits can result from relative efficiency and innovation*". These guidelines are available at http://www.oftel.gov.uk/publications.

4. Network effect

The E-economy infrastructure is characterized by what are called "*positive network externalities*" which are important in considering potential market foreclosure and barriers to entry resulting from vertical integration.

As indicated above, an important feature of the E-economy infrastructure is that it is typically composed of various complementary components that are combined to create composite goods (or systems) that are substitutes to each other. The very fact that much of the E-economy infrastructure involves such complementary products and services is the key reason for the appearance of such positive network externalities and highlights the importance of interconnection and interoperation.

Network effects are important in considering market foreclosure and barriers to entry

Positive network externalities, which are also known as network effects, arise when the value of a network increases with the number of its users. In this context, a single firm can become or threaten to become, because it is the "*first mover*" ("*first mover*" effect) or has a decisive lead over its competitors ("*tipping*" effect), the only supplier of certain products or services given the value of compatibility or interoperability.

The first company to attain critical mass in a market characterized by such network economies ("*first mover*" advantages) can expect to benefit from a "*snowball*" effect – sometimes referred to as positive feedbacks - that will reinforce its position on the market. Customers are indeed more likely to remain with the established network because of their sunk costs (sometimes referred to as "*lock-in*") and suppliers of complementary products are likely to tailor these products to the established network and be reluctant to prepare products for new entrants.

Network effects[39] are generally classified into two types: direct and indirect network effects. Direct network effects are generated through the direct effects of the number of the agents consuming the same product. Telecommunication networks, such as the use of telephones, fax machines, on-line services and the Internet are typical examples of products or services exhibiting direct network effects. Indirect network effects arise when the value of a product increases as the number of the complementary goods or services increases. Computer services exhibit indirect network effects. This indirect network effect in the computer industry is sometimes referred to as the hardware-software paradigm.

Such network effects are clearly relevant, efficient and occasionally unavoidable. However, they increase the risk that one firm, by achieving a critical mass – or tipping point – will dominate a market or retain market power for an extended period of time.

[39] For a summary of the economic literature on Network economics, see Annex III.

Network effects may raise entry barriers

Network effects are therefore relevant to competition analysis in two specific ways. First, the same demand-side economies of scale that induce the creation of a network in the first place can also serve as strong barriers to competition against the network, even by those who might offer a superior alternative. Once customers become *"locked-in"* to a product incorporating the current technology, they may be reluctant to switch to another product with a superior technology because of the premium associated with the widespread use of a common technology and switching costs.

Such entry barriers increase the likely duration of market power and facilitate in turn the exercise of such market power by the industry leader. This is especially likely if the network effects are substantial and if the network has a large installed base of users and if there exist a large number of complements for the network.

Network effects increase the incentive to engage in anti-competitive strategies

Second, network effects increase the incentive to engage in anti-competitive strategies. Entry barriers created by network economies can be minimised to the extent that new entrants or rival networks may take advantage of comparable network economies by, for example, having their users interconnected with the leading network or their products interoperating with complements of the dominant network. As a result, one would expect that there exists a likely incentive for firms to engage in anti-competitive practices to foreclose competitors access to such network economies.

<u>Section II.</u>

<u>Identification of potential anti-competitive effects that can result from vertical integration into the different layers of the E-economy infrastructure</u>

1. <u>Overview</u>

Vertical integration may produce serious foreclosure effects

As indicated under Section I., securing access for market actors and new entrants to networks (whether local access networks or backbone networks), access systems and to content is likely to be essential for the provision of a wide range of services and is likely to be a key issue in order to ensure that emerging market structures remain competitive.

In this respect, it is clear that vertical integration between firms that try to take advantage of the New Economy may produce serious anticompetitive foreclosure effects under certain market circumstances. Several questions should however be answered before it can be concluded that vertical integration may lead to foreclosure:

- The first question is whether the firm in question controls essential or bottleneck facilities and/or has and potentially could exercise horizontal market power in an upstream and/or downstream market. This involves the standard issues of horizontal market analysis discussed below, such as market definition as well as assessment of market power and of entry conditions;

Several questions must be answered before it can be concluded that vertical integration may lead to foreclosure

- If the precondition of horizontal market power is satisfied, the second question is whether the proposed vertical integration may be used to exercise or to increase their market power and, thereby, to harm competition.

Where there is such evidence, the overall evaluation of vertical integration may depend on the goals and enforcement practices of competition policy. Where vertical integration allows firms to exercise or increase their market power but simultaneously serves purposes that, by them, would substantially increase economic efficiency, **the issue for competition policy is to determine whether a defence on efficiency can be used to justify it.**

2. The precondition for foreclosure: control over essential and bottleneck facilities and/or detention of horizontal market power

Vertical foreclosure effects are very likely to arise where a combined undertaking either controls essential or bottleneck facilities in the E-economy chain or enjoys sufficient market power at one level of the vertically related layers such as to allow it to leverage its position into downstream or upstream markets.

2.1 Control over essential or other bottleneck facilities. Control over essential and other bottleneck facilities has been considered as a basic concern for anti-competitive effects[40] which, in itself, may discourage market entry by potential entrants and which, when combined with the control over other facilities horizontally or vertically, may give rise to unacceptable levels of elimination of competition and foreclosure effects.

Control over certain "gateway" layers creates greater potential to foreclosure

Each level of the vertically related supply chain – the various markets for content, access applications and network infrastructures – is a potential bottleneck candidate, as it may constitute an essential input for operators in a number of different markets. The existence of such bottlenecks may confer durable gatekeeper role to market operator enjoying market power.

In this respect, it should be noted that **control over certain *"gateway"* layers, which may be qualified as *"essential facilities"* for competitors and new entrants[41], creates greater potential to**

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[40] European Commissioner Mario Monti has recently underlined these concerns: "Telecommunication networks are the foundation of the e-Economy. It is therefore crucially important to ensure that control over these networks does not lead to distortions of competition. At all levels of the market local, national or global competition concerns are raised if the control over important communications infrastructure could be used to leverage the parties' positions into related markets. This concern is a common one when looking at internet-related markets, given that vertical integration – the presence of the same companies in upstream and downstream markets – is frequent", in "Competition in the e-Economy Excerpts: the New Economy in Europe: its potential impact on EU enterprises and policies", Brussels, 2 March 2001, available at http//www.europa.eu.int//comm./competition/speeches.htlm.

[41] The essential facility doctrine derives from a line of cases originally in sectors other than telecommunications. In particular, in the joined cases 6/73 and 7/73, *Commercial Solvents v. Commission*, [1974] ECR 223, the Court of Justice indicated that "*a dominant undertaking which both owns or controls and itself uses an essential facility, i.e. a facility or infrastructure without access to which competitors cannot provide services to their customers, and which refuses its competitors access to that facility or grants access to competitors only on terms less favorable than those which it gives its own services, thereby placing the competitors at a competitive disadvantage, infringes Article 86, if the other conditions of that Article are met. A company in a dominant position may not discriminate in favor of its own activities in a related market (…) without objective justifications*".

Of particular relevance, for the most recent interpretation of the essential facility concept under EC law, is the Court of Justice's important judgment of November 1998, in *Oscar Browner*

foreclose market access to competitors and/or to leverage market power because they can provide the means to effectively control all upstream or downstream related markets.

Several conditions must be fulfilled for any layer to qualify as an essential facility

Several conditions must be fulfilled for any layer or facility to be regarded as an essential facility. **The crucial condition seems, however, to be whether actual or potential competitors can be expected to provide an effective competitive pressure in the form of either existing or potential competing facilities or services that other firms might offer**. If this is not the case, the ownership of a facility which pass such a "*tipping point*" that there can be no alternative facility that can be set up or joined may be considered as the ownership of an "*essential facility*".

The key question is whether the facility can be by passed or duplicated

The key question is therefore whether competitors have the ability or not to bypass or duplicate the facility. To answer this question, it would be necessary to compare the sunk investment costs needed to duplicate the facility with the expected returns from such investment, which in turn depends on market structure, demand, product differentiation, economies of scale and scope and network externalities.

This study will limit itself to discussing two specific facilities directly related to the Internet structure: local access networks and backbone Internet networks. That does not mean that other facilities or services - such as, for example, conditional access systems[42] - may not qualify as "*essential facilities*".

On the contrary, cases which affect the vertical structure of the E-economy industries will require a complex examination of the specific features of competition on the market concerned, taking into account the existence of network externalities, in order to ascertain whether specific facilities or services are subject or not to effective actual or potential competition.

GmbH & Co. KG v. Mediaprint, case C/7/97 [1998] ECR I-7791, where the Court ruled that an infrastructure can only be considered as essential if it appears to be economically unfeasible or unreasonably difficult to duplicate in a reasonable time period.

For a summary of the EC case law relating to essential facilities, see John Temple Lang, "*Defining Legitimate Competition, Companies Duties to Supply Competitors and Access to Essential Facilities*" in 1994 Fordham Corp. L. Inst. (Barry Hawk, ed., 1993), p. 245.

For a summary of the EU Commission's interpretation of the essential facility doctrine's application in the telecommunication sector, see the Notice of the Commission on "*the Application of the competition rules to access agreements in the telecommunications sector – Framework, relevant markets and principles*", OJ C 265 of 22 August 1998, p. 2.

42 On the question as to whether conditional access systems can be considered as "*essential facilities*", see John Temple Lang, "*Media, Multimedia and European Community antitrust law*", in 1998 Fordham Corp. L. Inst. 000 (B. Hawk, ed 1998), p. 438.

The local loop is a key infrastructure for providing access services

2.1.1 Local access networks. In the 1999 Communications Review[43], the EU Commission recognized that urgent action is required to increase competition in the "*local loop*" which is still dominated by incumbent TOs. Accordingly, the EU Commission welcomed the national trend of introducing unbundling requirements ("LLU") and indicated that it will itself use recommendations and, in specific cases, its powers under the competition rules to encourage LLU throughout the EU.

This has been most recently reflected in the conditional approval by the EU Commission of the proposed *Telia/Telenor* merger in October 1999 which was only approved subject to the parties' commitments to unbundled the local loop and to divest their cable and other overlapping business.[44]

This is also reflected by the recent Communication from the Commission on "*Unbundled Access to the Local Loop*"[45], where the EU Commission emphasizes that "*providing access to the local loop to all new entrants will increase the level of competition and technological innovation in the local access network, which will in turn stimulate the competitive provision of a full range of telecommunications services from simple voice telephony to broadband services to the customer*".

According to the Communication, "*the local loop is a key infrastructure for providing access services to end-users and remains within the incumbent control*" and therefore constitutes "*a bottleneck for the distribution of retail access and also, in most cases, local call services*". As far as new markets for high-speed services are concerned, the EU Commission indicates that "*the presence of incumbents is already very strong and they would under the present conditions, be able to consolidate their dominant position on this new market (…) owing to their privileged access to end-users through the nation-wide existing cooper pair networks*".

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[43] EU Commission Communication on "*Fifth Report on Implementation of the Telecommunications Regulatory Package*" COM(1999) 537 final, 10 October 1999.

[44] Case COMP/M.1439, *Telia/Telenor*, EU Commission's Decision of 13 October 1999.

[45] Communication from the Commission on "*Unbundled Access to the Local Loop*", COM(2000)237, 26 April 2000.

Control over nation-wide local loop gives a considerable leverage

Given the size of the investments required, the local loop network is considered to be, '*with present technologies, economically unfeasible or unreasonably difficult to duplicate at a nation-wide level in a reasonable time period*". Since access to the local loop is therefore essential for competitors and new entrants wishing to compete with TOs, the EU Commission concludes that "*the control of the incumbent's nation-wide local loop gives them a considerable leverage for maintaining their dominant positions on existing voice telephony retail markets (…) or establishing similar positions on new emerging markets for high bandwidth services*".

As pointed out above and by the EU Commission in its Communication, it is clear that this analysis may need to be reassessed given the speed of technological changes and market developments which will influence the development of alternative local access networks.

Access to backbone Internet network is essential for most ISPs

2.1.2 Backbone Internet networks. As indicated above, most ISPs Networks need to be interconnected, directly or indirectly, to large backbone Internet networks in order to provide their customers with full Internet connectivity and to complete transactions. For ISPs networks, access to these facilities is therefore essential for the provision of their services. In this respect, owners or operators of these communications infrastructures, which generally also compete with smaller ISPs, stand in a critical position, either as providers of services to end users, or as providers of transmission service to others, or both.

Because of the specific features of network competition and the existence of network externalities, such a "*gateway*" position may provide powerful backbone Internet networks' owner or operator with the ability to leverage their market position in downstream or upstream markets where other alternative networks do not offer a genuine competitive constraint.

This has been most recently investigated by the EU Commission in the proposed mergers between *WorldCom and MCI*[46] and *MCI WorldCom and Sprint*.[47] The investigation carried out by the Commission showed that the merger, through the combination of the merging parties' extensive networks and large customer base, will result in the combined networks becoming an "*essential facility*" to which other ISPs would have no choice but to interconnect directly or indirectly "*in order to offer a credible Internet access service*".

46 Case IV/M.1069, *WorldCom/MCI*, Decision of 8 July 1998, OJ L. 116 of 4 May 1999, p. 1.

47 Case COMP/M.1741, *MCI WorldCom/Sprint*, Decision of 28 June 2000.

According to the EU Commission this "*would have allowed the merged company to behave independently of both its competitors and customers and given it the ability to control technical developments, raise prices and discipline the market by serial degradation of its interconnections with competitors*".

Measuring market power to assess the risk of foreclosure measuring

2.2 Holding of market power. In assessing whether an operator is in a position in which it could act anti-competitively by foreclosing upstream or downstream markets, it is necessary to establish the relevant market – both its product and geographical dimension – within the boundaries of which the market power of this operator can then be measured.[48]

Market power has traditionally been defined as "*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 its consumers*".[49]

The concept of market power does not preclude some competition in the market. As the European Commission has stressed, "*it only enables the undertaking that enjoys such a position if not to determine, at least to have an appreciable effect on the conditions under which that competition will develop, and in any case, to act in disregard of any such competitive constraint so long as such conduct does not operate at its detriment*".[50]

2.2.1.Market Shares. The primary test for establishing market power has been to examine market shares.[51]

The primary test for establishing market power has been to examine market shares

This analysis of market shares involves examination of absolute and relative levels and also changes, if any, over time. In assessing market power, economists would argue that it is the power over time which is of particular significance. A large market share held only briefly before the emergence of new competitors would suggest indeed that there was never any market power. In addition, where barriers to entry in an industry are low so that new competition may soon emerge, market shares do not reflect true power over that market.

48 For more details on the question of defining the relevant product market, see Question III, below.

49 Case 27/76, *United Brands Co & Anor v. EC Commission* [1978] ECR 207 and case 85/76, *Hoffman-La-Roche v. EC Commission* [1979] ECR 461.

50 Commission working document on "*Proposed New Regulatory Framework for Electronic Communications Networks and Services – Draft Guidelines on market analysis and the calculation of significant market power*", Com. (2001) 175 of 28.03.2001, para 64.

51 For more detail on the question of calculation of market shares, see CHAPTER III.

In practice therefore, the European Court of Justice and the EC Commission do not content themselves merely with quantifying market shares but also look at whether other factors indicate market power. In the light of the case law of the European Court of Justice and the administrative practice of the EC Commission, the following standards may be identified:

- save in exceptional circumstances, a very high market share of 75% or more over a relatively long period is such strong evidence of dominance that no further investigation is necessary[52];

- strong evidence of a dominant position is also provided by a market share of between 40% and 60%, provided it is confirmed by data on the relative market shares of competitors and other evidence of competitive conditions on the market and the firm's own structure, resources and conduct;

- a market share varying between 30% and 40% seems to fall below the level at which dominance is indicated. Further evidence would be required of substantial disparities in market share, significant impediments to entry and so on before dominance could be established;

- a market share of below 30% would not be evidence of a dominant position except in exceptional circumstances and in the light of other factors.

The standards cannot be applied mechanically to the E-economy

It must be noted, however, that these standards cannot be applied mechanically to the E-economy, where particular care needs to be taken when assessing significance of market shares. In particular, in fast-developing and dynamic markets, such as in the E-economy, the proof of a significant market share is seldom a substitute for full economic analysis of the issue of market power.

52 It is indeed accepted that, in traditional industries, very large market shares are in themselves evidence of a dominant position. In this respect, the European Court of Justice stated, in the case *Hoffman-La-Roche v. EC. Commission, that*:

"*Although the importance of market shares may vary from one market to another, the view may legitimately be taken that very large market shares are in themselves, and save in exceptional circumstances, evidence of the existence of a dominant position. An undertaking which has a very large market share and holds it for some time by means of the volume of production and the scale of the supply which it stands for –without those having much smaller market share being able to meet rapidly the demand from those who would like to break away from the undertaking which has the largest market share- is by virtue of that share in a position of strength which makes it an unavoidable trading partner and which, already because of this, secures for it, at the very least during relatively long periods, that freedom of action which is the special feature of a dominant position*". Case 85/75, *Hoffman-La-Roche v. EC. Commission* [1979] ECR 146.

Indeed, as indicated above, incumbents in the E-economy may have large market shares since competition is often a matter of "*winner-takes-most*". Such high market shares might be the transitory reward for successful innovation and high risks inherent in the required investments. They, however, remain under constant threat from innovating competitors, which can quickly leapfrog the market position of the incumbent technology or network and quickly attract customers and suppliers[53]. Incumbents are therefore only able to retain their position if they continue to innovate.

As underlined by the OFTEL & OFT Study[54], "*when products are new, or new generation of technology are emerging, market shares based on current or historic information may not be a true indicator of market power. Attention needs to be given to the likelihood of new business models emerging that might significantly alter the balance of power*".

High market shares do not necessarily point to market power and conversely

The analysis of market shares should also take into account the speed of technological convergence which may, as indicated above, influence the development of alternative products and facilities which today may not be considered as truly substitutable.

It follows from the above that market shares can be an unreliable indicator of true market power in the E-economy. A firm with a high market share will not enjoy a position of market power if potential entry of innovative competitors or new technologies imposes an effective competitive constraint on its conduct.

If a currently high market share in dynamic markets does not necessarily point to market power then, conversely, a current low market share does not rule out its absence in the possible near future. The practical importance of this point would seem to depend upon the nature of the vertical links between the market in question and other related markets where a position of market power may be held.[55]

53 On this question, see Davis S. Evans & Richard Schmalensee, "*Some economic aspects of antitrust analysis in dynamically competitive industries*", a paper prepared for the National Bureau of Economic Research conference on Innovation policy and the Economy, Washington DC, April 17, 2001, available at http://www.nber.org/papers/w8268.

54 "*Competition in e-commerce: a joint OFTEL and OFT study, consultation document*" (April 2000).

55 See John Vickers, Director General of the Office of Fair Trading, "*Competition policy and innovation*", a speech to the International Competition Policy Conference, Oxford, 27 June 2001, available at http://www.oft.gov.uk/html/rsearch/speech.htm.

Whether market shares may be indicative of market power is fact specific and needs to be addressed in the context of the specific product market

As indicated above, one of the essential features of the E-economy is its increased dependence on a wide and diversified set of vertically related activities, which must be combined efficiently. Where a firm has market power in one market and is vertically integrated into upstream or downstream markets, it may have the possibility to leverage this market power into these upstream or downstream markets in order to exclude its competitors.

Consequently, the potential for vertical integration to leverage market position into downstream or upstream markets should form part of the analysis of market power on these latter markets.[56]

In the end, the question of whether market shares – whether high or low - may be indicative of durable or ephemeral market power is fact specific and needs to be addressed in the light of the particular product market at issue. In this respect, the challenge for competition law is to properly assess whether current positions in product markets in question are actually contestable or not by innovative competitors[57], including an analysis of how technological change may affect or not the possibility for the undertaking concerned to behave independently.

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[56] In this respect, the European Commission indicates in Article 13.3 of the proposed Directive on a common framework for Electronic Communications Networks and Services that "*where an undertaking has significant market power on a specific market, it may also be deemed to have significant market power on a closely related market, where the links between the two markets are such as to allow the market power held in one market to be leveraged into the other market, thereby strengthening the market power of the undertaking*". Commission proposal for a Directive on a common regulatory framework for electronic communications network and services COM (2000) 393, OJ C 365 of 19.12.2000, p. 198.

[57] On this question, see "*Competition Policy in the New Economy: Is European Competition Law Up to the Challenge*", Christian Ahlborn, David S. Evans and Atilano Jorge Padilla, [2001] ECLR p. 156. See also "A*ntitrust Analysis in High-Tech Industries: a 19th Century Discipline Addresses 21st Century problems*", prepared remarks by Robert Pitofsky to Antitrust Issues in High-Tech Industries Workshop of 25-26 February 1999 (American Bar Association) and "*What are we learning from the Microsoft Case?* ", remarks by Commissioner Orson Swindle before the Federalist Society, 30 September 1999, both available at http://www.ftc.gov/speeches.

Barriers to entry constitute an important indicator of market power

2.2.2 Other indicators of market power. There is no closed catalogue of the indicators of dominance, other than absolute and relative market shares, used by the European Court of Justice and the EC Commission. The most obvious factor will be barrier to entry that exists as a result of specific features of the market or as a result of specific advantages enjoyed by operators.[58] While barriers to entry may often be lower in the E-economy, partly because successful entry so often depends on new idea, certain characteristics of markets in the E-economy may nevertheless tend to raise barriers to entry.

The most important of these are "*first mover*" advantages and network externalities which may tend to result in current market power being maintained and enhanced into the future, rather than being transient as might be expected within such dynamic markets.[59]

Certain characteristics of the E-economy may raise barriers to entry

The company first achieving a critical mass in terms of relative network size, traffic carried over the network and customers will be able to capture the bulk of future market growth. The market can then reach a "*tipping point*" so that this player will be in a position to obtain a dominant position for an extended period of time even in the face of vigorous competition and rapid growth of the market.

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58 The Commission indicates in this respect that this includes "*overall size of the undertakings, control of infrastructure not easily duplicated, technological advantages, absence of countervailing power, easy or privileged access to capital markets, financial resources, economies of scale, economies of scope and vertical integration*", Com(2001) 175 of 28.03.2001, paragraph 64.

59 *In AOL/Time Warner*, the EU Commission investigated the impact of "first mover" advantages and "snowball effects" although neither party held a market share of 25% or more in any vertically market directly affected by the transaction. In each of the markets of critical concern (online distribution of music, music player software and the UK ISP market), the EU Commission posited that a critical mass of exclusive content of Time Warner & Bertelsmann would draw new subscriber to its services. The increased subscriber base would in turn attract more content providers, which would again attract even more subscribers. Case COMP/M.1845, *AOL./Time Warner*, Commission's decision of 11 October 2000.

Similarly, *in World Com/MCI*, the EC Commission indicated in this respect that "*the merger will create a snowball effect in that MCI World Com would be better placed than any of its competitors to capture further growth through new customers, because of the attractions for any new customers of direct connection with the largest network and the relative unattractiveness of competitor's offerings owing to the treat of disconnection or degradation of peering which MCI World Com's competitors must constantly live under*". Case IV/M.1069, *WorldCom/MCI*, Decision of 8 July 1998, OJ L. 116 of 4 May 1999, p. 1.

Such "*first-mover advantages*" and resulting network externalities may virtually constitute an insurmountable advantage for incumbent. As explained above, E-economy markets are usually characterised by a high degree of sunk costs and significant economies of scale. New entrants may have to incur higher sunk costs to penetrate the market on a scale large enough for them to obtain the same economies of scale as incumbents.[60]

In addition, E-economy industries are not different than other in the sense that "*brand recognition*" and reputation for reliability[61] can also virtually create insurmountable advantages for incumbent. Here again, new entrants may have to incur a significant higher level of sunk costs in order to create brand awareness and to overcome customer inertia towards switching from a long-established incumbent.

Finally, the ownership of "*essential facilities*" and/or of intellectual property rights[62] may provide their owner with an absolute cost or quality advantage which both may act as significant barriers to entry over the shorter term. Such short-term entry barriers are likely to have long-term implications, in particular if the markets concerned could potentially be characterized by "*first mover*" advantages.

3. Potential foreclosure practices to exercise or increase market power

Vertical foreclosure can result from a variety of practices

Vertical foreclosure can result from a variety of practices by market operators. Two main categories of practices can be identified, although this does not suggest that there exists a rigid demarcation between the two categories: exclusionary practices (refusal to deal or discriminatory practices) and leveraging practices in related markets (bundling and imposition of technological standards) can be identified.

60 On this question, see the OFTEL Guidelines on "*the application of the Competition Act in the Telecommunications Sector*", available at http://oftel.gov.uk/publications.

61 For more details on the question of "*brand recognition*" and reputation for reliability, see CHAPTER II.

62 Intellectual property rights, which are designed to encourage and protect innovation, can and are often used to barricade a market against entry by new competitors. In this respect, Robert Pitofsky indicates that "*incentives to innovate must be protected in intellectual property markets and innovation competition can yield great consumer benefits. On the other hand, threats to competition can be substantial. For example, the combination of intellectual property rights and network effects will almost inevitably lead to monopoly and the monopoly can diminish or eliminate future innovation*". See "*Antitrust and Intellectual Property: unresolved issues at the heart of the New Economy*", prepared remarks of Robert Pitofsky for the Antirust, Technology and Intellectual Property Conference of 2 march 2001, available at http://www.ftc.gov/speeches.

Whether vertical foreclosure threatens competition and economic efficiencies is a question of facts along with dynamic economic analysis

Whether vertical foreclosure threatens competition and economic efficiencies is a question of fact along with dynamic economic analysis. Foreclosure will not always increase market power nor will it always be profitable for efficiency reasons. Therefore, what is needed first is to identify the particular foreclosure practices that can potentially be used to exercise and/or increase market power and then to analyse, according to a well-specified and coherent dynamic economic analysis, consistent with the facts of the case, whether those foreclosure practices may be effective and harm competition.

In particular, recent work in the economic literature[63] suggests that foreclosure practices may be effective and harm competition where the following conditions are satisfied:

- the ability to effectively compete of nearly all existing competitors and/or new entrants on downstream and/or upstream markets is harmed;

- the foreclosed rivals do not have counterstrategies to find existing and/or potential alternative sources of supply to protect themselves from foreclosure;

- the foreclosure practices are profitable - and therefore likely – due to notably reduced competition on the downstream and/or upstream market, potential for dynamic customer lock-in implying long term gains and network effects.

Integrated firms may have an incentive to restrict competition upstream or downstream

3.1 Exclusionary practices. Where firms are partially vertically integrated, they may have an incentive to use their market power in one market to restrict competition in an upstream or downstream market in order to favour their own downstream or upstream arm. For example, a firm in a dominant position with respect to content, integrated with an infrastructure provider, might seek to deny that content to competing infrastructure providers in order to restrict competition in the infrastructure market.

Alternatively, a firm with a dominant position with respect to the provision of access to infrastructure, which is also vertically integrated into content provision, might deny access to a competing content provider in order to restrict competition in the content market.

[63] For an overview of this literature, see Annex II.

3.1.1 Outright refusal to deal or to provide access. Where an operator owns an "*essential facility*", any limitation on access to this infrastructure/facility may act as an absolute barrier to entry limiting the ability of downstream competitors to compete effectively.

Refusal to deal or to provide access may limit the ability to compete effectively

Given the specific features of the E-economy markets and the existence of strong network externalities, refusal to supply access to a facility or product can also foreclose market access downstream even where the case does not fulfil the strict criteria set out above to qualify as an "*essential facility*". Such a refusal to deal could indeed, given the importance of the facility or product in order to attract and retain customers, reduce the attractiveness of its competitors, which could in turn limit their ability to compete.

Whether a refusal to grant access to a specific facility may be considered as an anti-competitive behaviour needs to be assessed on a case-by-case basis. In accordance with the case law of the European Court of Justice[64], a refusal to grant access to a facility required to supply new or existing products or services should only be considered as constituting a restraint of competition where:

- it constitutes an insuperable barrier to entry for competitors in the relevant downstream or upstream markets or leads to serious, permanent and inescapable competitive handicap which would make the activities of the undertaking seeking access uneconomic;

- the refusal cannot be justified by objective economic or technical reasons. Instead, its primary purpose is to foreclose competition, in the relevant upstream or downstream markets, on the part of the undertaking that is seeking access.

In assessing whether a refusal to grant access constitutes or not a restraint of competition, attention should also be paid to long-term implications on investment and competition and not only to short-term effects of such a refusal.

A full competitive evolution of refusal to grant access requires a rule of reason approach

As indicated above, the failure to consider properly the long-term effects of decisions that may dilute property rights is of paramount importance in E-economy industries, where innovation is the prime form of competition.

In this respect, some authors have shown that a potential entrant (whilst having innovated) has little incentive to enter if barriers to entry for subsequent imitators are sufficiently low to cause low *ex post* profits.[65]

Mandating winners of the innovation race to give latecomers or "*free-*

64 In particular, *Oscar Browner GmbH & Co. KG v. Mediaprint*, case C/7/97 [1998] ECR I-7791.

65 See Chapter III, paragraph on *"Relevance of entirely new sets of criteria towards a dynamic approach (an analysis of economic literature)"*.

riders" access to the result of their success on a non-discriminatory basis may therefore "*have a serious detrimental effect on companies' incentive to invest in R&D and on the speed of innovation*".[66]

Against this framework, a full competitive evaluation of refusal to grant access requires a cautious approach, on the one hand, preserving property rights so that incentives to engage in dynamic competition is maintained[67] and, on the other, ensuring that these rights are not used to block entry to further rounds of dynamic competition.

Two recent cases illustrate the potential foreclosure effects resulting from refusal to deal

Two recent cases, where the central issue was access to content, illustrate the potential foreclosure effects resulting from refusal to deal or grant access. In the *AOL/Time Warner* vertical merger[68], the Commission found that the new entity, through structural links and existing contractual arrangements with Bertelsmann, would have had preferred access to Bertelsmann content and, in particular, to its large music library. As a result, the merged entity would have controlled the leading source of music publishing rights in Europe and would have been able to foreclose downstream competitors. Indeed, according to the EU Commission, "*one entity controlling such a sizeable music catalogue could exercise substantial market power, by refusing to license its rights or threatening not to license them, or imposing high or discriminatory prices and other unfair commercial conditions or its customers wishing to acquire such rights (such as Internet retailers offering music downloads and streaming)*".

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66 Christian Ahlborn, David S. Evans and Atilano Jorge Padilla, "*Competition Policy in the New Economy: Is European Competition Law Up to the Challenge*" [2001] ECLR p. 156.

67 As Advocate General Jacobs pointed out in *Oscar Browner GmbH & Co. KG v. Mediaprint*, "*if access to production or distribution facilities were allowed too easily, there would be no incentive for a competitor to develop competing facilities. Thus, while competition was increased in the short term, it would be reduced in the long term. Moreover, the incentive for a dominant undertaking to invest in efficient facilities would be reduced if its competitors were, upon request, able to share the benefits*".

68 Case COMP/M.1845, *AOL./Time Warner*, Commission's decision of 11 October 2000.

In *the Vivendi/Canal+/Seagram* merger[69], the pooling of Seagram's Universal music arm and Vivendi's multi-access Internet portal Vizzavi raised similar concerns in the emerging pan-european market for portals and the emerging market for on-line music. The EU Commission considered that Vizzavi's position was likely to be strengthened on the market for portals due to the addition of Universal's music content. Indeed, the market investigation showed that other competing portals would most probably lose access to Universal's music catalogues as a result of its integration with Vizzavi and that the remaining major music providers, in view of the very large distribution structure of Vivendi and Canal+, will be connected on exclusive or preferential terms to the merged entity. According to the EU Commission, this content will in all likelihood not be accessible for competitors after the transaction and Vizzavi will be in the position where it becomes the only portal having the music must-stock products.

Refusal to license may also have significant foreclosure effects

3.1.2 Refusal to Licence. It is an established principle that European competition law does not affect the existence of intellectual property rights but that it may impose limits on the exercise of such exclusive rights. In addition, it is now well established that a refusal to grant a licence, even if it is the act of an undertaking holding a dominant position, cannot in itself constitute an abuse of a dominant position.[70] However, it is also clear that the exercise of an exclusive right by the proprietor may, in exceptional circumstances, lead to significant foreclosure effects where these rights are used to impede the emergence of new services and products and to leverage upstream or downstream market positions.[71]

It should be noted in this respect that the European Court of First Instance[72] has narrowly limited the situations in which an obligation can be imposed upon the proprietor of intellectual property rights to grant a licence. According to the European Court of First Instance, an obligation to licence an intellectual property right can only exist where it concerns a product or service which is "*either essential for the exercise of another activity*" or is "*a new product whose introduction might be prevented, despite specific, constant and regular potential demand on the part of consumers*".

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69 Case COMP/M. 2050, *Vivendi/Canal+/Seagram*, Commission's decision of 13 October 2000.

70 See, in particular, Case 238/87, *Volvo v. Veng*, [1988] ECR 6223 and joined cases C-241/91 P and C-242/91 P, *Maguill*, [1995] ECR I-743.

71 See, in particular, the judgment of the Court of Justice in *Maguill* in which the Court indicated that "*the appellants, by their conduct, reserved to themselves the secondary market of weekly television guides by excluding all competition on that market (…) since they denied access to the basic information which is the raw material indispensable for the compilation of such a guide*".

72 Case T-504/93, *Tiercé Ladbroke v. Commission* [1997] ECR II-092.

In the E-economy, which increasingly relies on products and services that are the embodiment of ideas, the ability to obtain intellectual property rights encourages innovation. A cautious approach, examining the impact on economic incentives to innovate and balancing them against potential foreclosure effects resulting from such refusal to licence intellectual property rights, is therefore required on a case-by-case basis[73].

The potential foreclosure effects should be balanced against the impact on innovation

Besides the two above-mentioned *AOL/Time Warner* and *Vivendi/Canal+/Seagram* mergers[74], the on-going investigation against Microsoft's alleged discriminatory licensing and refusal to supply software interface information[75] is illustrative of the difficult economic questions raised by refusal to licence intellectual property rights in this sector.

In this case, Sun Microsystems is complaining against Microsoft strategy to refuse to supply interface information with the intention of driving all competitors out of the server software market. Most PCs today are embedded into networks, which are controlled by servers. Interoperability, which is the basis for network computing, can only function if the operating systems running on the PC and on the server can talk together through links or so-called interfaces. To enable competitors of Microsoft to develop server operating systems that can talk to the dominant Windows software for PC, interface information must be known. Without interoperating software and as a result of Microsoft dominance in the computer software market, computers running on Windows operating systems would be *de facto* obliged to use Windows server software if they wanted to achieve full interoperability.

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73 In this respect, Advocate General Jacobs indicates in its Opinion in Case C-7/97 *Oscar Browner GmbH & Co. KG v. Mediaprint* that "*in the long-term, it is generally pro-competitive and in the interest of consumers to allow a company to retain for its use facilities which it has developed for the purpose of its business. Particular care is required where the goods or services or facilities to which access is demanded represent the fruit of substantial investment. That may be true in particular in relation to the refusal to license intellectual property rights*".

74 See also the case COMP/M.JV.37 – *B SKY B / Kirch Pay TV*, Decision of 21 March 2000 where the Commission investigated the possibility for KirchPayTV to exclude competition on the market for digital interactive television services.

75 See "*Commission opens proceedings against Microsoft's alleged discriminatory licensing and refusal to supply software information*", IP/00/606 of 3 August 2000. See also "*Commission initiates additional proceeding against Microsoft*", IP/01/1232 of 30 August 2001.

Underlining the importance of the case, Mr. Monti indicated that "*the Commission welcomes all genuine innovation and advances in computer technology wherever they come from (…). Effective protection of copyrights and patents is most important for technological progress. However, we will not tolerate the extension of existing dominance into adjacent markets through the leveraging of market power by anti-competitive means and under the pretext of copyright protection*".[76]

Exclusionary practices may also consist in discriminatory conditions

3.1.3 "Undue preference" and discriminatory practices raising rival costs in vertically related markets. When a company that is dominant upstream is also competing in the downstream market, there is a risk that this company shows undue preference to its own downstream activity by selling to it on more favourable terms than are available to third party competitor. Such discrimination or undue preference practices (both price or non-price related), by raising the costs of key inputs for competing firms, may have strong exclusionary impacts by foreclosing market entry or encouraging market exit.

Excessive prices constitute a good example of such discriminatory practices

The charging of excessive selling prices constitutes a good example of such discriminatory practices to raise rival costs in vertically related markets. Overpricing has been defined by the European Court of Justice as "*charging a price which is excessive because it has no reasonable relation to the economic value to the product supplied*".[77]

One method of establishing excessive prices is by comparing the price and the production costs of a product (cost approach)[78]. In addition, in the absence of satisfactory cost data, such an assessment may be made by comparing the prices charged for the same product or service on other geographic markets (market comparison approach).[79]

76 Idem.

77 Case 27/76, *United Brands Co v. EC Commission* [1978] ECR 207.

78 This analysis implies the assessment of the difference between the costs actually incurred and the price actually charged to determine whether it is unreasonable or clearly excessive in itself. However, production costs can be extraordinarily difficult to determine, especially for multi-product firms where fixed costs such as capital investment, R&D and administrative and selling costs have to be allocated between many products. See Case 27/76, *United Brands Co v. EC Commission* [1978] ECR 207.

79 This approach was confirmed by the European Court of Justice in Case 110, 241 & 242/88, *François Lucazeau and others v. Société des Auteurs, Compositeurs et Editeurs de Musique (SACEM)* [1989] ECR 2811 and case 395/87, *Ministère Public v. Jean-Louis Tournier* [1989] ECR 2521. The European Court of Justice ruled that significant differences in the level of royalties charged to discotheques in different Member States were *prima facie* evidence of an abuse of dominant position: "*When an undertaking holding a dominant position imposes scales of fees for its services which are appreciably higher than those charged in other Member States and where a comparison of the fee levels has been made on a consistent basis, that difference must be regarded as indicative of an abuse of dominant position*".

Applying either method to E-economy markets may lead to practical difficulties in establishing price abuse, in particular, at what point a price is so high that it may result in foreclosure effects. One reason is that costs are often difficult to assess, particularly where undertakings produce or supply a multiplicity of products. Appropriate cost allocation is therefore fundamental to the determination of whether a price is excessive.[80]

Establishing price abuse may be difficult and requires trade offs between efficiencies and competition problems

econd reason is that the E-economy is characterised by a fixed cost recovery problems. For demand and supply side reasons, the most efficient way for firms to recover these costs is to engage in discriminatory pricing across time, customers and regions. This provides the crucial appropriate incentives for continued investment and innovation, which is the lifeblood of the E-economy.[81] In addition, mandating access to latecomers or "*free riders*" at prices that are fair, reasonable and non-discriminatory using cost-oriented tariffs as the appropriate benchmark could be seen as rewarding the passive and less energetic at the expense of those who pioneered a field. Some commentators therefore argue that latecomers should be charged discriminatory prices including a premium that takes into account and reward the large fixed costs associated with high risk inherent in investments in R&D.[82]

iinst this framework, the assessment of whether such price discriminatory practices may have anti-competitive effects raises complex issues and must be undertaken by examining the impact of the likely exclusionary effects on competition and balancing them against economic incentives to innovate. In this respect, the impact of such discriminatory practices will depend on the importance for market operators to have access to the product and/services in order to compete effectively.

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80 In this respect, the European Commission indicates: "*where a company is engaged in a number of activities, it will be necessary to allocate relevant costs to the various activities, together with an appropriate contribution towards common costs. It may also be appropriate for the Commission to determine the proper cost allocation methodology where this is a subject of dispute*". See the "*Notice on the application of the competition rules to access agreements in the telecommunications sector*", O. J. C 265 of 22.08.1998, p. 2.

81 "*EC Antitrust in the New Economy: Is the European Commission's view of the Network Economy Right?*", Cento Veljanovski, [2001], ECLR, p. 115.

82 For an opinion supporting this point, see "*Antitrust Analysis in High-Tech Industries: a 19th Century Discipline Addresses 21st Century Problems*", prepared remarks of Robert Pitofsky for Antitrust Issues in High-Tech Industries Workshop, 25-26 February 1999, available at http://www.ftc.gov/speeches. See also the Opinion of Advocate General Jacobs in Case C-7/97 *Oscar Browner GmbH & Co. KG v. Mediaprint* where he indicates that if access is required, "*the undertaking must however in my view be fully compensated by allowing it to allocate an appropriate proportion of its investment costs to the supply and to make an appropriate return on its investment having regard to the level of risk involved*".

Several cases investigated by the EC Commission illustrate the potential foreclosure effects on downstream or upstream markets, which may result from such discriminatory practices.

Several cases illustrate potential foreclosure effects which may result from discriminatory practices

In *Telia/Telenor*[83], the EU Commission considered that the strong position of the merged entity in the capacity markets and its control over local loop networks will allow it to discriminate against their competitors in favour of its ISP activities.

Similarly, in *WorldCom/MCI*[84] and *MCI World Com/Sprint*[85], the EU Commission considered that the strength and size of the networks of the new entity would enable it to pursue various stratagems to raise rivals' costs and to attract customers away from competing networks.

To the extent that the new entity was also active on the ISP market, the Commission considered that "it could attempt to leverage its position there to gain a dominant position downstream. It could do this because of the inability of other top-level networks to offer a genuine competitive constraint and because of the influence and control it has over the cost base of resellers (ISPs) active downstream".

In both cases, the Commission indeed considered that the new entity could degrade the offering of competing ISPs by deciding not to upgrade the capacity at private peering points or foreclose peering agreements, thereby putting them at a cost and quality disadvantage. By opening up such a quality differential between itself and its competitors, it would be well placed to persuade any prospective new customers for Internet services to ignore the offerings of its rivals.

Finally, in *AOL/Time Warner*[86], the EU Commission found that AOL could "*use its position either to charge supra-competitive prices for the carriage of content or to restrict access to the on-line music market by favouring Time Warner and Bertelsmann and degrading the quality of access for competing content providers*".

The investigation carried out by the Commission in this latter case also provides a good illustration of how technology can be used to discriminate against competitors in very sophisticated and virtually undetectable ways.

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83 Case COMP/M.1439, *Telia/Telenor*, Decision of 13 October 1999.

84 Case IV/M.1069, *WorldCom/MCI*, Decision of 8 July 1998, OJ L. 116 of 4 May 1999, p. 1.

85 Case COMP/M.1741, *MCI WorldCom/Sprint*, Decision of 28 June 2000.

86 Case COMP/M.1845, *AOL./Time Warner*, Decision of 11 October 2000.

The Commission found that "*the generality of AOL users tend to surf the Internet through the navigational tools displayed on AOL pages (such as links to third parties' websites), rather than using search engines or typing the address of the sites they are looking for. In this context, it can be useful to reiterate that beside basic Internet connectivity, AOL aggregates and packages content from the Internet for the benefit of its customers (…). In accomplishing this editorial task, AOL sells promotions and leases shopping areas within its network to content providers. The contracts concluded by AOL contain restrictive clauses prohibiting promotion or links to websites outside the AOL network or the sale of products with those of AOL. As a result of the restrictions, AOL users are kept within AOL networks, even though they have the impression they are surfing the Internet without restrictions*".

Firms may also have an incentive to cross subsidize their products and enter into predatory pricing practices

3.1.4 Predatory pricing and cross-subsidisation. Where firms are partially vertically integrated, they may also have an incentive to use their market power in one market to cross-subsidize its products and enter into predatory pricing practices in upstream or downstream markets in order to drive its competitors out of the latter markets.

Predatory pricing has been defined as "pricing behaviour that involves a reduction of price in the short run, so as to drive competing firms out of the market or to discourage entry of new firms in an effort to gain larger profits via higher prices in the long run that would have been earned if the price reduction had not occurred".[87]

Penetration pricing may allow a new entrant to displace an incumbent despite the presence of network effects

It should be noted that predatory pricing must not be confused with normal price competition, the latter being a natural and expected feature of the competitive process. Price reductions may be evidence of the competitive process at work and should therefore not be prohibited merely upon proof that a competitor has suffered some disadvantage. In establishing the intention of the dominant undertaking to remove its competitors from upstream or downstream markets by lowering its prices in the latter markets, it may therefore be a matter of some difficulty to distinguish between, on the one hand, a deliberate attempt to exclude rivals from the market, and, on the other hand, a legitimate competitive response. In particular, E-economy firms engage extensively in so-called "*penetration pricing*" through discounts and hardware subsidies as well as free products, content and access aimed at growing the subscribers to a critical mass and, in turn, lower unit costs/prices.[88]

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[87] P.L. Joskow and A.K. Klevorick, *A Framework for Analysing Predatory Pricing Policy*, 89, Yale L.J., December 1979, 213, 219-220.

[88] See "*EC Antitrust in the New Economy: IS the European Commission's view of the Network Economy Right?*", Cento Veljanovski, [2001] ECLR p. 115.

The Court of Justice established the relevant legal framework governing predatory pricing under Article 82 of the EC Treaty.[89] The Court applied a combined cost-based and strategy test in determining the predatory nature of low pricing.[90]

The tests set out by the Court of Justice are notoriously difficult to apply. The very limited number of cases in which the European Commission has successfully been able to establish and prosecute predatory behaviour testifies to this fact.[91] One reason for this is that costs are often difficult to assess, particularly where undertakings produce or supply a multiplicity of products. A second reason is that, as explained above, intention is crucial. Intention, however, may be difficult to ascertain, especially when harming competition is of the essence of the competitive process.[92]

Accordingly, pricing strategies by a company that is trying to enter a new market by launching a new product should be treated with less suspicion that pricing strategies by a firm with an already established products. In addition, a predatory strategy should only be identified where it cannot be profitably sustained in the long term even if the firm succeeds in achieving dominance and therefore obtains the benefit of

89 For a thorough analysis of the different tests for identifying predation, see Luis Miguel Hiojosa Martinez's article, „*Predatory pricing Literature under European Competition Law: the Akzo case*" [1990] 27 C.M.L.R.Rev. 83 and Philip Andrews's article *"is meeting competition a defense to predatory pricing? The Irish Sugar Decision suggests a new approach"*, [1998] E.C.L.R.Rev: 49.

90 The Court held that "*Prices below average variable costs by means of which a dominant undertaking seeks to eliminate a competitor must be regarded as abusive. A dominant undertaking has no interest in applying such prices except that of eliminating competitors so as to enable it subsequently to raise its prices by taking advantage of its monopolistic position, since each sale generates a loss, namely the total amount of the fixed costs and at least, part of the variable costs relating to the unit produced. Moreover, prices below average total costs, that is to say, fixed costs plus variable costs, but above variable costs, must be regarded as abusive if they are intended as part of a plan for eliminating a competitor. Such prices can drive from the market undertakings which are perhaps as efficient as the dominant undertaking but which, because of their smaller financial resources, are incapable of withstanding the competition waged against them*". Case C-62/86, *Akzo Chemie BV v. EC Commission* [1991] ECR I-335.

See also the test specific to the telecommunications sector developed by the Commission in its "*Notice on the application of the competition rules to access agreements in the telecommunications sector*", *Official Journal C 265 of 22.08.1998, p. 2.*

91 Other than Akzo, *Tetra pak v. Commission (II)*, Ibid, is the only case in which such an action has successfully been taken, and in that case, most of the condemned pricing were below average variable costs.

92 According to Ahlborn, Evans and Padilla, "*under the above test of predation, all successful firms struggling in winner-takes-most markets are bound to be regarded as predator. (…) Despite the fact that New Economy firms in an innovation race satisfy the AKZO test (i.e. they price below average total costs and intend to eliminate their competitor(s)), (…) an intervention by the Commission in such circumstances would be unnecessary, harmful and futile*". "*Competition Policy in the New Economy: Is European Competition Law Up to the Challenge*", Christian Ahlborn, David S. Evans and Atilano Jorge Padilla, [2001] ECLR p. 156.

economies of scale and access to revenue streams from complementary markets.[93]

Leveraging practices may require strong anti-trust scrutiny when undertaken to monopolise complementary products

3.2 Practices in related markets - Leveraging. An undertaking that has a dominant position in one market will sometimes be able to exploit that position to strengthen its position in an upstream or downstream market. This can cover a huge variety of practices. Two examples are given here: bundling practices and imposition of technological standards.

Leveraging may take place for a variety of reasons that can be pro-competitive or anti-competitive, depending on the circumstances. Whether such leveraging is in fact likely to harm competition is a complex issue, particularly where there are potential efficiencies that may be at issue. However, where leveraging practices are undertaken primarily to monopolize or attempt to monopolize complementary products - and thereby to decrease innovation incentives and the likelihood of entry - so that the firm concerned continue to be victorious for the next market, such practices may, on balance, require strong antitrust scrutiny.

There might be a number of efficiency-based reasons to enter into bundling practices

3.2.1 Tying, bundling and integration practices. As previously underlined, the dynamic competitive process in New economy industries often involves combining features and services that were previously available separately to create products that are differentiated from existing offering. Accordingly, depending on the context of markets at issue, there might be a number of valid business rationales and efficiency-based reasons for a firm to enter into such bundling practices, part of which may be reflected in costs savings, lower transactional price, augmentation of the demand and thereby lower composite price for consumers.

At the same time, bundling practices can be used as strong leveraging devices

At the same time, tying – or equivalently bundling or integration - practices can be used as strong leveraging devices in that they may foreclose opportunities for other firms to sell related products or increase barriers to entry. In this framework, tying may make the prospects of entry less certain, reducing the entrants' incentive for investment and innovation.[94]

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[93] See "*Competition, innovation and antitrust enforcement in dynamic network industries*", speech by Daniel L. Rubinfeld, 24 March 1998, available at http://www.usdoj.gov/art/public/speeches.

[94] See Choi, J.P. and C. Stefanadis, *"Tying, investment and the dynamic leverage theory"*, *mimeo* presented at the conference "*The economics of the software and Internet Industries*", Toulouse) (France) (IDEI), 18-21 January 2001, available at http://www.idei.asso.fr/. See also Carlton, D.W. and Waldman, M. (1998): *"The Strategic Use of Tying to preserve and create Market Power in Evolving Industries"*, NBER Working Paper n° 6831, 1998.

The concept of tying refers to situation where the sale of one product (the tied product in respect of which it is not dominant and intends to increase its market share) is conditioned on the purchase of another product (the tying product for which it is dominant).[95]

As far as the concept of bundling is concerned, two forms of bundling are distinguished in economies. Under pure bundling – also known as tying – the firm sells only the bundle, as it does not make the individual components available on a stand-alone basis. This may take the form of technical tying, whereby the individual components only function effectively as part of the bundled system and cannot be used alongside components from other suppliers. Under mixed bundling, the firm sells components both individually and within a bundle that is offered at a price below the sum of the prices for the stand-alone components.

The assessment of whether bundling harms competition raises complex issues

The assessment of whether bundling has anti-competitive effects and harm competition raises complex issues and is an empirical matter. Inevitably, an evaluation of each particular practice in context, adopting a "rule of reason approach", will be necessary before a clear conclusion can be reached. The main concern will be to determine whether the bundling has any exclusionary effects on competition by discouraging the incumbent's rivals from investing and innovating. Here again, the assessment of such exclusionary effects must be balanced against any countervailing efficiencies on the long run, such as lower prices resulting from the exploitation of economies of scale. In addition, the technical or economic possibility for unbundling the products in question should also be taken into account.

[95] The severity with which unjustified tying policies are treated is shown in two cases where the EU Commission condemned the imposition of such clauses. In *Eurofix-Bauco v. Hilti* (1988) OJ L65, p.19, the EC Commission found that Hilti, a producer of fastening systems used in the building industry, was abusing its dominant position by supplying cartridge strips to certain end-users or distributors only when purchased with the necessary complement of nails. The Court of First Instance held that Hilti's strategy was not a legitimate mode of competition on the part of a dominant undertaking and that the behaviour impaired competition in that it was liable to deter other undertakings from establishing themselves on the market. Similarly, in *Tetra Pak II*, the EU Commission condemned the obligation imposed by the dominant supplier of filing machines which required its customers to use only the supplier's cartons with the machines and moreover, to obtain those cartons only from the supplier itself. These clauses aimed at making the market in cartons wholly dependent on the market in machines and tended towards the elimination of that market. See Case T-30/89, *Hilti AG v. EC Commission* (1991) ECR II-149, confirmed on appeal by the European Court of Justice in case C-53/92P, *Hilti AG v. EC Commission* (1994) ECR I-667.

The EC Commission has investigated the possibility for market operators to enter into bundling practices in several cases.[96] As recently illustrated by General Electric/Honeywell controversy[97], the European Commission often attaches a high probability to portfolio effects, in particular bundling, without the support of any explicit model. The US authorities tend to consider that there is a low risk of such effects and that the possible harm to competition is likely to be much more speculative than the benefits to consumer. Empirical evidence indeed showed that the threat to competition from such effects had been exaggerated. There seems to be a broad consensus in the US today that efficiency is good and that there is nothing wrong with the pursuit of "Competitive Advantage", provided consumers benefit from it in terms of price, quality and innovation.

The EC Commission has investigated the possibility to enter into bundling practices in several cases

In *AOL/Time Warner*[98], the Commission found that the merged entity, unlike its competitors which do not own proprietary content, "*would be able to bundle Time Warner's and Bertelsmann's huge music content portfolio, with Internet access and proprietary services and give its subscribers exclusive or preferential access to that content"*. The Commission noted that the merged entity would have a number of possibilities for promoting its Internet dial-up services through its content offer, thereby attracting sufficient new subscribers to attain a dominant position on the Internet dial-up access market.

Similarly, in *Telia/Telenor*[99], the Commission emphasised the possibility for the new entity, in the above-mentioned context of convergence, *"to offer a package of services such as voice, fast-Internet access, digital pay TV and digital interactive services".*

The market investigation carried out by the Commission confirmed that *"the likelihood that the merged entity would adopt various bundling strategies aimed at leveraging its strong position in one area to strengthen its overall position"* had to be considered very high.

Bundling practices may also take the form of technological tying

It should be noted that bundling practices may also take the form of technologically tying together two separate products, for example through technological arrangements in the production process or in product design. Designing a product so that it is effectively bundled with a separate product or operates better with complementary specific products raises difficult questions as to the interface between legitimate

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96 For a complete review of bundling practices identified by the US antitrust authorities in the Microsoft case, see the Antitrust Bulletin Vol XLVI, N° 1/spring 2001.

97 Case COMP/M General Electric/Honeywell, decision of 3rd of July 2001 available at : http://www.europa.eu.int/comm/competition/mergers/

98 Case COMP/M.1845, *AOL./Time Warner*, Decision of 11 October 2000.

99 Case COMP/M.1439, *Telia/Telenor*, Decision of 13 October 1999.

product design and anti-competitive bundling.

The European Commission has investigated the possibility for *AOL/Time Warner*[100] to enter into such forms of technologically tying practices. It concluded that it would have been possible for the new entity to format Time Warner's and Bertelsmann's music, which constitutes the leading source of music publishing rights in Europe, in such a way as to be compatible only with AOL's music player (Winamp), but not with competing music players. Because of these technical limitations of other players, the new entity would have been in a position to impose Winamp as the dominant music player.

Finally, a dominant undertaking may bind market operators to itself in a market in which it is already dominant, for example, by entering into exclusive agreements with them. This would cover cases where, for example, a dominant content provider enter into an exclusive agreement with a downstream infrastructure provider, thus foreclosing competing content providers to access to this infrastructure. Similarly, a dominant infrastructure provider could also enter into exclusive agreements with content providers to foreclose access of competing infrastructure providers to this content.

In this respect, the investigation carried by the EC Commission in *Vivendi/Canal+/Seagram*[101] provides a good example of the impacts that these kind of agreements, if entered into by market operators enjoying market power, may have on upstream or downstream markets. The EC Commission indeed posited that other music content providers would be very likely to offer their content to Vizzavi, on exclusive or preferential terms, given its high customer base. Such agreements will in practice foreclose access for competing portals to must-stock products and prevent them to compete effectively.

Leveraging may consist in technological foreclosure

3.2.2 Technological foreclosure. Technological foreclosure played a key role in the Commission's review of the proposed merger *Vivendi/Canal+/Seagram, in Telia/Telenor* and in several other cases involving interactive television.[102]

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100 Case COMP/M.1845, *AOL./Time Warner,* Decision of 11 October 2000

101 Case COMP/M. 2050, *Vivendi/Canal+/Seagram*, Decision of 13 October 2000.

102 See, for example, the case IV/M.490, *Nordic Satellite Distribution*, Decision of 19 July 1995, OJ L 53 of 2 March 1996, p. 20, the case IV/M.993, *Bertelsmann/Kirsh/Première*, Decision of 27 May 1998, OJ L 053 of 27 February 1999 p.1 and the case IV/M. 1027, *Deutsch Telecom/Beta Research*, Decision of 27 May 1998, OJ L 53 of 27 February 1999,p.31. For a summary of these merger cases, see Lindsay MC Callum, "*EC Competition Law and digital pay television*" in Competition Policy Newsletter 1999, number 1, February.

See also the BiB case (a joint venture set up between BskyB, BT, Matsuchita and Midland Bank which provides digital interactive TV services in the U.K., such as limited Internet access, home banking, home shopping and e-mail via television sets) where the Commission expressed a serious concern as to whether BiB would allow third parties – whether pay-TV operators or digital interactive TV services operators - to have non-discriminatory access to the digital set top

In these cases, the Commission expressed concern that the parties' control over the point of access of the Internet (or as the case may be, point of access for pay TV), either the mobile terminal or the set-top box, could allow the parties to act as gate-keepers to the developing TV-based and mobile phone-based Interned portal markets. Control over this technology could foreclose competitors in upstream or downstream markets by raising their cost of entry.

Similarly, in *AOL/Time Warner*[103], the EU Commission has looked as to whether the new entity would be able to play a gate-keeper role and impose the technical standards for on-line distribution over the Internet. It concluded that the merged entity would be in a position to dictate the technical standards for delivery of music over the Internet. It noted that "*competing record companies wishing to distribute their music on line would then be required to format their music using the new entity's technology. Because of its control over the relevant technology, the new entity would be in a position to control downloadable music and streaming over the Internet*" and raise competitors' costs through excessive licence fees.

Furthermore, the Commission also examined whether AOL could impose Winamp, its software-based music player, as the dominant software player. The Commission concluded that Winamp would become the only music player able to play virtually all the music available on the Internet. "*Given their technical limitations, competing music players will exert no competitive constraint on the pricing of Winamp*", thus allowing AOL to charge supra-competitive prices to upstream or downstream competitors wishing access to it.

boxes owned by BiB. To remove this concern, conditions have been agreed to ensure that third parties have the possibility to have fair, reasonable and non-discriminatory access to all proprietary components of BiB's digital set top box.

103 *Case COMP/M.1845, AOL./Time Warner, Decision of 11 October 2000.*

TITLE I

MAIN E-ECONOMY CHARACTERISTICS AND POTENTIAL ANTI-COMPETITIVE IMPACTS

CHAPTER II

MAIN ECONOMIC CHARACTERISTICS OF E-ECONOMY TRANSACTIONS AND POTENTIAL ANTI-COMPETITIVE IMPACTS OF VERTICAL DISTRIBUTION STRATEGIES

CHAPTER II.

MAIN ECONOMIC CHARACTERISTICS OF E-ECONOMY TRANSACTIONS AND POTENTIAL ANTICOMPETITIVE IMPACTS OF VERTICAL DISTRIBUTION STRATEGIES

E-commerce implies fundamental changes in the traditional way of buying and marketing products. Business distribution strategies are likely to be affected in order to take advantage of the new tools, and efficiencies that e-commerce may generate.

The development of e-commerce has introduced new trading patterns which brings about two parallel markets for the trade of the same goods or services and gives rise to a variety of new intermediaries on the virtual markets, such as online marketplaces and portals.

Whilst certain characteristics of the New Economy might be expected to facilitate entry and reduce certain costs, with the benefit of greater competition being passed onto the consumers, e-commerce can also encourage or facilitate certain types of anti-competitive behaviour between firms that try to take advantage of the New Economy, notably in the field of vertical agreements, and so reduce competition.

Section I.

Main economic characteristics of E-Economy transactions

Main economic characteristics of E-economy Transactions

It has often been suggested that the development of e-commerce will lead to greater market efficiency.

1. Level of competition in electronic commerce

Level of competition in electronic commerce

One of the main arguments in favour of greater market efficiency in electronic markets is the diminution of search costs. The consumer seeks out the most efficient seller, while at the same time cutting down search costs. In addition, the product eventually selected is closer to consumer preferences since the search engines allow the consumer to search for "the" desired product.

Diminution of search costs

In effect, on-line purchasers have access to inexpensive information on prices and product characteristics. Search engines such as pricewatch.com or computeresp.com are specialised in price comparison. Others, such as Bargainfinder (bf.cstar.ac.com/bf) or jango.com, also mention product characteristics.

However, the development of electronic commerce may also lead to a greater differentiation on the part of sellers allowing them to avoid direct price competition. This practice compensates for the decrease in profits following decrease in search costs. A key variable is the importance of the cost of information concerning a product versus the cost of information about prices. [104]

Although it is not possible to test directly the hypothesis of the *"frictionless market"*, the following hypotheses are most often referred to test the level of competition in e-commerce.

Non-price differentiation

Hypothesis 1: price of an article is lower on the electronic market than on the traditional market.

Hypothesis 2: price elasticity of goods sold via the Internet is greater than that for goods sold on physical markets.

Hypothesis 3: costs incurred by sellers in making price changes (the so called menu costs) are lower for on-line sellers than for sellers on traditional markets.

Hypothesis 4: price dispersion observed on electronic markets is less than on physical markets.

1.1 Price levels

Price levels

One of the first studies seeking to determine whether the level of prices used by on-line sellers is lower than that of sellers on physical markets, compared prices for second-hand cars on both electronic and traditional auction markets between 1986 and 1995 in Japan.

The study showed that price levels are higher on the Internet. However, before rejecting Hypothesis 1 and concluding that e-commerce does not lead to greater market efficiency, two things must be considered. On the one hand, auction markets are very different from traditional distribution markets. In effect, the fact that auction prices are higher is rather a sign of efficiency. On the other hand, cars sold on the electronic market are generally newer, thus better valued.

Uncertainly of the impact of E-Commerce on price level

Another study in 2000 comparing prices of car sales on websites with those of traditional sellers from 1995 to 1999 showed that a consumer pays on average 2% less for the same vehicle on the electronic market.[105]

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[104] Bakos, Y. (1998): *"The Emerging Role of Electronic Marketpaces on the Internet", Communication of the ACM,* Vol. 41(8), August, pp. 35-42.

[105] Scott Morton, F., F. Zettelmeyer and J. Silva Risso (2000): *"Internet Car Retailing", NBER Working Paper No. W7961.*

Price comparison between the electronic and traditional markets for books, CDs and software, on a sample of 30.000 sales from February 1997 to January 1998.[106] Again showed that prices observed on the Internet are higher than those on the physical markets for these three categories of goods This study concerned typically homogeneous products. The author suggested these findings could be the result of market immaturity (see section III).

In contrast another study[107] for books and CDs found that prices are significantly lower on the Internet. The study, which was carried out from 1998 to 1999, indicated that the market was immature and that it has since gained in efficiency.

1.2 Price elasticity

The test for price elasticity for different goods is an indicator of the degree of competition faced by various sellers. Price elasticity measures the sensitivity of the demand when confronted by variations in the price of a good. If there is a high degree of elasticity (*i.e.*, if consumer demand reacts in a significant manner to increases in the price of a good), then the firms won't be able to increase their prices, as they would like.

Reduced price sensitivity due to ease of access to information

Experimental economy has carried out simulations of buying behaviour on the electronic market for wine.[108] This experiment, which did not involve testing directly if price elasticity is stronger on the Internet than on the traditional market, provided some of the answer. It seems that consumers are more sensitive to prices when there is little information available on the products. Conversely, the supply of information on products tends to soften competition, increase consumer loyalty as well as consumer satisfaction.

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106 Bailey, J.P. (1998a): *"Intermediation and Electronic Markets: Aggregation and Pricing in Internet Commerce", Ph.D. Thesis, Technology, Management and Policy, Massachusetts Institute of Technology, Cambridge, MA.*

Bailey, J.P. (1998b): *"Internet Price Discrimination: Self-Regulation, Public Policy, and Global Electronic Commerce", mimeo, The Robert H. Smith School of Business, University of Maryland.*

107 Brynjolfsson, E. and M. D. Smith (2000): *"Frictionless Commerce? A Comparison of Internet and Conventional Retailers", Management Science,* Vol. 46(4), April, pp. 563-585.

108 Lynch, J.G. and D. Ariely (2000): *"Wine Online: Search Costs Affect Competition on Price, Quality and Distribution", Marketing science,* Vol. 19(1).

In effect, the more a consumer is provided with information allowing him to better find the product meeting his preferences, the more satisfaction the consumer derives from the product and the less sensitive he is to price variations in the product. Therefore, the comparison of price elasticity for different goods between electronic and traditional commerce may be biased.

The low search costs characterising electronic commerce allow consumers to identify the product, which meets their preferred choice, and becomes therefore less sensitive to prices. [109]

The analysis of price elasticity of goods purchased on the Internet should also take into account the lack of information about brands, which may lead consumers to respond to this lack of information by reverting to leading brands. Price elasticity among grocery goods is weaker for leader brands. [110]

Better information on products may diminish price competition and unable consumers to better find the product matching best their preferences.

1.3 Menu costs

Menu costs are those costs supported by a retailer when he modifies his prices (for example, re-labelling in traditional commerce).

Lower Menu costs

Costs of price adjustments are less in e-commerce. This acts in favour of stronger competition, since when adjustment costs are high, certain price variations may not be made if the costs that they incur exceed the benefits. [111]

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109 Alba, J., J. Lynch, B. Weitz, C. Janiszewski, R. Lutz, A. Sawyer and S. Wood (1997): *"Interactive Home Shopping: Consumer, Retailer and Manufacturer Incentives to Participate in Electronic Marketplaces", Journal of Marketing*, Vol. 61, July, pp. 38-53.

110 Degeratu, A., A. Rangaswamy and J. Wu (1998): *"Consumer Choice Behavior in Online and Regular Stores: The Effect of Brand Name, Price and Other Search Attributes"*, presented at *Marketing Science and the Internet*, INFORM College on Marketing Mini-Conference, Cambridge, MA. 6-8 March.

106 Brynjolfsson, E. and M. D. Smith (2000): *"Frictionless Commerce? A Comparison of Internet and Conventional Retailers", Management Science*, Vol. 46(4), April, pp. 563-585*; this study measured the capacity of a retailer to undertake small price modifications, and found that retailers in e-commerce do not hesitate to change their prices even for small variations.*

Bailey, J.P. (1998a): *"Intermediation and Electronic Markets: Aggregation and Pricing in Internet Commerce", Ph.D. Thesis, Technology, Management and Policy, Massachusetts Institute of Technology, Cambridge, MA. . this study sought to test the hypothesis whereby the costs of price adjustment are less in e-commerce by comparing the number of price changes and found that retailers in e-commerce do not hesitate to change their prices even for small variations.*

1.4 Price dispersion

All three of the studies discussed above, reject Hypothesis 4 and indicate that price dispersion is higher in e-commerce.

Normally, price competition leads to convergence in prices. The authors explain this result either by the immaturity of the market or by the presence of strategic behaviour on the part of retailers on the Internet.

Higher price dispersion

In total, Hypotheses 1 to 3 are not rejected and tend to confirm the idea of greater efficiency on electronic markets. In contrast, the rejection of Hypothesis 4 seems to indicate the opposite.

The hypotheses used to test the efficiency of the market may appear rather restrictive to the extent that they only take account of prices. For example, the quality and level of service are also aspects that show market efficiency and consumers satisfaction improvement. However, for methodological reasons, it is difficult to carry out empirical studies that use quality as an indicator of efficiency gains on a market. The choice of a variable is a delicate one, specific to each product and much more subjective than prices. It is for this reason that most studies testing this hypothesis are limited to prices.

Sellers in e-commerce are not price takers

The different studies could occasionally lead to contradictory results, but one thing is sure: the sellers in e-commerce are not price takers. Prices are determined in a strategic manner.

Let us now turn to strategic choices of these sellers, and provide a response to the price dispersion observed on the Internet.

2. <u>Strategies of firms in e-commerce</u>

2.1 Price discrimination

The possibility to personalise the product offer, combined with the capacity to obtain information about a given consumer and his buying behaviour, makes price discrimination possible.

Three levels of potential price discrimination

This discrimination allows sellers to increase profits while decreasing the surplus of the consumer. However it also makes it possible to serve consumers who would otherwise have been excluded from the market, which increases the efficiency of the market.

There are three levels of potential price discrimination:

Perfect price discrimination

- First-degree discrimination refers to perfect price discrimination. Since the firm is able to observe all consumer characteristics, it may charge a price equal to the consumer's valuation for the good and then capture all consumer surpluses.

Imperfect observation of consumer characteristics

- Second-degree discrimination is based on imperfect observation of consumer characteristics. The firm develops a non-linear tarification, the aim of which is to lead consumers to reveal their own preferences. This mechanism is known as adverse selection.

Observable feature of consumers

- Third-degree discrimination is based on an observable feature of consumers (such as age or sex), which then proposes different prices for these different groups of consumers.

The initiation of discrimination often implies, at the same time, second and third-degree discrimination. The application of price discrimination can depend on the nature of the product. It is easier for a product with a certain degree of specificity, since the prices and characteristics of a product are more open to negotiation.

Price discrimination may seem to be uncommon and unfair, but there are different cases of price discrimination which seem completely natural[112] such as preferential tariffs for students or the elderly or School books sold for a higher price to libraries than to individuals

By reference to product characteristics new books may be first published in hardcover and then distributed in cheaper versions, once the market has been exploited. Finally, the books are sold in pocket versions. Equally, the version E of IBM's laser printer appeared in 1990. The old version was modified so that it would be less efficient and thus sold more cheaply. Therefore, those consumers with less ability to pay would not be excluded from the market and may obtain a cheaper version of the printer.

The reduction of adjustment costs of prices is one of the elements that makes discrimination possible. In addition, On-line sellers may use certain sophisticated tools to get closer to first-degree price discrimination.[113]

Information on consumers may be gathered in several ways. The most frequent is the use of a "cookies file" either on the consumer's site or on the retailers' site in the consumer's database. The information stored

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[112] Odlyzko, A. (1996): *"The Bumpy Road of Electronic Commerce" in WebNet 96 World Conference Web. Soc. Proc.; H. Maurer, ed., AACE,* pp. 378-389.

[113] Bailey, J.P. (1998b): *"Internet Price Discrimination: Self-Regulation, Public Policy, and Global Electronic Commerce", mimeo, The Robert H. Smith School of Business, University of Maryland.*

on the retailer's site implies that one can reach the IP (Internet Protocol) address of the user or that the consumer is asked to identify himself before having access to the server.

Examples of price discrimination on the Internet

Examples of price discrimination on the Internet

Price matching policy

Price matching policy: Books.com uses the design of its website to propose different prices to customers with a greater sensitivity as regards price variations. Customers have the possibility of clicking on a button "compare price" in order to know the prices offered by Barnes & Noble and Amazon.com. If one of the competitors offers a better price, Books.com immediately lowers its price to be just under the best price. But to benefit from that system, the customer must click on the right button (and wait a certain length of time). In addition, the next customer will have to go through the same procedure if he also wants to benefit from the new price since the price always returns to its former level after having been lowered to that of the competitor.[114]

Several interfaces offering different degrees of convenience

Several interfaces offering different degrees of convenience: It has been found that travel agencies on the Internet offering the highest and lowest prices in fact belonged to the same company. The site offering the best price has a less attractive appearance and takes more time.[115]

Alternative of immediate purchase on auction sites

Negative effect of price discrimi-nation: undue profits

Alternative of immediate purchase on auction sites: The site Shopping.com offers the possibility to bid for an item or to obtain it immediately for a fixed price. The customer choosing to bid almost always benefits from a significant price difference, but he must wait for the close of bidding and he is uncertain about the amount of gain. Customers benefit from different prices depending on their preference for the item. In other words, Shopping.com offers a worse price to those customers who have demonstrated less elasticity regarding prices (since they prefer not to wait).

[114] Corts (1996) proposes a general model on how price matching policies allow price discrimination. Bailey, J.P. (1998b): *"Internet Price Discrimination: Self-Regulation, Public Policy, and Global Electronic Commerce", mimeo, The Robert H. Smith School of Business, University of Maryland.*

[115] Clemons, E.K., I.H. Hann and L.M. Hitt (1998): *"The Nature of Competition in Electronic Markets: An Empirical Investigation of Online Travel Agent Offerings", Working Paper, The Wharton School of the University of Pennsylvania,* June.

Positive effect of price discrimi-nation: serving consumers normally excluded from the market

Price discrimination can be applied quite the same way as on the physical market for books. One can imagine different qualities at different prices.[116]

These practices are currently not very often observed, but new technology will render them potentially durable. The extent of use of these methods will be proportional to the development of B2C commerce, which is also in its early stages. The point here is to warn of potential risks of abusive use call for vigilance. However it is not necessarily harmful. There are positive aspects of price discrimination, such as serving those consumers that would normally be excluded from the market.

The electronic environment presents a new frame of analysis that could modify some of the conclusions drawn by economic theory.[117]

The electronic environment changes the economic analysis of price discrimination

Modelling of strategic choices in price discrimination. The theory, according to which it is in a seller's interest to practice first-degree discrimination in order to capture all the surplus of the consumer, refers to a monopolistic environment In fact, economic theory has always considered first-degree price discrimination in the frame of a monopoly situation, on the condition that the latter is able to know each consumer's ability to pay.

The incentive to price discriminate was modelled in an oligopolistic environment, given that it was perceived that e-commerce probably allows price discrimination in a more competitive environment.[118] Assuming that there exists a technology allowing price discrimination at low cost, a seller may prefer not to use it. This will very much depend on the attachment of the customer to the item.

In a duopolistic environment, discrimination by both firms can lead to lower prices than in the situation where no firm discriminate.

116 Odlyzko, A. (1996): *"The Bumpy Road of Electronic Commerce" in WebNet 96 World Conference Web. Soc. Proc.; H. Maurer, ed., AACE,* pp. 378-389.

117 *This is highlighted by Ulph and Vulkan (2000a, b) in which are modelled strategic choices in price discrimination* .Ulph, D. and N. Vulkan (2000a): *"Electronic Commerce and Competitive First Degree Price Discrimination"*, mimeo, *UCL and University of Bristol*.

Ulph, D. and N. Vulkan (2000b): *"E-Commerce, Mass Customization and Price Discrimination"*, mimeo, *UCL and University of Bristol*.

118 *Ulph and Vulkan (2000a) focused on the incentives for a seller to practice first-degree price discrimination*.Ulph, D. and N. Vulkan (2000a): *"Electronic Commerce and Competitive First Degree Price Discrimination"*, mimeo, *UCL and University of Bristol*.

It must follow that when several firms in oligopoly practice price discrimination, it is as if they were engaged in competition in not just one, but on as many markets as there are different types of consumers.[119]

How can price discrimination be avoided?[120]

Price competition: Sellers must benefit through discrimination from a certain market power in order to set a price above perfect competition price, which is not possible with a pure price competition situation (referred to as Bertrand competition).

Discrimination as practiced by Books.com could even prove profitable for a consumer in the context of Bertrand competition, if this consumer has the appropriate behaviour.

Price discrimination can be avoided

Consumer strategies: A consumer may be treated as an "average consumer" by using an anonymous gateway. A consumer may also decide to be discriminated against if he considers, for example, that the associated service is worth the trouble. He can also reveal his preferences while benefiting from the advice of a seller, to ultimately make his purchase anonymously with a competitor.

Reputation: A seller may choose not to discriminate out of concern for his reputation, if he is not only concerned for the profit that he would realise on one particular sale, but for potential sales in the future. In addition, the renown of the trademark is a determining asset in e-commerce.

Intermediation: Intermediaries may also help to preserve consumers' surplus by reducing their search costs regarding prices or characteristics of products. For example, Uvision.com helps to find the best price on the software market.

119 In Ulph and Vulkan (2000a), the issue at hand is that of pure first-degree discrimination, where it is not possible to distinguish among goods. In a second paper, Ulph and Vulkan (2000b) added to the choice of sellers the possibility of personalising the offer (mass customisation). They focused on the choice of the combination of price discrimination and mass customisation strategies in an oligopolistic environment, since the Internet allows the use of one without the other.

120 Bailey, J.P. (1998a): *"Intermediation and Electronic Markets: Aggregation and Pricing in Internet Commerce", Ph.D. Thesis, Technology, Management and Policy, Massachusetts Institute of Technology, Cambridge, MA.*

They may also certify the practices of a site. For example, TRUSTe (www.truste.org) is a non-profit organisation developed by the Commerce Net consortium that lists the practices and private policies of sites in order to give them its approval. It can certify that a site does not give out information on customers for marketing purposes. Even if TRUSTe has still not identified price discrimination as an important aspect of its mission, it is well placed to become a body allowing self-regulation of this type of practice.

Intermediaries in e-commerce see themselves being given the new roles of research and confidence.

2.2 Bundling

A producer may increase his profits by selling several goods together, under certain conditions. Bundling on physical markets can be justified in certain cases. For example, for printed newspapers the bundling exists by the simple fact that many articles are sold in the same paper, without the consumer having the option to buy them separately. It would obviously be too expensive to sell the articles *"à la carte"*.

Bundling has the same objective as price discrimi-nation

In contrast, such separate sales would be completely possible for an on-line "newspaper". So one could think that bundling of information goods will disappear. Actually, it will not, since it is also a strategy that allows the producer to increase his profit.

There are, however, other sectors where bundling is completely unrelated to a problem of costs as, for example, Microsoft's versions of Windows and cable TV services. [121]

Implicitly, the offer of a large bundle of information goods, which no consumer will use in its totality, has the same objective as price discrimination. "*The conventional approach to price discrimination operates by increasing the number of prices charged to accommodate the diversity of consumer valuations. In contrast, bundling reduces the diversity of consumers' valuations so that sellers need to charge only one price, do not need to identify different types of consumers and do not need to enforce any restrictions on the prices paid by consumers.*[122]

[121] *Bakos and Brynjolfsson (1999) give the example of Electric Library, a website that provides access to about 1000 newspapers and magazines, 2000 books and 18000 photos in exchange for a subscription fee of $59.95 per year*. Bakos, Y. and E., Brynjolfsson (1999): "*Bundling information goods: Pricing, profits and efficiency*", *Management Science,* Vol. 45(12), December, pp. 1613-1630.

[122] Bakos, Y. and E., Brynjolfsson (2000): *"Bundling and competition on the Internet: Aggregation Strategies for Information Goods"*, *Marketing Science*, Vol. 19(1), January, pp. 63-82.

A supplier can therefore decrease the price-elasticity of demand for information goods by bundling them, which can make this strategy more profitable than selling them individually.

New strategic opportunities for pricing. The specificities of information goods create new strategic opportunities for sale and pricing, such as site licensing or subscription.[123]

Bundling decreases price-elasticity of demand

Site licensing granted to businesses or universities allows that any member may use the programme or the database in question. In site licensing, a producer gathers together a group of consumers in order to "smooth" the various consumers' value that they place on the same good (this is why it is considered a particular form of bundling).

A sale may also be bundled in the course of time, the payment thus taking the form of a subscription. The alternative of a subscription would be a pricing by film or by each page downloaded. However the majority of experiences of pay-per-view have not been very convincing. As consumers are generally risk-averse, they prefer a subscription system that allows them to know in advance how much they will have to pay. Financial or legal information services, such as Reuters, Bloomberg or Lexis, all have a subscription system.

What are the characteristics of information goods? Information goods, based on digital data (such as stock market information, music, newspapers, software, etc.), are characterised by a production cost that is significantly higher than the cost of their reproduction and distribution, these latter being extremely low.

Specific characteristics of information goods

Because of this characteristic, the analysis of bundling strategies in the case of information goods presents an additional interest. In effect, for other types of goods, the reaction of the consumer to bundling is not the only element to be taken into account by the supplier. He must also take into account the fact that the addition of a supplementary good in the bundle has a cost. If this production cost is too high, the producer will have no motivation to offer a bundle larger than that which a consumer can use. On the contrary, for information goods, the "production cost" effect, which tends to reduce the size of the bundle, no longer has an impact. Only the strategic aspect about demand affects the seller's decision here because the addition of supplementary information good costs almost nothing.

Consequently, there are bundles containing a large amount of information goods (see the example given above of a subscription to an on-line library), in which it is clear that a single consumer is not capable of using all the goods included in the bundle.

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123 Odlyzko, A. (1996): *"The Bumpy Road of Electronic Commerce" in WebNet 96 World Conference Web. Soc. Proc.; H. Maurer, ed., AACE,* pp. 378-389.

The analysis of bundling strategies in the case of information goods thus deserves particular examination, as literature on bundling is usually limited to the study of only a few goods having a significant marginal cost.

Need for a particular examination of bundling of information goods

Bundling of information goods and monopoly. Under certain hypotheses, when a monopoly aggregates independently-valued information goods, the more it increases the number of goods contained in a bundle, the more consumer surplus it is able to capture.[124]

Profit on each good increases

Consumer's surplus on each good tends towards zero

Intuitively, since each consumer does not place the same value on different goods, the more goods there are in a bundle, the closer the average value given by the consumers to the bundle. Thus, the monopoly is able to offer a single price that comes close to the average value that each consumer places on the bundle. Furthermore, when the number of information goods being sold together in the bundle increases, the profit realised by the monopoly on *each* good also increases, and the consumers' surplus on each good tends towards zero. However, the consumer surplus on the *totality* of the goods may continue to increase. A monopoly's potential gain from bundling diminishes with the marginal cost of the reproduction of the good, and with the degree of correlation between the values attributed to the goods.

Bundling of information goods, deterrence of market entry and predation. [125] Large scale bundling could create economies of aggregation for information goods with very low marginal cost, and this regardless of network externalities or economies of scale with potential presence of entry barriers and predatory behaviour.

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124 *It is from this point of view that Bakos and Brynjolfsson (1999) carried out their study. They focused on the strategic behaviour of a monopoly with the possibility of practicing bundling of information goods, i.e. for a large amount of goods with a very low marginal cost.*Bakos, Y. and E., Brynjolfsson (1999): *"Bundling information goods: Pricing, profits and efficiency", Management Science,* Vol. 45(12), December, pp. 1613

125 *Bakos and Brynjolfsson (2000) pursued this analysis in another study, this time in a competitive framework* Bakos, Y. and E., Brynjolfsson (2000): *"Bundling and competition on the Internet: Aggregation Strategies for Information Goods", Marketing Science*, Vol. 19(1), January, pp. 63-82. *This article successively considered different frames of analysis. It looked first of all at competition between a firm selling a single good and a firm that offers a bundle including a substitute good that only poorly compares with that of the competitor. This analysis explains the strategy of Microsoft Office, which includes numerous printing fonts as part of its basic package. The article next looks at the competition between a firm that sells a bundle of information goods and another that sells separately the goods that make up the bundle of its competitor. Finally, the article looks at the competition between two firms practicing bundling.*

A firm practicing bundling of a significant number of information goods will be encouraged to add new goods to the bundle, even if they are imperfect substitutes for the goods already in the bundle. For example, a bundle could contain competing information channels, such as a cable TV bundle containing CNN and CNBC.

New competitors are discouraged

Regarding the entry of a competitor selling an isolated good, it could be discouraged if the established firm practices bundling, even if it possesses better technology or offers better quality. Generally, it becomes much more difficult for a firm selling its products separately to compete with an established firm that bundles its information goods.

Development of predatory behaviour

Reciprocally, a market entrant would be able to take market share from the established firm by bundling and by engaging in predatory behaviour. An entrant who sells a large bundle can force a single-product incumbent firm to exit the market even if it could not do so by selling the same good separately. This would even be the case if the incumbent had better technology or quality.

2.3 Lock-in

A consumer may face switching costs, which can lock him into his current system or brand. When the costs of switching from one brand of technology to another are substantial, users face lock-in.[126]

There are numerous illustrations of the presence of switching costs on physical markets. For example, it is quite costly for a consumer to change banks, most of all in terms of time (changing bank accounts requires a redistribution of bank account number in the case of automatic payments, waiting checks to be processed, paying the costs of closure, etc.).

Context of e-commerce specifically favourable to lock-in practices

The lock-in may be a deliberate strategy on the part of suppliers, because it allows them to reduce competition. Customer loyalty cards and other types of programmes have this as a goal. On the other hand, such practices are not necessarily harmful to the consumer. Even if the suppliers' fundamental objective is to diminish competition, customer loyalty programmes can provide the customer with preferential conditions, gifts, etc.

For various reasons, the context of e-commerce is especially favourable to lock-in practices. First of all, on the Internet competition is "just a click away". The different search engines and shopbots (from "shopping robots") significantly reduce consumer search costs, and thus lead to more intense competition. Lock-in strategies are a reaction to this potentially strong competitive environment. Given these

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[126] Shapiro, C. and H. R. Varian (1998) *"Information Rules: A Strategic Guide to the Network Economy", Harvard Business School Press*.

dramatically reduced search costs, it is natural for firms to try to build customer loyalty.[127]

If firms have an evident interest in employing lock-in strategies to protect themselves from intense competition, certain characteristics of e-commerce are also likely to create switching costs and to thus lead to lock-in situations.

Sources of switching costs for consumers.[128] There are opportunities for product customisation offered by the Internet. For example *My Yahoo* offers the possibility of personalising one's homepage. As this requires a certain amount of time from the subscriber, he is encouraged to remain faithful to the website in order to obtain the full benefit of his investment, rather than to do the same on a competing website.

There are also many products on the Internet, which depend on network effects. In the presence of network effects, a single consumer might be reluctant to leave a site that has attained a certain critical size for a smaller site.

In addition, the use of certain websites requires a non-recoverable investment. In effect, the optimal use of a service sometimes requires a certain degree of familiarity. This generally means an investment in terms of time. This can be illustrated by comparing two competing services. The financial service website on *Yahoo* is easy to use from the very first visit to the website, which makes it attractive but does not encourage customer loyalty. In contrast, MSN's website has somewhat more difficult access, but offers better services to consumers taking the time to use it.

Another example is Amazon's "One Click" system, which facilitates transactions for consumers already having placed an order on the website. The lock-in effect is a result of the fact that an Amazon customer, by going to a competing website, would lose the savings in time that he would have had with Amazon's One Click.

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127 as emphasised by Varian H. R. (1999): *"Market Structure in the Network Age"*, in Brynjolfsson and Kahin eds., *Understanding the Digital Economy*, M.I.T. Press, Cambridge MA, pp. 137-150.

128 Gaudeul and Jullien (2001) define three sources of customer loyalty programmes on the Internet Gaudeul, A. and B. Jullien (2001): *"E-Commerce: vers une analyse économique", forthcoming in Revue Economique.*

Consequences for competition.[129] The first effect is the creation of market power. As explained above, consumers may be loyal to a particular supplier because of the lock-in effect, and thus are less sensitive to an eventual price increase. As reduction of demand elasticity tends to diminish price competition, it gives certain suppliers market power. Therefore, to a certain extent, lock-in effects inhibit competition.

Consequences for competition:

- Creation of market power

- Cross subsidising

The second effect is that of "cross-subsidising". E-businesses are encouraged to attract new customers to their websites so that they will form a captive customer base, on which the e-business can impose prices above the competitive level. In this manner, one sees a form of "subsidising" of new customers by old customers. In effect, suppliers are motivated to offer better terms to new customers, with these advantages being financed by the profits from old customers whose demand is less sensitive to price variations.

2.4 Brand name and confidence

Most information goods available on the Internet have the characteristics of "experience goods", which means that they are goods the quality of which can only be judged after the transaction. These are thus in contrast with search goods, whose quality can be determined before purchase.[130]

Most information goods are "experience goods"

In effect, *"the final value to a consumer of an information good cannot be evaluated without the consumer becoming familiar with the good. However, gaining this familiarity removes the consumer's motivation to buy the good, since the transfer of value has already been effected*".[131]

The purchase of a good without the possibility of testing it beforehand therefore involves a risk for the consumer. In order to minimise this risk, the consumer will tend toward well-known brand names whose reputation assures him of quality.

Many digital products are experience goods that buyers must first consume in order to learn their quality. However, information product sellers are reluctant to offer product information prior to purchase

[129] *The impact of the lock-in effect on competition in e-commerce is that described by Klemperer (1995)*Klemperer, P. (1995): *"Competition when Consumers have switching costs", Review of Economic studies*, Vol. 62, pp. 515-532.

[130] Nelson, P., (1970): *"Information and Consumer Behavior", Journal of Political Econom*y, Vol. 78, March/April, pp. 311-329.

[131] Gaudeul, A. and B. Jullien (2001): *"E-Commerce: vers une analyse économique", forthcoming in Revue Economique*. Non-official translation.

because product information is often the product itself.[132]

Brand name and confidence are essential in e-commerce

Reputation is an important quality even for ordinary goods. In addition to the problems linked with the characteristics of an experience good, Internet purchasing may involve other risks regardless of the nature of the good. An example is the risk involved in payment for a good. A website's good reputation leads the consumer to believe that the site has taken the necessary precautions to secure payment transactions. Furthermore, going to a website of a well-known brand eliminates the risk of entering a "phantom" website, which was intended to actually sell anything and which disappears as soon as the consumer pays).

Generally, 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.

Firms' strategies regarding reputation. Establishing a good reputation may be very costly, especially for a firm that is an Internet pure player, *i.e.* a firm with no activity on the physical market and which consequently does not benefit from a recognised brand name. This cost thus constitutes a barrier to entry for certain firms.

Building a reputation is costly for new entrants

On the other hand, those firms that have already developed an important activity on the physical market and that subsequently launch into e-commerce ("clicks and mortar" firms) benefit from a considerable competitive advantage over Internet pure players. For other firms, excluding extremely costly advertising campaigns, there are other means allowing them to build their reputation. [133]

New sites can propose attractive prices sufficiently low so that it compensates the consumer for any "risk" undertaken in buying on the site. This practice help build customer confidence in a site because, on the one hand, customer uncertainty is significantly reduced after a first purchase (if satisfactory) and, on the other hand, "*word of mouth communications (by e-mails) about the website seem especially effective on the Internet, especially concerning forums"*.[134]

The number of visitors to a website can also be regarded as indicating the website's quality. Thus, certain websites make these statistics available in order to show any upward trend in the "hits" on the site.

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[132] Choi, S-Y., O. D. Stahl and A. B. Whinston (1997a): *"Intermediation, Contracts and Micropayments in Electronic Commerce", Electronic Markets Newsletter*, Vol. 1997 (4).

[133] *Gaudeul and Jullien (2001) provide three possibilities.* Gaudeul, A. and B. Jullien (2001): *"E-Commerce: vers une analyse économique", forthcoming in Revue Economique.*

[134] Non-official translation

Finally, there are certain services specialised in providing information about websites. This information includes the number of visitors to a site and their opinions of the site. New customers can leave their opinions and consult those of other users. An example of this type of service is the website Alexa, a subsidiary of Amazon.

Finding new strategies to build reputation

Other sites are intended to promote confidence in the Internet and to facilitate transactions.[135] Some of these rely on customer information in order to establish the reputation of certain e-businesses, such as Bizrate.com, or provide certificates of authenticity, such as Verisign.com.

Hypertext links to well-known sites are occasionally used to bestow consumer confidence.[136] Generally, hypertext links may benefit a website by allowing monetary reward for efforts, advertising or rapid access to other sites, or the site may be more attractive because it provides access to other services. Thus, consumers are attracted to portal websites (those including numerous hypertext links) in order to quickly and easily access a large number of services, which the portal website itself does not have the time or resources to do itself.

Providing good product information can also be a way to send a positive signal to consumers.[137]

Consumer reactions. Even if shopbots helped reduce the market power of e-businesses with well-known brand names, the brand and customer loyalty enjoyed by certain firms strongly influences consumer choices.[138] A seller would benefit from an advantage in terms of prices as compared with its competitors in 3.1% of the cases where there is a recognised brand name, and in 6.8% of the cases where there is customer loyalty.

Well-established brands enjoy

Confidence and reputation are essential in e-commerce for information goods, as well as for all goods sold on the Internet. A good image among consumers is indispensable to the success of a website. Despite

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135 Kollock, P. (1999): *"The Production of Trust in Online Markets"*, *Advances in Group Processes*, Vol. 16 (July), edited by E. J. Lawler, M. Macy, S. Thyne, and H. A. Walker, Greenwich, CT: JAI Press

136 Brynjolfsson, E. and M. D. Smith (2000): *"Frictionless Commerce? A Comparison of Internet and Conventional Retailers"*, *Management Science*, Vol. 46(4), April, pp. 563-585.

137 Urban, G.L., F. Sultan and W. Qualls (1998): *"Trust Based Marketing on the Internet"*, *M.I.T. Sloan School of Management Working Paper, 4035-98.*

138 *Brynjolfsson and Smith (2001) empirically tested consumer behaviou.r* Brynjolfsson, E. and M. D. Smith (2001): *"The Great Equalizer? Consumer Choice Behavior at Internet Shopbots"*, Working Paper, *Sloan School of Management, M.I.T.* and *H. John Heinz III School of Public Policy and Management, Carnegie Mellon University.*

a greater competitive advantage

the diversity of means allowing sellers to send positive signals of quality and reliability, the construction of a good image remains a significant cost that can constitute a considerable barrier to entry, especially for Internet pure players. Brand confidence is a major advantage in e-commerce, with those sites benefiting from an established reputation on the physical market enjoying a great competitive advantage and facing less competition from other firms. [139]

3. Role of intermediaries in e-commerce

Role of intermediaries

In order to thoroughly understand e-commerce, one has to consider the role of intermediation. It seems that a large number of Internet innovations relate to intermediation. Furthermore, the changes linked to intermediation are the most decisive for the totality of economic exchanges.[140]

Definition. The activity of intermediation, occurring widely in the physical market, deserves particular analysis in e-commerce. The following definition can be offered: *"[a]n* intermediary, *also called a* middleman *or* broker *in the research literature in various fields, helps to facilitate transactions between buyers and sellers by providing value-added services such as aggregation and distribution of products and product information, quality checks and warranties".*[141]

The phenomena of disintermediation and reintermediation. The hypothesis has often been advanced that the development of e-commerce will lead to a general trend of disintermediation. Owing to the relative abolition of geographical constraints, the low costs of entry and costs of transactions on the Internet, e-commerce is viewed as favourable to direct contacts between producers and consumers. Therefore, e-commerce could function without intermediaries, and could even compete with and threaten the existence of intermediaries in traditional commerce.

disintermediation has not actually been observed

For the time being, disinter mediation has not actually been observed. On the contrary, the presence of intermediaries seems to be increasing. In reality, the role of intermediaries is not limited to the distribution and supply of a product. Excluding the management of physical infrastructure, they ensure other key functions, which have been

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139 Shankar, V., A. Rangaswamy and M. Pusateri (1998): "*The Impact of Internet Marketing on Price Sensitivity and Price Competition*", mimeo presented at *Marketing Science and the Internet*, INFORM College on Marketing Mini-

140 *The Economist* (2000): *"survey on e-commerce"*, february.

141 Choi, S-Y., O. D. Stahl and A. B. Whinston (1997b): "*The Economics of Electronic Commerce*". New York, NY: Macmillan.

enumerated in several studies. Four key functions can be identified.[142]

Four keys functions of intermediaries

Aggregation. *Intermediaries may aggregate either the demand or the offer of a good. Examples of sites designed to aggregate demand, i.e. to group together a number of consumers, are uncommon. There is, however, the example of group purchasing sites, such as* Mobshop.com, *in which prices decrease as the number of buyers increases.*

Aggregation

"Aggregating" the offer consists of grouping together products from different producers. For example, in the physical market this function is fulfilled by supermarkets. In the physical market, the advantage is "one-stop shopping" by which journey and time are saved by not needing to shop in several different stores. Of course this geographical aspect is not relevant on the Internet. However, the aggregation of a number of goods gives the consumer an advantage in terms of time and simplicity, in view of the multitude of websites and the time sometimes required for the first purchase.

Thus, intermediaries create value by aggregating different goods or services that ordinarily would be provided by separate industries (Bakos, 1998).[143] For example, let us take the case of a consumer wishing to buy a car. He must first of all make his choice among existing models, based on advice from others, or from magazines or his personal experience. He will then have to negotiate a price, order the vehicle and go to a dealer to pick it up, obtain financing from a bank and then insure his car. Certain intermediaries, such as autobytel.com and Microsoft's carpoint.com offer all these services in one *personalised* product. There are other intermediaries with similar functions in other sectors, such as in travel, with intermediaries like travelocity.com and expedia.com.

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142 *For example, Bailey (1998a) identified four discussed here above.* Bailey (1998a): *"Intermediation and Electronic Markets: Aggregation and Pricing in Internet Commerce", Ph.D. Thesis, Technology, Management and Policy, Massachusetts Institute of Technology, Cambridge, MA. It may be that e-commerce has certain characteristics that give these functions particular importance, thereby leading to the appearance of new intermediaries. Far from disappearing, Internet intermediation is developing in many different forms, thus leading to "reintermediation".*

Confronted with a number of differences in the literature on the Internet economy concerning the meaning of these terms, it should be specified that disintermediation is a phenomenon provoked by e-commerce, with repercussions on the physical market. Reintermediation concerns essentially e-commerce, whether its actors are Internet pure players or "clicks and mortar".

If disintermediation remains, at least for the time being, a rather marginal phenomenon, reintermediation is, in contrast, quite undeniable.

143 Bakos, Y. (1998): *"The Emerging Role of Electronic Marketpaces on the Internet", Communication of the ACM,* Vol. 41(8), August, pp. 35-42.

The difference between aggregation and bundling (see section 1.2.a above) consists of the fact that aggregated goods are usually personalized, *i.e.* that the composition of the bundle is made "*à la carte*".

Pricing

Pricing. *As supply and demand are difficult to evaluate, an intermediary fixing a price based on the aggregated offer and the potential demand for a good behaves like a Walrassian middleman and helps to determine the market's equilibrium price. In fact, he helps to centralise the offer and demand as well as to fix the market price.*

Search

Search. *The information provided by intermediaries can be of two types: prices or characteristics of a product. The dissemination of this information especially benefits consumers, whose search costs decrease. This is because intermediaries organise and filter the information as well. In addition, they provide more objective information than the sellers themselves. The information on the various products offered on the market is generally accompanied by an easy access to the product in question. This function of bringing the buyers and sellers closer together is sometimes called "matching".*

Portal sites, such as AOL, Yahoo, Wanadoo and MSN, are a good example of intermediaries enabling the consumer to facilitate his search for a product on the Internet. The intermediaries offering aggregated products, as discussed above, also fulfil a search function.

Trust

Trust. *As mentioned above, confidence has an essential role in Internet transactions. Because of the information he possesses, an intermediary is able to protect the market actors from the opportunistic behaviour to which they might otherwise be susceptible. By acting as the guarantor of both sides in the transaction, he preserves them from the risks of the transaction. The intermediary's own reputation and long-term presence on the market encourage his impartiality.*[144]

Intermediaries help to intensify price competition

Effect on competition in the market for product offers. By reducing consumers' search costs, intermediaries help to intensify price competition. As this does not benefit sellers, some search engines are refused access to certain websites. These websites refusing to disclose their prices argue that information solely about prices harms their offer. For a single good, price differences can arise from supplementary services offered by the site. In this case, although the supplier's goods may be more expensive, they are also of better quality, therefore the price information provided by the agent effectively gives a false impression of the seller's goods.

[144] For a more in-depth analysis on the role of confidence on the Internet, see section 1.2.d above.

The presence of "asymmetrical" network effects. Intermediation is characterised by strong network effects.[145] A distinction can be drawn between direct network effects (between users of the same type) and indirect network effects (between different types of agents, consumers and sellers). Intermediation on the Internet could create network effects, and studied the strategies resulting there from, such as cross-subsidisation.[146]

Presence of "asymmetrical" network effects

The role of intermediation in the creation of network effects develops from the double function of Internet intermediaries. In most cases, this consists of satisfying two types of customers: sellers and buyers. The buyers generally want there to be many sellers in order to give them a wide choice, and sellers want there to be as many buyers as possible. Therefore, in order to attract one side of the market, the opposite side must be present, and vice versa. However, which side should one start with? Should preferential conditions first be proposed to consumers, in order to attract sellers, or vice versa? Intermediaries find themselves confronted with this "chicken-and-egg" problem.

Cross-subsidisation and "free agents"

Competition between intermediaries, cross-subsidisation and "free agents". In the presence of asymmetrical network effects, intermediaries tend to practice cross-subsidisation, which means proposing a price below marginal cost to certain types of agents, and to realise profits on another category of agent thanks to a supra-competitive price.[147] This effect from cross-subsidisation could even lead to free services from certain agents, which has been widely observed on the Internet for information goods. Their analysis suggests that the presence of such network effects could justify, on the one hand, an imperfect competitive situation and, on the other hand, lead to aggressive strategies to capture demand. However, the authors emphasise that the problem of competition between intermediaries should be approached with precaution. In particular, their analysis only takes account of the *matching* function of intermediaries.

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145 Gaudeul, A. and B. Jullien (2001): *"E-Commerce: vers une analyse économique", forthcoming in Revue Economique.*

146 *The problem of indirect network effects caused by intermediation on the Internet is also examined in an article by Caillaud and Jullien (2000) in which the authors modelled these effects in order to determine their impact on competitionCaillaud, B. and B., Jullien (2000)*: *"Chicken and Egg: Competing Matchmakers"*, mimeo presented at IDEI Conference: "The Economics of The Software and Internet Industries", Toulouse (France).

147 Gaudeul, A. and B. Jullien (2001): *"E-Commerce: vers une analyse économique", forthcoming in Revue Economique.*

4. Competition between firms in e-commerce

4.1 Presentation of firms involved in e-commerce

Competition between firms in E-Commerce

Firms involved in e-commerce come from many different sources. This diversity is relevant for the analysis of competition to the extent that it leads to different costs, restrictions and strategies for these firms.

There are generally considered to be two types of firms: those whose activity is essentially concentrated on the Internet ("Internet pure players") and those firms that operate on both the physical market and on-line market, the "clicks and mortar" firms.

An additional distinction should be made regarding mail-order firms, which have advantages as compared with other firms on the physical market (the cost structure of each type of firm will be examined later).

Two types of firms involved in e-commerce :

- Internet pure players

- Click and mortar firms

A study concerning on-line sales of more than 2000 French *retail firms* for the last quarter of 2000 was carried out in 2001 which showed that the Internet pure players are generally small, independent - and new – 60% of those existing in 1999 were created that year. [148]

Also according to this study, the privileged sectors in e-commerce (except for services) are in value records (with 38% of sales from the Internet) and clothing (28% of sales). The sector with the highest proportion of e-commerce is "non-beverage food products" where this proportion reaches 23%, although in value Internet sales represent only 2% of this category. In fact, these sales concern rare or special local products, such as wine or other fine foods, supplied by many small producers.

Cost structure and comparative advantages of e-commerce firms

4.2 Cost structure and comparative advantages of e-commerce firms [149]

The examination of the cost structure of e-commerce enterprises is faced with problems. In effect, firms consider these data as confidential and strategic and generally do not want to reveal them. This fact causes a bias in any studies on the subject.

The results of the study are based on information *declared* by firms, so they perhaps sought to minimise their communication costs. The declared expenses seem unrealistic in view of the massive advertising expenses. *"The advertising budget would not have exceeded 50 000 FF in three-fourths of the cases […]. Two out of five e-commerce*

[148] Merceron, S. (2001): *"Le commerce de détail s'initie à la vente sur Internet", INSEE PREMIERE,* N° 771, Avril.

[149] *The figures and results of this section are from Merceron (2001.)* Merceron, S. (2001): *"Le commerce de détail s'initie à la vente sur Internet", INSEE PREMIERE,* N° 771, Avril.

businesses declared an advertising budget of zero in 1999"[150]. Nevertheless, it is true that certain well-known brand names can almost dispense with the need for advertising (for example, Darty did not need to exert much promotional effort to attract the customers of its Internet competitor, just a few months after the launch of its website).

Scarcity of available information

In effect, the different types of firms do not benefit from the same comparative advantages. As mentioned above, those firms having a familiar brand name on the physical market have a considerable advantage. This advantage concerns consumer search costs, since the firm's offer is already known, as well as consumer confidence (concerning payment, quality, respect of the contract, etc.). However, these firms, particularly those in the large retail sector, waited a long time before entering e-commerce: "*at the end of 1999, 80% of those e-businesses with shops achieved less than 1% of their turnover on the Internet*". The motive for firms that finally decided to participate in e-commerce is basically to seize the opportunities available on an emerging market, to improve their services and to promote their image.

The firms originating from the mail-order sales sector also benefit from a number of comparative advantages. Their logistics infrastructure is already in place and they have a know-how that will take their competitors time to acquire. Mail-order selling used to experience a slowdown, but then "*e-commerce allows a relationship with the consumer that is both interactive and more personalised [and] thus offers the opportunity for a new development, while keeping the principles and know-how acquired in mail-order sales".*

This logistics aspect is very important because only one-fifth of e-commerce firms delegate this work to a contractor or sub-contractor. In the majority of cases, the firms take charge of the logistics and preparation of the orders themselves, either in warehouses or shops.

Two-thirds of e-commerce websites are hosted by an access provider. Thus, the average cost of creation of an e-commerce site is relatively low, *i.e.* less than 150 000 francs for three-fourths of all firms. The subsequent implementation, which 80% of firms carry out themselves, costs less than 7000 francs per year for half of firms. It can thus be concluded that "technical" expenses are not a sufficiently high cost to constitute a barrier to entry into e-commerce.

150 Non-official translation.

4.3 Cannibalisation

The dual presence of "clicks and mortar" on the two types of markets may present strategic problems for these firms. Businesses want to avoid competing against themselves (cannibalisation) by developing one activity that will compete against the former activity and thus lower prices. [151]

Cannibali-sation

The consumer makes his choice so as to most closely meet his preferences and to minimize his transaction costs (search time, risk of the transaction, etc.).[152] Based on this theoretical model, the authors conducted an econometric study. Considering consumer behaviour, the development of an online activity by a "bricks and mortar" firm does not necessarily lead to cannibalisation.

Based on certain hypotheses, notably that there is a certain proportion of consumers with Internet access and without search costs, this analysis leads to the following conclusions[153]:

First of all, prices in traditional commerce will tend to diminish as this proportion increases. Next, the relationship between online and offline prices directly depends on the shopping costs on the physical market, Internet navigation costs and transport costs. Finally, online sellers propose higher prices when they also are active on the physical market.

This theoretical analysis is complemented by an empirical study on the market for books and CDs in Sweden, which shows that the prices on the Internet are lower. However, the article concludes that there is a potential cannibalisation effect as regards "clicks and mortar" firms that limits the pro-competitive impact of e-commerce.

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151 For example, Bailey (1998b) suggested that if Barnes & Noble does not have a price matching strategy as aggressive as that of Amazon, it is perhaps because they do not want to compete in their branch of the physical market. Since Barnes & Noble claimed that their on-line prices are the same as in their stores, they do not wish to greatly alter their prices.
Bailey, J.P. (1998b): "Internet Price Discrimination: Self-Regulation, Public Policy, and Global Electronic Commerce", mimeo, The Robert H. Smith School of Business, University of Maryland.

152 *Ward and Morganosky (2000provided an element of the answer by focusing on the manner in which e-commerce distribution chains compete with traditional distribution chains. They propose a model in which the consumer chooses his means of purchase based on the degree of his familiarity with the latter and his search costs.*.Ward M. and M. Morganosky (2000): *"Does Online Retailing Cannibalize other Market Channels?"*, mimeo *University of Illinois, Urbana Champain*.

153 *Friberg, Ganslandt and Sandström (2000) conducted a theoretical analysis in order to study the link between prices observed online and offline.*Friberg, R., M. Ganslandt and M. Sandström (2000): *"E-commerce and Prices-Theory and Evidence", SSE/EFI working paper series in Economics and Finance* No 389, June.

In conclusion, the theoretical and empirical literature on this subject is only in its early stages of development and thus may give contradictory conclusions. The studies are also relatively rare and do not allow economic analysis to come to any definitive conclusions on this subject.

After having described the strategies of firms in e-commerce, we will assess depending on the strategies chosen the different antitrust concerns that may arise. Regarding the traditional distribution systems such as selective exclusive, antitrust issues are arising due to the emergence of e-commerce. Indeed these two sales channels compete with each other, and due to the characteristics of the Internet (lower costs, worldwide network…), free-riding problems between retailers may occur. On the one hand, suppliers may try to protect their traditional networks, by refusing to deal their goods to Internet pure players. On the other hand traditional retailers may complain of free riding.

These different points will be stressed out below in Section II.

Section II.

Identification of potential anticompetitive effects that can result from e-commerce when it constitutes a new sales channel

E-Commerce, a new sales channel

E-commerce constitutes a new sales channel, which competes with traditional systems of distribution, such as **selective distribution** which is a "*distribution system where the supplier undertakes to sell the contract goods or services, either directly or indirectly, only to distributors selected on the basis of specified criteria and where these distributors undertake not to sell such goods or services to unauthorized distributors*"[154]; and **exclusive distribution** which is an agreement by which **"***the supplier agrees to sell his products only to one distributor for resale in a particular territory. At the same time the distributor is usually limited in his active selling into other exclusively allocated territories"***.**[155]

In the case where the supplier has set up a selective or an exclusive distribution network, the following competition concerns may arise:

- 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;

- Suppliers may start to sell their own products via the Internet;

- Internet pure players may complain that they are not being supplied.

[154] Block Exemption Regulation (hereinafter the "BER") on vertical restraints, n° No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, *Official Journal L 336, 29/12/1999 p. 21 – 25.*

[155] Commission Notice - Guidelines on Vertical Restraints (Hereinafter "Guidelines on Vertical Restraints) *O.J C 291 of 13.10.2000, page 1* n°161.

1. The risk of free riding (in selective/exclusive distribution)

1.1 Internet retailers may free ride traditional retailers

A "free-rider problem" can occur when a distributor or supplier takes advantage of the promotion efforts of another distributor to sell its own products.

Internet retailers may free ride traditional retailers

In the cases where e-commerce constitutes a new retail channel, competing with traditional retailing, there are risks of free riding between on-line and traditional retailers. Customers may prefer to verify the quality of the product in person[156], and then buy it from an online seller, often at a lower price.

Free riding can take several forms: An Internet retailer may free ride the efforts of traditional retailers; in the specific case of exclusive distribution, an exclusive distributor may free ride another one by selling its products on its territory.

1.1.1 The difference of costs. One competition concern raised by the Internet is that retailers which only trade products via the Internet (Internet pure players) can free-ride on traditional retailers.

Costs borne by suppliers are not the same

Indeed, the costs borne by these suppliers are not the same. For franchising and selective distribution, distributors have to meet certain selection criteria. For example, in the perfume retail sector, most authorised retailers or their sales staff must have professional qualifications in perfumery and must provide adequate advisory and demonstration services for customers in their retail outlets. The location, name and presentation of the retail outlet must reflect the prestige of the brand, and the quality of the outlet is assessed by reference to the nature, standing and external appearance of other shops in the immediate neighbourhood, as well as the facade, shop window size and decoration, sales area, lighting, floor, furniture, fixtures and fittings of the shop. If another activity is carried on in the retail outlet, the eligibility of the application for the opening of an account is also assessed in light of the scale of the other activity, the external and internal presentation and separation of the two activities and the competence of the staff allocated to the sale of the products.

[156] See as example European Commission: Report on the evaluation of Regulation EC 1475/95 on the application of article 85§3 of the treaty to certain categories of motor vehicle distribution and servicing agreements, n°139.
Available at:
(http://www.europa.eu.int/comm/competition/car_sector/distribution/eval_reg_1475_95/report/en.pdf).

Internet pure players can sell products at a lower price

A distributor selling its products on the Internet does not bear the same costs as a traditional distributor. Consequently, it can sell its products at a lower price. Products sold under selective, exclusive, or franchising agreements must meet high quality or high technology standards. The products' specificities imply that a consumer will usually want first-hand contact with the products before purchase. This is particularly the case for cosmetics and perfumery products. Perhaps, once the customer has had this first contact with a traditional retailer, he will make his actual purchase from an online seller at a lower price over the Internet. This constitutes free-riding and unfair competition on the part of Internet distributors.

Products' specificities imply first-hand contact with the products before purchase

1.1.2 The attempt at homogeneity of the network. This does not serve the interest of the supplier since Internet retailers do not participate in the same way in the promotion of their suppliers' products, and thus to the increase of its profits. After a while, brick and mortar retailers could decide to stop selling the suppliers' products, since they have more constraints than benefits.

Risk of attempt at homogeneity of the network

Brick and mortar retailers could decide to stop selling the suppliers' products, since they have more constraints than benefits

This would also be harmful for the sales of the supplier since vertical restraints have positive effects by, in particular, promoting non-price competition and improved quality of services. When a company or trademark is not well known, it can only try to increase its profits by optimising its manufacturing or distribution process. Vertical restraints can help the supplier to promote his goods, and give him the confidence that his suppliers will endeavour to sell his goods, and to make them compete with other products.

This would also be harmful for the sales of the supplier

As stated in the recent Commission's guidelines on vertical restraints, there are also good reasons for territorial protection and it can allow:

"To open up or to enter new markets": Where a manufacturer wants to enter a new geographic market, for instance by exporting to another country for the first time, this may involve, as noted by the Commission in its guidelines (116.2), '*special first time investments" by the distributor to establish the brand in the market. In order to persuade a local distributor to make these investments it may be necessary to provide territorial protection to the distributor so that he can recoup these investments by temporarily charging a higher price. Distributors based in other markets should then be restrained for a limited period from selling in the new market.* ***This is a special case of the free-rider problem***".

Thus, an exclusive distributor, investing considerable effort to launch a new product on a new geographic territory through extensive promotional campaigns, could not benefit from its efforts. Indeed, all promotion has a cost that is included in the price of a product. Other distributors situated in other exclusive territories and who have already launched this product, are thus able to sell the product at a lower price. Even if this issue is not new, it involves wider and more important consequences when dealing with e-commerce.

The customer can find products more easily via the Internet, and at a lower price, and can then buy them from the website. This is considered as free riding, since although the distributor located in the other exclusive territory did not make any efforts to sell this product on the customer's territory, it receives the benefits (*i.e.*, customer sales) from the promotional campaigns devised by the other distributor.

In the meantime, the exclusive distributor did not get the expected results (*i.e.*, sales).

The risk of depreciation of the product

Possibility for customers to be able to buy luxury goods anywhere could be harmful for the high quality image of such products

1.1.3 The risk of depreciation of the product. The possibility for customers to be able to buy luxury goods anywhere could be harmful for the high quality image of such products. Indeed, as pointed out by the Commission in its decision of 12 December 1991[157] (Yves Saint Laurent Parfums): '*The articles in question are high-quality articles based on specific research, which is reflected in the originality of their creation, the sophistication of the ranges marketed and the qualitative level of the materials used, including their packaging. Their nature as luxury products ultimately derives from the* ***aura of exclusivity and prestige that distinguishes them from similar products falling within other segments of the market and meeting other consumer requirements****. This characteristic is, on the one hand, closely linked to the producer's capacity to develop and maintain an up-market brand image and, on the other, depends on appropriate marketing that brings out the specific aesthetic or function quality of each individual product or line of products.*"

The Commission's decision was upheld by the CFI[158]**:** "Generalised distribution of the products at issue, as a result of which Givenchy would have no opportunity of ensuring that its products were sold in appropriate conditions, would entail the risk of deterioration in the presentation **of the products in retail outlets which could harm the `luxury image' and thus the very character of the products concerned**".

157 Decision 16 December 1991: Yves Saint Laurent Parfums, OJ L012, 18/01/1992, p.24.

158 CFI, 12 december 1996, GALEC v. Commision of the European Communities, Case T-88/92, ECR 1996 p. II; 1961; Case T-19/92, ECR 1996, p.II.1851.

1.1.4 The question of the imperviousness of the network Against this framework, traditional retailers can complain that e-commerce retailers are being supplied even though they do not satisfy the qualitative criteria or non-compete clauses applied to traditional retailers.

Traditional retailers can complain that e-commerce retailers are being supplied even though they do not satisfy the qualitative criteria or non-compete clauses applied to traditional retailers

(i) Selective Distribution. This was the case concerning selective distribution in the luxury cosmetic sector in the French case relating to *Parfumsnet*[159], an undertaking selling luxury cosmetic products over its Internet website (Parfumsnet.fr), such as Yves Saint Laurent and Van Cleef and Arpels perfumes and cosmetic products. These brands complained that Parfumsnet was selling these products without being admitted to their selective distribution network, and that the products were not being presented appropriately on the website in order to preserve the luxury image of the goods. The plaintiffs argued that Parfumsnet was a free rider trying to take advantage of the New Economy, without supporting charges inherent to this selective distribution system.

Cf Parfumsnet case for selective distribution

The President of the Tribunal de Commerce of Nanterre considered, that Parfumsnet had to cease immediately the marketing of the plaintiffs' products on its website, and that this manner of selling products without being admitted to the exclusive distribution network constituted unfair competition.

This case raises the question as to whether suppliers can protect the imperviousness of their networks on a global market like e-commerce.

(ii) Exclusive Distribution. Concerning exclusive distribution, traditional distributors have also voiced complaints concerning free rider e-commerce retailers, who face lower costs and so can undercut costs. A good example of this problem is the "*Fair Allocation System*"[160] case in the United States. In this case a group of 25 Chrysler dealers in the Northwestern U.S. was losing sales to another dealer that sold at low prices over the Internet.

Cf the "Fair Allocation System" case for exclusive distribution

The innovative dealer offered low, "*no haggle*" pricing, and was among the first dealers nationwide to sell over the Internet. The Internet enabled this dealer to sell to customers over a wide geographic area in eastern Washington, Idaho, and western Montana. To combat this new form of competition, the full price dealers established the "*Fair Allocation System*" and threatened to refuse to sell certain

159 Tribunal de commerce of Nanterre, 4 October 2000, available on www.parfumsnet.fr.

160 See Balto, "Emerging antitrust issues raised by e-commerce", available on www.ftc.org.

Chrysler models and to limit the warranty service they would provide particular customers unless Chrysler limited the allocation of vehicles to the Internet seller.

1.2 Free ride by approved retailers of other approved retailers over the Internet (the specific case of exclusive dealing agreements)

The specific case of exclusive dealing agreements

Under exclusive distribution, a territory is assigned to the distributor and he can only enter into competition and sell his products in non-exclusive territories under certain conditions (passive sales).

Under BER a supplier is allowed to restrict active sales but not passive sales

According to Article 4 of the Block exemption Regulation on Vertical Restraints [161] a restriction of the territory within which a distributor may sell is considered a hardcore restriction. However, the BER also contains important exceptions to the provisions on hardcore restrictions. According to Article 4(b) of the BER, a supplier is allowed to restrict active sales by its direct buyers to a territory or a customer group which has been allocated exclusively to another buyer or which the supplier has reserved to itself.

However, exclusive dealing agreements must permit passive sales to such territories or customer groups. Otherwise, the exclusive dealing agreement cannot benefit from the block exemption.

The Commission's guidelines on vertical restraints[162] (Hereinafter "Vertical Guidelines") gives a definition of what is to be considered as a passive or an active sale (considérant 50 in fine):

General definition of active and passive sales given by the guidelines

1.2.1 General definition of active and passive sales given by the guidelines[163]: "Active" sales mean actively approaching individual customers inside another distributor's exclusive territory or exclusive customer group through, for instance, direct mail or visits; or actively approaching a specific customer group or customers in a specific territory allocated exclusively to another distributor through advertisements in medias or other types of promotions specifically targeted at that customer group or targeted at that customer in that territory; or establishing a warehouse or distribution outlet in another distributor's exclusive territory.

"Passive" sales mean responding to unsolicited requests from individual customers, including delivery of goods or services to such

[161] Block Exemption Regulation (hereinafter the "BER") on vertical restraints, n° No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, *Official Journal L 336, 29/12/1999 p. 21 – 25.*

[162] Commission Notice - Guidelines on Vertical Restraints; *O. J C 291 of 13.10.2000, page 1.*

[163] Point 50.

customers It can also include general advertising or promotion in medias or on the Internet that reaches customers in other distributors' exclusive territories or customer groups, but which are a reasonable way to reach customers outside those territories or customer groups, as for instance to reach customers in non-exclusive territories or in one's own territory.

Furthermore, according to the Commission's Vertical Guidelines, *"Every distributor must be free to use the Internet to advertise or to sell products. A restriction on the use of the Internet by distributors could only be compatible with the BER to the extent that promotion on the Internet or sales over the Internet would lead to active selling into other distributors' exclusive territories or customer groups"* .[164]

The Vertical Guidelines add, "In general, the use of the Internet is not considered a form of active sales into such territories or customer groups, since it is a reasonable way to reach every customer". The fact that it may have effects outside one's own territory or customer group results from the technology, i.e., easy access from anywhere.

Due to worldwide characteristics of the Internet it is difficult to allocate and protect exclusive dealing territories

1.2.2 Exclusive distribution, where exclusive territories are allocated to resellers, a problem of free riding between approved resellers may occur. Indeed, due to worldwide characteristics of the Internet, difficult to allocate and protect exclusive dealing territories.

Due to this new distribution channel, some problems of free riding can occur between approved exclusive retailers or franchisees. One distributor may free ride on the promotion efforts of another distributor.

Given the growth of Internet trading and website marketing, these conflicts are likely to become an important issue.

1.3 Suppliers and manufacturers may decide to retail their own products

With the Internet, suppliers/ manufac-turers may be tempted to retail their own products

The Internet is likely to affect the supply chain. In traditional commerce, the costs of maintaining a network of retail outlets and the attractiveness of having a relatively wide range of products within each outlet may have deterred manufacturers from retailing their own products. With the Internet the suppliers/manufacturers may be tempted to retail their own products.

According to the Vertical Guidelines (point 51 in fine), the supplier cannot " *reserve to itself sales and/or advertising over the Internet".* On the contrary we could consider that the supplier can, without reserving it to itself, sell its products over the Internet.

[164] Point 51.

Here the issue is whether a supplier can compete with his retailer by selling products over the Internet.

1.3.1 Competition concerns. Suppliers do not usually sell their products directly (except in certain cases for exclusive distribution), since it is very difficult and expensive to set up one's own network, in different countries and cities, in order to reach final customers. With the Internet, and its worldwide network, this is now possible. The Internet creates the perfect opportunity for a supplier to start selling its products, and thus enter into competition with its retailers.

This question has not yet been raised before a European jurisdiction, but the U.S. has seen a similar case, discussed below

In most cases, the supplier has more "resources" than its retailers, thereby allowing it to set up a more attractive website. Besides it can take advantage of its trademark to "reference" its website to the disadvantage of its retailers, since when a customer will look for a particular trademark he will be directed to the supplier's website. The supplier can also sell its products at a lower price, since it is vertically integrated.

This question has not yet been raised before a European jurisdiction, but the U.S. has seen a similar case, discussed below.

1.3.2 The case "Emporium Drug Mart, Inc".[165] According to the American Arbitration Association (hereinafter AAA), the undertaking "Drug Emporium, Inc." infringed the rights of its franchisees by selling its products on the website DE.com.

The claimants were franchisees who operated in their respective territories high volume, low margin drug stores bearing the service mark "Drug Emporium". The respondents were Drug Emporium, Inc (DEI), the franchisor, and its subsidiary, Drug Emporium.com (DE.com), a virtual drug store on the Internet. The franchisor was directly selling its products online via its website "drugemporium.com". The franchisees complained before the AAA that the franchisor had allegedly infringed his contractual obligations stipulated in the franchise agreement, as well as the use of the trademark.

The case "Emporium Drug Mart, Inc"

The claimants' arguments were the following:

"The license granted is the exclusive license to use the service mark in their respective territories, in the business of purchasing and selling drugs and related items, and that the operation of DE.com infringes that license"(…)

"DE.com is then unlawfully engaged in the same business as

[165] Emporium Drug Smart Inc: American Arbitration association, Texas, September 2, 2000 available on www.juriscom.net/txt/jurisus/ce/aaa20000902.htm.

franchisees in their territories".

The AAA agreed with the claimants' arguments: "Franchisees have the exclusive right to operate high volume low margin drug stores within their territory using the name Drug Emporium. (…) Franchisees have demonstrated a likelihood of success in proving that respondents have violated this term of the franchise (…). It is for this panel to decide whether a virtual reality is real or whether it is a phantom. We will take respondents at their word. Respondents have marketed drugemporium.com as "The full service online drugstore" and have certified drugemporium.com to be a drugstore in its filing to the SEC. We also infer from the respondents' conduct that honoured the claimants' territories until now-including the offer of compensation during the test period for drugemporium.com-that the parties reasonable expectation was that the complainants would not be forced to compete with direct drug store sales by respondents […]; Respondents have also attempted to build market share by offering special sales at prices that vastly undercut prices available at the claimants' stores".

1.3.3 Does the use of the Internet by the supplier constitute unfair competition? The question is whether, under EC rules, such behaviour of the supplier should also be forbidden. In our opinion, a supplier should be free to use the Internet for the promotion of its products. This can only be profitable for its distributors, who will gain new customers due to this new promotion support.

Open Use of internet to promote suppliers products

It is a more difficult question to know whether the supplier should also be free to sell its products on the Internet.

Indeed, in doing so the supplier would destroy its distribution network, since traditional retailers would complain, and could refuse to sell its products.

The supplier could also commit not to engage in unfair competition. For example, concerning selective distribution, the supplier should take care not to sell its products at a discriminatory price. The supplier should also put on its website the list of its retailers. The only issue is to know whether the supplier can use its trademark as its website name, and whether this could constitute a kind of free riding on the efforts of its distributors.

Use of Internet to sell suppliers products still open

Secondly, concerning exclusive distribution, the question is more difficult. Does the supplier have the right to sell those products exclusively allocated to exclusive retailers? According to case law and the Regulation on vertical restraints, the supplier should be free to do so for passive sales. Once again, the difficult question is to know what should be considered as a passive or an active sale.

Internet pure players may complain that they are being refused entry in the distribution network

1.3.4 Avoid free riding problems, suppliers may set up distribution systems on the Internet. Other antitrust concerns may appear. Internet pure players may complain that they are being refused entry in the selective distribution network, and that the qualitative criteria employed by suppliers have been used as an excuse for not supplying them with certain products. Exclusive dealers may complain being prevented from passive sales over the Internet.

2. E-commerce retailers may complain for not being supplied

E-commerce retailers may complain for not being supplied

Internet "pure players" may complain that selective distribution criteria are used in order to prevent them to trade products on the Internet. They can also complain that the allocation of exclusive territories is not appropriate to Internet, and as a result prevent them from having access to this new distribution channel.

2.1 Concerning selective distribution

Under the Block Exemptions Regulation such systems are exempted if they fulfill the conditions of article 4 and 5

Difficulty of applying objective criteria for selective distribution across both forms of distribution.

Thus according to the Guidelines on vertical restraints[166]: *"Qualitative and quantitative selective distribution is exempted by the Block Exemption Regulation up to 30 % market share, even if combined with other non-hardcore vertical restraints, such as non-compete or exclusive distribution, provided active selling by the authorized distributors to each other and to end users is not restricted. The Block Exemption Regulation exempts selective distribution regardless of the nature of the product concerned. "*

If the market share held by the parties is over 30%, thus the selective distribution systems will constitute an element of competition, which is in conformity with Article 85(1) of the Treaty provided that the conditions set by the CFI are met.[167]

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[166] point 186.

[167] See for example judgment of the Court of First Instance in Case T-88/92 Groupement d'achat Édouard Leclerc v Commission [1996] ECR II-1961." Selective distribution systems constitute an element of competition which is in conformity with Article 85(1) of the Treaty if four conditions are satisfied:
first, that the characteristics of the product in question necessitate a selective distribution system, in the sense that such a system constitutes a legitimate requirement having regard to the nature of the product concerned, in particular its high quality or technical sophistication, in order to preserve its quality and ensure its proper use;

There are, however, inherent qualitative differences in characteristics of retailers doing business on e-commerce and traditional markets, and be difficult applying objective criteria for selective distribution across both forms of distribution.

Moreover the Commission in its guidelines stated that "each distributor must be free to use the Internet to advertise or to sell products" and adds *"Notwithstanding what has been said before, the supplier may require quality standards for the use of the Internet site to resell his good"* (…) *"the latter may be relevant in particular for selective distribution."*[168]

possibilities to protect suppliers networks

To protect its network the supplier has the following possibilities:

To simply prevent the sales of its products over the Internet (an outright ban);
To adapt its selective distribution criteria in order to restrict or even prevent the sales of its products over the Internet (a qualitative criteria);
To allow only its retailers to sell under certain conditions its products on the Internet (a selective criteria).

We will examine whether these different solutions restrict competition.

2.1.1 An Outright ban on selling products over the Internet.

Outright ban on selling products over the Internet

According to the Vertical Guidelines (point 51) "*every distributor must be free to use the Internet to advertise or to sell products*" and an '*an outright ban on Internet or catalogue selling is only possible if there is an objective justification*".

Within the concept of "objective justification", an outright ban to sell products over the Internet seems durable. The Commission does not provide examples of what may be considered an "objective

secondly, that resellers are chosen on the basis of objective criteria of a qualitative nature which are laid down uniformly for all potential resellers and are not applied in a discriminatory fashion; **thirdly**, that the system in question seeks to achieve a result which enhances competition and thus counterbalances the restriction of competition inherent in selective distribution systems, in particular as regards price;
and, **fourthly**, that the criteria laid down do not go beyond what is necessary".

See also judgments of the Court of Justice in Case 31/80 L'Oréal v PVBA [1980] ECR 3775, paragraphs 15 and 16; Case 26/76 Metro I [1977] ECR 1875, paragraphs 20 and 21; Case 107/82 AEG [1983] ECR 3151, paragraph 35; and of the Court of First Instance in Case T-19/91 Vichy v Commission [1992] ECR II-415, paragraph 65.(33) See also paragraphs AEG [1983] ECR 3151, paragraph 35; and of the Court of First Instance in Case T-19/91 Vichy v Commission [1992] ECR II-415.

[168] Commission's Notice on vertical restraints, point 51.

justification” regarding exclusive distribution.[169]

In Yves St Laurent: exclusive Distribution

In the Yves Saint Laurent decision[170], the Commission considered that due to the nature of the products, **an outright ban to sell by mail was not an appreciable restriction of competition**: "***Although the ban on selling Yves Saint Laurent Parfums products by mail order is in itself liable to limit the commercial autonomy of the authorized retailer, it cannot be deemed to be an appreciable restriction of competition***. *On the one hand, supplying the products under optimum conditions* ***presupposes direct contact between customers and a sales staff that is capable of suggesting*** *a choice between the various products and various brands, taking account of the personal requirements of each consumer. On the other hand, the requirement in question is a necessary corollary to the criteria designed to ensure that the contract products* ***are presented in as homogeneous a way as possible and that the producer can continuously supervise the qualitative*** *level of its distribution network".(Considérant 5).*

If we consider that for the sales of certain types of products, a direct contact is necessary between the customer and the product, as well as a sales staff suggesting a choice between the various products, then it may be considered, in line with the Commission case law that an outright ban to sell products over the Internet could be justified.

Selective distribution

The Commission recently considered that an outright ban on selling products on the Internet is not compatible with Community competition rules. Indeed in the frame of the renewal of the individual exemption granted to Yves Saint Laurent Parfums selective distribution system the Commission emphasizes[171]: *"In these guidelines the Commission stressed the importance of the Internet for the competitiveness of the European economy and encouraged widespread use of this modern means of communication and marketing.* ***In particular it believes that a ban on Internet sales, even in a selective distribution system, is a restraint on sales to consumers which could not be covered by the 1999 regulation.*** *The YSLP system satisfies the exemption conditions set by this regulation. YSLP has applied selection criteria authorising approved retailers already operating a physical sales point to sell via the Internet as well".*

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169 Point 49 in fine, "*however a prohibition imposed on all distributors to sell to certain end users is not classified as a hardcore restriction if there is an* ***objective justification*** *related to the product, such as a general ban on selling* ***dangerous substances*** *to certain customers for reasons of safety or health*".

170 Commission Decision of 12 December 1991, Yves Saint Laurent Parfums.

171 Press release IP/01/713 , 17 May 2001 "Commission approves selective distribution system for Yves Saint Laurent perfume" available at: http://europa.eu.int/rapid/start/cgi/guestfr.ksh?p_action.gettxt=gt&doc=IP/01/713|0|RAPID&lg=EN.

The Commission has also considered that a prohibition on distant sales including through the Internet constitutes an "hard core" restriction.[172]

Qualitative criteria employed may exclude "a priori" sales over the Internet.

2.1.2 Qualitative criteria employed may exclude "a priori" sales over the Internet. Without expressly saying that its products cannot be sold on the Internet, the supplier could also put in place selective distribution criteria, which cannot be Internet sales.

In the absence of objective justifications, such criteria have the effect of restricting competition, since they prevent the establishment of a new distribution chain.

E-commerce retailers may complain[173] that they are being refused supply of products that are readily available to distributors in traditional sales channels. Under EC competition law, selective distribution would usually be exempted from Article 81, as long as the criteria adopted for choosing distributors are objective and qualitative.

(i) Indeed, the appointment criteria for authorized retailers laid down in most of the contracts refer specifically to the professional qualification of staff, the location and fitting of the retail outlet, the shop name, a direct contact with the products and an employee in the retail outlet capable of giving consumers appropriate advice on the products.

The insertion of these clauses has the consequence of excluding the sales of the products via new distribution channels, namely the Internet. Thus, retailers could complain that such criteria go beyond what is necessary, and are merely designed to exclude these products from the new distribution chain.

Therefore, the question is whether all the distributors are chosen on the basis of objective criteria of a qualitative nature, which are laid down uniformly for all potential distributors and are not applied in a

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172 Press release, IP/00/1418, Brussels, 6 December 2000 "Commission opens proceedings against the distribution practices of B&W Loudspeakers" available at: http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/00/1418|0|AGED&lg=EN.

173 See OFT report on *"E-commerce and its implications for competition policy"*, point 6.116: *The most common competition complaint in the e-commerce area currently relates to e-commerce operators being refused supply of products, when they are readily available to distributors in traditional sales channels. Differences between e-commerce and traditional commerce raise difficulties for applying the same qualitative criteria to both traditional and e-commerce retailers. The conditions employed for assessing selective distribution may therefore require refinement as e-commerce develops as a sales channel.*

discriminatory fashion, and if the criteria laid down do not go beyond what is necessary[174].

(ii) According to Commission case law, selective criteria cannot have the effect of excluding a priori modern forms of trading:

"*In the light of the foregoing, it is necessary at this stage to address Galec's pleas and arguments relating* ***to whether its members are excluded a priori from the Givenchy network by the combination of the selection criteria****, and to consumer attitudes in that regard.*
The Commission has made it clear on many occasions during this case that the Decision ***does not envisage the a priori exclusion of modern forms of trading,*** *such as the hypermarkets operated by the Leclerc Centres*." [175]

See the Galec Case

"*In finding that such criteria, which, according to Galec, rule out some potential retailers `a priori', were legitimate, the Commission offended against the principle that restrictions placed on the distribution of products must be proportionate and the principle that quantitative restrictions are prima facie unlawful (see, in particular, the judgments in Metro I, Metro II, L'Oréal and AEG). The restrictions go beyond what is necessary in the light of the characteristics of the products at issue, the need to protect their quality, and their proper use*".[176]

As the current criteria have this effect, in order for a selective distribution system to be valid, the supplier should refine its criteria. Indeed, there are inherent qualitative differences in retailer characteristics between e-commerce and traditional markets, and it may be difficult for a supplier to apply similar qualitative criteria for selective distribution across both forms of distribution.

Thus e-commerce retailers may complain that the qualitative criteria employed by suppliers have been used as an excuse for not supplying them with certain products.

Establishment of selection criteria specific to the Internet

2.1.3 Establishment of selection criteria specific to the Internet

Another solution for the supplier to preserve the imperviousness of its network is to set up selective distribution criteria for its approved retailers, specific to the Internet.

This clause is not forbidden by the Block Exemption

This type of clause is not forbidden by the Block Exemption Regulation or the guidelines. According to the guidelines, "*In a selective distribution system the dealer should be free to advertise and*

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174 Conditions for a selective distribution system to constitute an element of competition that is in conformity with Article 81(1). See judgment of the Court of First Instance, 12 December 1996, Galec.

175 CFI, 12/12/1996, Case T88/92 points 156, 157.

176 CFI, GALEC, 12/12/1996, Case T19/92, point 81.

Regulation

sell with the help of the Internet" (point 53 in fine). Therefore, this begs the conclusion that it would only be the approved retailers for a traditional "bricks and mortar" shop that would be free to open an Internet website.

Rising approved retailers

As stated above this solution has been clearly confirmed by the Commission. It considered that the selective distribution system of Yves Saint Laurent Parfums authorizing **approved retailers** to sell via the Internet was compatible with Community competition rules.

2.2 Concerning exclusive distribution

Exclusive distribution

One of the issues raised by the Internet is its the impact on the traditional distinction between active and passive sales under EC competition law and how to protect allocated sales territories without restricting passive sales.

Distinction between active and passive sales

The non-geographic nature of the Internet makes it difficult to appraise what will be considered a passive or an active sale. For instance, does the fact that a website must be accessible to customers which are not located in its territory mean that its sales are active sales? Should it be considered as establishing a warehouse or distribution outlet in another distributor's exclusive territory, hence as an active sale, according to the Commission's guidelines?

The Commission took a position, much more in favour of Internet sales. According to the vertical guidelines, using a website to distribute products is to be generally considered as a form of passive selling (point 50).

2.2.1 The specific definition of active and passive sales on the Internet. According to the guidelines, *"Every distributor must be free to use the Internet to advertise or to sell products. A restriction on the use of the Internet by distributors could only be compatible with the BER to the extent that promotion on the Internet or sales over the Internet would lead to active selling into other distributors' exclusive territories or customer groups"(point 51).*

The guidelines goes on saying, "*In general, the use of the Internet is not considered a form of active sales into such territories or customer groups, since it is a reasonable way to reach every customer*"; the fact that it may have effects outside one's own territory or customer group is the result of the technology, (*i.e.*, easy access from anywhere).

According to the Commission, the fact that one customer visits the website of a distributor and that this distributor sells products to a customer not located on its territory, should be considered as a passive sale.

Against this framework, the Commission only considers a sale over the Internet as an active sale if one of the following conditions is fulfilled:

The website is specifically targeted at customers primarily inside the territory or customer group exclusively allocated to another distributor;

The website uses banners or links in pages of providers specifically available to these exclusively allocated customers;

Unsolicited e-mails are sent to individual customers or specific customer groups.

As stated by Competition Commissioner Mario Monti in his speech of 2 March 2001[177], "*The solution we have adopted in our vertical guidelines considers that using a website to distribute products is in general considered a form of passive selling. In addition, the approach adopted distinguishes between taking steps to help customers find an Internet site (active sales) and taking steps to facilitate sales to customers who have already found the web site*".

According to Commissioner Monti[178] "*it is mostly a matter of common sense. If a distributor based in France registers with a DE domain name, or advertises on German websites, or send commercial emails to German customers, then these actions would appear to be active selling. If, on the other hand, the French company simply provides a German language version of its website, then we would regard that as passive, the Internet equivalent to speaking German on the telephone to a customer who has called you*".
Commissioner Monti nevertheless emphasized that "*There are of course, complications and unresolved issues, but further elaboration of these principles will probably requires cases, where the theory can be tested against the practice*"

2.2.2 This distinction is not fully satisfactory, and we consider that it can give rise to problems of free riding between distributors.

Distinction between active and passive sale not clear

Indeed, the distinction between an active and a passive sale is not so clear. In fact, sending unsolicited e-mails can clearly be considered as active selling, and can be compared to the traditional means considered to be active sales, such as direct mails or visits. It is more difficult to assess what is a *"specifically target website"* and when the Internet can be considered as a *"reasonable way to reach customers in non-exclusive territories"*.

177 The New Economy in Europe: its impact on EU enterprises and policies, www.europa.eu.int/rapid.

178 Mario Monti Commissioner for Competition Policy Competition in the New Economy 10th International Conference on Competition Bundeskartellamt Berlin, 21 May 2001. (www.europa.eu.int/rapid/start/cgi/guestfr.ksh?).

Can a specific territory be protected from free riding

Can a specific allocated territory can be protected from free riding over the Internet. One possible solution would be to give a very restrictive meaning to the criteria set out in the Commission guidelines.

2.3. The specific issue of vehicle distribution

The specific issue of vehicle distribution

2.3.1 Overview of the sales of new cars on the Internet. The Internet can offer an alternative distribution method for vehicle in Europe. The main driving factors for the growth of automotive commercial activities on the Internet are: comprehensiveness and quality of information, attractiveness of presentation, interactivity allowing personalized two-way communication and costs-effectiveness.[179] According to some authors it is conceivable that a new entrant manufacturer, or even a new brand from an existing manufacturer, without needing to look after a network of long-standing dealer partners, might wish to select this route and sell directly to end-consumers.[180]

Can it constitute a constraint to the development of Internet Sales.

However according to the Commission's Report on the evaluation of Regulation EC 1475/95 on the application of article 85§3 of the treaty to certain categories of motor vehicle distribution and servicing agreements (Hereinafter the "Commission's Report") "*some constraints to the success of e-commerce in car distribution can be identified: the low degree of access to the Internet in Europe, legal factors (such as security of transactions, protection of intellectual property rights), the attitude of certain consumers preferring to have direct contact with dealers, and the manufacturers' tight control of their network in Europe".*[181]

In its report the Commission[182] stated that in general "*car manufacturers and independent importers express a very cautious attitude toward Internet sales, saying that, while the Internet will grow as an information tool with a wide range of services, all sales realized through electronic sales methods will be directed through the existing distribution network*".

179 European Commission: Report on the evaluation of Regulation EC 1475/95 on the application of article 85§3 of the treaty to certain categories of motor vehicle distribution and servicing agreements, n°139,(http://www.europa.eu.int/comm/competition/car_sector/distribution/eval_reg_1475_95/report/en.pdf).

180 International Car Distribution Programme (hereinafter ICDP) "beyond the block exemption II", 6/99, p.14.

181 See also ICDP, " Vehiclesales & supply stream: electronic new media and car distribution": T. Chieux & P. Wade, Research Report 7/98, April 1998., p. 6.

182 See § 143.

It is said that the overall distribution policy will not change for three main reasons:

- Consumers need to touch and feel "in the real world" a really emotional product;

- Cars cannot be delivered by mail (unlike books from Amazon.com for instance);

- Pre-delivery inspection and used vehicle exchange can only be dealt with physically by a dealer.

On the other hand other manufacturers and importers acknowledge that the Internet will grow dramatically in many field, although it is still unclear if and how the Internet may evolve to become a sale function. These importers refer to the US market where in 1999 5% of the new vehicles were sold via the Internet and 35% chosen via the Internet according to these importers, who believes that there will be a similar trend in Europe.[183]

For the moment in Europe none of the Internet based operators are able to sell cars directly to consumers.[184] They have to go through the dealer network and thus the existing dealer system.[185] Currently, car manufacturers are themselves carrying out direct selling of cars to customers on only a very limited trial basis (but still via or in cooperation with the dealer network). Some car manufacturers are now developing their Internet business to include spare-parts trade.

However it seems unlikely for the following legal factors that in the near future the Internet will replace the traditional dealerships for the purpose of selling new cars. In the future if Commission Regulation (EC) No 1475/95 of 28 June 1995 on the application of Article 81 (3) of the Treaty to certain categories of motor vehicle distribution and servicing agreements[186] is not modified Internet pure players may complain being prevented from selling cars on the Internet. Indeed as it will be assessed below the actual legal framework is not adapted**.**

183 Commission's report, § 144.

184 ICDP, "Electronic new media and car distribution", 17/98, p.21.

185 For instance Renault has enabled potential clients to take reservations on the Internet, but it is not yet directly involved in sales, which are still carried out by the dealers. In the near future however it is planning to invest in e-commerce and is going to establish several web sites: Renault. site to inform final consumers on products and services of the car manufacturer and to sell new vehicles.

186 *Official Journal L 145 , 29/06/1995 p. 0025 – 0034.*

Sales of cars via the Internet and regulation 1475/95

2.3.2 Sales of cars via the Internet and regulation 1475/95. The marketing and sales of new cars via the Internet was not considered at the time Regulation 1475/95 was adopted. The Regulation does therefore not give any guidance on a number of issues concerning this new marketing and selling tool.

The promotion of new vehicles by dealers via the Internet cannot be prohibited, the only limit being that the dealer may not personally contact potential customers located outside his contract territory

Pursuant to article 4 §1 (1) c) of Regulation 1475/95 a dealer can use all existing means to promote the sales of new motor vehicles provided that he observes the minimum standards laid down by the manufacturer relating to advertising and does not personally contact potential customers located outside his contract territory (e.g by e.mail) (article 3§8 b) of the regulation).

Thus According to the Commission's Report on motor vehicles, the promotion of new vehicles by dealers via the Internet cannot be prohibited the only limit being that the dealer may not personally contact potential customers located outside his contract territory.

The Commission pointed out in its report that the regulatory framework for the distribution of motor vehicles is not adapted to certain new e-commerce activities: it can be used to prevent or limit Internet operators not belonging to a distribution network to become dealers or brokers for the marketing of new motor vehicles.

Three possibilities are offered to Internet pure players to act as an agent or a broker for a dealer, to act as a dealer or to act as an intermediary. As we will see below, only the later is under the current framework possible.

2.3.3 Internet pure player acting as an agent or a broker for a dealer. Indeed some provisions of the regulation 1475/95 could be, and already have been, used by car manufacturer to impede the activity of an Internet operator acting as broker or agent for a dealer[187]:

- The dealer must have the agreement of the car manufacturer to appoint an agent for distributing the cars in its territory (article 3 point 6 of the Regulation).

- The dealer is prohibited from entrusting third parties with the distribution of cars outside its contract territory (article 3 point 9 of the regulation).

- The manufacturer may also oblige the dealer not to maintain branches or depots outside his contract territory and not to solicit customers for contracts goods or corresponding goods by personalized advertising outside its contract territory (article 3 point 8 of the regulation).

[187] Commission's report n °404.

However as pointed out by the Commission in its report the use of the Internet removes geographical barriers and does not take into account territorial exclusivity. *"The question arises as to how the activity of an Internet operator has to be assessed under the above rules. Moreover, in the view of the ever increasing use of the Internet it is questionable whether these rules are still appropriate".*

2.3.4 Internet pure player acting as a dealer. Under the bock exemption n°1475/95 such a situation is not possible. The Internet operator would not fulfil the traditional criteria for the selection of new dealers used by all car manufacturers and covered by the regulation[188], such as a physical showroom within their sales territory, which corresponds to the standards of the manufacturer (article 4 §1 point 1 a).

Internet pure player acting as a dealer

Besides Regulation 1475/95 only exempts distribution agreements for new cars if the distributor not only sells new vehicles, but also provides after sales servicing (article 5§1 point 1 a)). Internet operators do not have the infrastructure to provide after-sales service in the geographic area in which they operate.

Thus it seems difficult if not impossible for an Internet distributor, with no bricks and mortar facilities to fulfil these requirements.

2.3.5 Internet operator acting as an intermediary. The only real option available for an Internet operator under the present legal framework is to act as an intermediary for the consumer [189], e.g. to buy car in the name of, or on behalf of a consumer.

Internet operator acting as intermediary

However this solution is not satisfactory, since the Internet operator will need to have the consent and signature of the consumer to be able to purchase the vehicle. Indeed as explained above an Internet operator cannot be considered, as a dealer, and an authorized dealer cannot sell vehicles to non-authorized dealers.

Thus the only solution is to act on behalf a consumer, which is a very limited solution. This is confirmed by the strategy currently adopted by car manufacturers.

Antitrust issues will not only arise when e-commerce retailers are competing with traditional retailers, but also when e-commerce

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[188] See ICDP, "Internet Car retailing: Characteristics and evolution of UK new car sales" by Stephen Dorman, July 2001 (http://www.icdp.net/Members_europe/Members_europe_downloads/icdp_report0301.PDF).

[189] See the example of "Oneswoop".

introduces new layers and intermediaries in the sales process (Section III).

Section III

Identification of potential anticompetitive effects that can result from the Internet when it constitutes a new intermediary

1. General overview of B2B marketplaces and portals

1.1 Definition

Internet when it constitutes a new intermediary

1.1.1 B2Bs. B2Bs electronic markets are Internet-based electronic markets designed to allow online business-to-business communications and transactions. B2B participants include suppliers, distributors; commerce services providers, infrastructure providers and customers.[190]

General overview of B2B marketplaces and portals

These online marketplaces are "*secure sites where trading partners can post their sales offers or procurement orders, which can be integrated with the participants' corporate supply management IT systems, and which often incorporate dynamic pricing mechanisms, such as auctions, reverse auctions and exchanges.*"[191]

The driving purpose of B2Bs is to create virtual markets that allow companies, which must purchase intermediate goods (as part of the process to develop and deliver a final product or service) to communicate and transact business more efficiently with their suppliers. That purpose has several distinct elements. The buyer needs to search for, identify, negotiate for, order and receive the materials and then pay the supplier. Some or all of this is accomplished through a standardized online format. B2Bs are also branching out into additional areas of supplier/customer interaction that may be handled more efficiently through the B2B interface, including joint product or component design.

1.1.2 Portals. Portals are very similar to traditional shopping malls. They bring together sellers of different products under the umbrella of a single website, often providing additional services such as product delivery, credit card facilities and e-mails.[192] Portals are not retailers themselves. Unlike B2B marketplaces, they trade with end customers.

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190 See "B2B basics and antitrust issues" by Pamela Jones Harbour, www.ftc.gov/opp/ecommerce/comments/harbour.htm.

191 OFT report, August 2000, E-commerce and its implications for competition policy, n°3.42.

192 OFT report, August 2000, E-commerce and its implications for competition policy, n°3.43.

In some recent decisions[193], the Commission has acknowledged that there may exist separate markets for Internet portals, depending on the various revenue streams which portal operators receive (advertising revenue, subscription, etc.). The Commission has also distinguished between vertical portals, i.e., those focusing on the provision of relatively narrow access to a particular content category such as sportline.com, and horizontal portals such as Yahoo, which provide comprehensive directories, personal homepages and e-mail. In addition, the Commission noted that there are potentially separate markets within portals for horizontal portals according to which platform is used to access the Internet (i.e., PC, mobile phone, TV, etc).

1.2. Different forms of B2Bs

B2Bs marketplaces can take a variety of forms, with one seller interacting with many buyers[194], many sellers with one buyer[195], or many buyers and many sellers. B2B marketplaces do not trade products directly to final customers.

Different forms of B2Bs

Horizontal or vertical B2Bs. B2Bs can be horizontal and/or vertical. If the marketplace offers a wide range of products, then it is usually considered as a horizontal marketplace. If the marketplace is specialized in one particular category of goods, and is present at each step of the supply chain, then it is considered as vertical.

As B2B marketplaces refer to transactions that occur online through the support of the Internet, they are therefore a distinct system of suppliers, distributors, commerce services providers, infrastructure providers and customers using the Internet for communication and transactions.[196]

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193 COMP/JV.48: Vodafone/Vivendi/Canal+; COMP/M.1982-Telia/Oracle/Drutt; Case IV/M 2050, 13.10.2000, Vivendi/Canal+/Seagram, OJ C 311, 31.10.2000, p.3.

194 According to the OFT report these market generally take the form of auctions, and are particularly suited to products whose value is unknown or difficult to determine through conventional channels such as perishable goods, patents, capital assets etc.).

195 According to the OFT report vendor catalogues are similar in spirit to e-malls. These marketplaces bring together the offer of a large number of sellers, providing buyers with a one-stop shop for their procurement needs.

196 FTC report.

1.3 The pricing mechanisms used by B2Bs [197]

Four primary means to establish prices: catalogs, auctions, exchanges, negotiations

Although other pricing methods are possible, currently there are four primary means by which participants can establish prices in B2B marketplaces: catalogs, auctions, exchanges, and negotiations. Although catalog pricing is usually fixed, the other means of pricing are dynamic. The goal of all of these methods is to bring greater transparency to the pricing process and thereby increase the efficiencies of the B2B market.

1.3.1 Catalogs Some B2Bs use catalog aggregators or metacatalog, to normalize or standardize product data from multiple vendors so that buyer can easily compare it[198]. The FTC stated in its report that purchases using a B2B electronic catalog often follow the following steps, examining in sequential order:

A home page, allowing the buyer to choose from any of the following: the placement of a new order, tracking of an existing order; view of order history, and view detailed information of an order.

The product catalog, where the buyer may search for example, by manufacturer, name, product category and end-use category.

A page showing the results of the buyer's search, including quantities and prices, the buyer can then select the specific goods to be purchased.

Catalogs

A "shopping cart" displaying selected products, and allowing the buyer to modify quantities, shipment address, billing location and to delete the order.

A price quote page indicating the prices and shipping charges for the products in the "shopping cart".

Confirmation of orders

According to the FTC workshop panelists the catalog appears, as a pricing mechanism, to be particularly appropriate for the sale of low-priced items bought frequently in small quantities.

Catalogs provides buyers with the opportunity to make meaningful comparisons between different manufacturers' products (with respect to price and other attributes) much faster and more efficiently than if they were using traditional paper catalogs.

Sellers benefit from these efficiencies by reaching previously unsolicited prospective customers. Also, sellers can adjust prices

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197 See "B2B basics and antitrust issues" by Pamela Jones Harbour.

198 Morgan Stanley Dean Witter : The B2B Internet Report: Collaborative Comments, April 2000.

without reprinting new catalogs and can customize pricing for particular customers based on, *e.g.*, previously negotiated discounts, without making that information available to other customers.

1.3.2 Auctions. Auctions are another means of establishing online pricing. A "forward auction" allows multiple buyers to bid on a specific product from one seller; a "reverse auction" permits multiple sellers to "bid down" the price of an item sought by a specific buyer.

Auctions

While the bid model used will vary with the nature of the industry, the reverse auction is one of the more dynamic pricing mechanisms of numerous B2Bs. "A reverse auction is a buyer-driven auction which allows multiple sellers to bid competitively in order to provide product to ultimate end buyers. Prices move down. Preparation for a reverse auction usually takes the form of a buyer issuing a *"request for quotation"* in which product specification and commercial terms are specified. *"Suppliers prepare their bids and submit them during the auction itself, with the option to move their prices down as bidding proceeds.(…) auction are particularly appropriate for items that are unique and differentiated but simple to describe and understand."*[199]

1.3.3 Exchanges An exchange is a "*two-sided marketplace where buyers and suppliers negotiate prices, usually with a bid and ask system, and where prices move both up and down.*"[200]

Exchanges

Electronic exchanges are similar to trading on a securities exchange, with similar anonymous, real-time matching of orders and quotes. Multiple buyers and sellers interact, with prices moving up and down during trading. This form of exchange works well for commodity-type products. *Currenex*, a B2B that brings together banks and corporations to trade currency, is an example of a B2B exchange.

1.3.4 Negotiations. Negotiation refers to a variety of models whereby the B2B consolidates and compares information, after which sellers and customers contact one another and negotiate a private agreement. Negotiation refers to a number of arrangements, such as request for proposals, whereby the B2B consolidates and compares information regarding specific requests, followed by negotiations between the potential participants to the transaction.

Negotiations

1.4. The revenue model used by B2Bs

B2Bs generate 5 types of revenues

B2Bs may generate revenue via transaction fees, membership fees, service fees, advertising or marketing fees, or fees for information.[201]

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199 See FTC report p.10.

200 See FTC report, p.11.

1.4.1 Transaction Fees. Transaction fees may be charged per transaction, as a flat fee for a set number of transactions, on the basis of transaction value, or as a percentage of savings resulting from the trade.[202]

Transaction Fees

According to some authors[203] Transaction fees represent a traditional approach to generating revenue; however, use of this method is likely to decrease. Membership fees, or payment in order to use a site, are similarly likely to be less compatible with long-term user relationships. When a company has to pay to use a site, it has invested in a single trading mode and has thereby reduced its trading flexibility, thus defeating one of the primary advantages of operating on a B2B. Service fees can be tied to value-added services, such as shipping options, chat rooms, or industry information. Advertising, especially through banner ads, is a common revenue generator because it generates name recognition for other sites, particularly sellers' sites.

Membership Fees

1.4.2 Membership Fees. Membership fees are, typically, paid up front or at certain intervals to participate on a marketplace. A membership fee may function as a type of sunk cost and, as such, may have implication for switching costs.

Services Fees

1.4.3 Services fees. Services fees are fees for additional functionality that B2Bs may offer either directly or indirectly. Value-added services that B2Bs are offering include logistic; financial services; industry information.

Some people consider that "service fees for value-added services will dominate over membership and transaction fees as the primary source of significant revenue".[204]

Advertising and Marketing Fees

1.4.4 Advertising and Marketing fees. Advertising in B2Bs can take many forms including "banner advertising", and all the usual promotion forms.

1.5 Ownership structure of B2Bs

The simplest division in B2B ownership and control models is between B2Bs owned and operated by industrie participants, that is the companies that plan to use the B2Bs, and ownership by non-industry

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201 See the Decision Vodafone/Vivendi/Canal+.

202 FTC report p.14.

203 See Pamela Harbour.

204 See Harting in the FTC report, p.15.

participants, such as venture capitalists or technology firms.

Many B2Bs are hybrids; some B2Bs are owned in part by participants, whether buyers, sellers or both. *Covisint*, was formed by a consortium of buyers who plan to take the newly formed exchange public in the future. Similarly, there are varying degrees of B2B participant involvement in management - whether board of directors or operational - that range from complete control by participating companies to independent management and board membership.

2. Examples of B2Bs

Many various B2Bs joint ventures have been cleared by the Commission

There has been a flurry of B2B cases in the EU over the past year. In September 2000, Mario Monti, the European Commissioner for Competition Policy, indicated that there is a large number of such cases under review and that an internal working group within the Commission's Competition Directorate-General has been set up to co-ordinate the Commission's approach.[205]

The European Commission has cleared B2B ventures in relation to aircraft components,[206] services to the chemicals industry, [207] office equipment, [208] foreign currency options,[209] mutual funds,[210] hotel booking services,[211] office supplies,[212] plant and machinery construction components[213] and second hand trucks.[214] It is also reviewing arrangements notified under Article 81 in respect of the Covisint automotive B2B exchange and in relation to a B2B market for support services for industrial products.[215] At a national level, the UK

205 "Barriers in Cyberspace", speech by Mario Monti of 18 September 2000 before the Kangaroo Group Competition and Information Technologies Conference.

206 MyAircraft.com (M 1969 *UTC/Honeywell/i2/MyAircraft.com* [2000]).

207 Chemplorer.com (M 2096 *Bayer/DT/Infraserv Hoechst* [2000]).

208 Emaro.com (M 2027 *Deutsche Bank/SAP* [2000]).

209 Volbroker.com (*Deutsche Bank/UBS/Goldman Sachs/Citibank/JP Morgan/NatWest*, Commission press release of 31 July 2000).

210 Cofunds.com (M 2075 *Newhouse/Jupiter/Scudder/M&G*, [2000]).

211 M 2197 *Hilton/Accor/Forte/Travel Services* [2001].

212 Date (M 2374 *Telenor/ERGO Group/DNB/Accenture* [2001]).

213 EC4EC (M 2172 *Babock Borsig/MG Technologies/SAP Markets/EC4EC* [2000]).

214 Supralift (M 2398 *Linde/Jungheinrich* [2001]).

215 *Covisint* [2001] OJ C 49/4; *SKK/Rockwell International/Tinken/INA/Sandvik/Endorsia* [2001] OJ C 122/7.

competition authorities have published the first contention B2B case has come before the UK courts.[216] Also, the German authorities have undertaken three second phase investigations into B2B markets, the Covisint auto-components joint venture,[217] RubberNetwork (tyre industry related indirect goods)[218] and CC-Markets (chemical industry related indirect goods).[219]

For a detailed assessment of B2Bs already cleared please refer to Annex VI.

3. Efficiencies generated by B2Bs

3.1 General overview of efficiencies generated by B2Bs

Efficiencies generated by B2Bs

The main objective in creating a marketplace for its participants is to reduce costs, mainly administrative costs (this is what is called e-procurement) and the costs of the products. If on a given market the biggest buyers are on a marketplace, almost all the suppliers will want to offer their products on this marketplace. The buyers will have a wider choice of products, and will be able to get them at a better price. Moreover, the use of the Internet reduces research costs. For example, in reverse auctions the buyer will make his demand for certain goods through the B2B marketplace, to which he will receive rapid and multiple responses. As pointed out in the FTC report, '*B2Bs can make it easier for buyers to comparison shop, replacing thumbing through bulky paper catalogues with quick and efficient mouse click searching*".

B2Bs have the potential to

According to authors[220] B2Bs have the potential to generate significant efficiencies[221] such as lower administrative costs; lower search costs,

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216 *Network Multimedia Television Limited v. Jobserve Limited* [2001] All ER (D) 57.

217 Bundeskartellamt decision of 29 September 2000 B5-40/00 - *Covisint*.

218 Bundeskartellamt decision of 26 January 2001 B3 – 110/00.

219 Bundeskartellamt decision of 23 October 2000 B3-76/00.

220 Pamela Harbour see above, See also FTC report.

221 Erkki LIIKANEN Member of the European Commission responsible for Enterprise and the Information Society "E-marketplaces: new challenges for enterprise policy, competition and standardisation" Workshop "E-marketplaces: new challenges for enterprise policy, competition and standardization "Brussels, 23 April 2001 "*It is widely assumed that B2B electronic markets cans have important pro-competitive effects. They potentially increase market transparency and contribute to a further integration of separate geographic markets.*
In addition, e-market places are expected to e a source of substantial efficiencies, as they should allow a reduction in transaction costs and en improvement of inventory management. Nevertheless, the quantification of these benefits is currently difficult and many claims as to their size seem to be exaggerated".

generate significant efficiencies

lower inventory costs, allowing of cooperative buying or selling. All of these efficiencies can generate wealth by lowering business operating costs and increasing productivity.

Commissioner Monti also stressed out that "*There are a number of different forms of business to business exchanges, but all are aimed at providing a more efficient environment to bring together buyers and sellers of particular products or services. Therefore, we are not opposed to the creation of B2B electronic market places as such. The fact that these exchanges try to sign up as many industry players as possible does not create a competition problem in itself. As with stock exchanges, the efficiency of a B2B electronic market place may well increase with the number of users*.

*However, there are of course issues that could raise competition concerns. **Looking at the sellers**, one concern would be the question whether the B2B electronic market place will allow the exchange of sensitive information between competitors. Another issue relates to the question whether these systems can be used to exclude individual companies from the virtual market place. **Looking at the buyers**, we would need to examine whether the concentration of buyer power was a cause for concern"*.[222]

Lower administrative costs

3.1.1 Administrative costs. B2Bs may facilitate the costs of effecting the transaction itself. Administrative costs encompass the time spent to order a product, to fill the different forms and also the costs of fixing incorrectly processed transactions.

Due do B2Bs marketplaces, companies will engage themselves in paperless transactions, with concomitant benefits in terms of speed, consistency, order tracking, error avoidance, and reduce efforts. The number of people needed to complete a transaction should also decrease.

Lower search costs

3.1.2 Search costs. B2B can reduce search costs e.g. the costs buyers incur identifying suppliers and their offering and vice-versa. For example B2Bs can make it easier for buyers to comparison-shop, replacing searching through bulky paper catalogs with quick and efficient mouse click searching. Reduce search costs also mean that suppliers will have access to a wider range of customers and that buyers will have access to a broader range of offers

222 Mario Monti European Commissioner for Competition Policy Competition and Information Technologies Conference "Barriers in Cyberspace" – Kangaroo Group Swissôtel, Brussels, 18 September 2000. (http://www.europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=SPEECH/00/315/0/RAPID&lg=EN).

Search costs could also be diminished through reverse auction, that provide a better transparency.

3.1.3 Joint purchasing and joint selling. According to the FTC report, B2Bs can also facilitate efficient joint purchasing, which may help reduce transaction through scale economies in purchasing, reduce manufacturing costs and produce other costs savings. The heightened interaction between buyers and suppliers that B2Bs offer may facilitate supply chain management.

That is, B2Bs could enable suppliers all along the supply chain, potentially reaching multiple tiers of suppliers, to learn more quickly what buyers want and when they want it, reducing forecasting that traditionally has proved inaccurate and expensive.

Joint purchasing and joint selling

FTC Chairman Robert Pitofsky[223] stated "*As we learned at the FTC's workshop in June, B2B electronic marketplaces offer great promise as means through which significant cost saving can be achieved, business processes can be more efficiently organized, and competition may be enhanced. B2b have a great potential to benefit both businesses and consumers through increased productivity and lower prices. Of course, as is the case with any joint venture, whether in the traditional or New Economy, B2Bs should be organized and implemented in ways that maintain competition. The antitrust analysis of an individual B2B will be specific to its mission, its structure, its particular market circumstances, procedures and rules for organization and operation, and actual operations and market performance*"

Collaboration

3.1.4 Collaboration. B2Bs marketplaces can also enhance innovation since it enables participants to collaborate in research and product development.

Examples of pro-competitive gains generated by a B2Bs: Covisint

3.2 Examples of pro-competitive gains generated by a B2Bs: Covisint[224]

David Bailey[225] stressed out the pro-competitive gains generated by Covisint. According to him the FTC decision in Covisint seemingly reveals the importance of affirmatively presenting the pro-competitive aspects of a B2B venture during an antitrust appraisal, rather than merely being used as a secondary justification.

223 www.ftc.gov/opa/2000/09/covisint.htm, Ftc press release, September 11, 2000.

224 Covisint- "A competitive Collaboration?" David Bailey, May 1, 2001; (http://www.ftc.gov/opp/ecommerce/comments/baileyabstract.htm).

225 Covisint- "A competitive Collaboration?" David Bailey, May 1, 2001; (http://www.ftc.gov/opp/ecommerce/comments/baileyabstract.htm).

According to this author Covisint will generate the following efficiencies:

Connectivity on an industrial scale

Covisint allows firms with different internal processing system to interface with one another. As a result of this connectivity on an industrial scale, Covisint avoids duplication of resources and allows smaller firms to enter the electronic marketplace for auto inputs, by utilizing Covisint's non-exclusive Internet infrastructure. Hence, manufacturers will benefit from greater and easier comparison-shopping from more prospective suppliers of auto parts, whilst suppliers may avoid the costs of serving manufacturer-specific B2Bs.

A more efficient mechanism for the exchange of data

The Internet provides a more efficient mechanism for the exchange of data than historical modes by enabling instantaneous communication, although this heightens the risk of anticompetitive price coordination. In this way, new sales channels may become viable that were not previously cost-effective, as via using the Internet Covisint enables parts information to be gathered and disseminated at low marginal costs.

Significant cost savings through "disintermediation"

Covisint may generate significant cost savings through "disintermediation". This process may provoke antitrust concern to the extent that former intermediaries objects to the occurrence of vertical market foreclosure, when their role acting between supply tiers is eliminated. Yet, it seems that the fact that a firm is precluded from the market is not necessarily indicative of unlawful exclusion since there may be substantial gains from bypassing certain supply tiers. Ultimately, the extent to which this process will produce efficiencies depends on the role of a supply level and whether it can be effectively integrated into the function of another tier supplier.

Elimination of substantial costs associated with offline mechanisms

Covisint, like B2Bs more generally, has been heralded as potentially elimination of substantial costs associated with offline mechanisms. Using the Internet, firms can search effortlessly and rapidly, place and modify orders instantly, with minimal administrative costs to exploit the shared underlying technology. However, antitrust analysis should take account of the fact that this Internet-related benefit may not be specific to Covisint. Nevertheless, it is likely that the magnitude of economies produced by an "industry-sponsored e-hub" like Covisint may reach an unparalleled level.

Enabling participants to collaborate in research and product improvement

Perhaps the *raison d' être* behind Covisint in the long-term is to drive automotive downstream competition by using its software to enables participants to collaborate in research and product improvement. This applies a dynamic conception of competition through communicating ideas in 'real time,' and enabling the lead-time from product design to the dealer's showroom to be shortened. In this way, Covisint is likely to change the nature of transacting between businesses. Although currently there is no uniform method of trading parts, it seems that Covisint will promote a shift from short-term, arms-length dealings to longer-term and more collaborative relationships due to its capabilities for joint research and production.

This has important antitrust consequences since it means that there should be an additional emphasis to the static focus on prices and output, by recognizing the pro-competitive need for collaboration in the long run, in order to promote innovation in auto products and processes.

However, if marketplaces or portals can generate significant efficiencies, which at the end are profitable to end-customers, they can also lead to anti-competitive behaviour, which can prevent these same customers from taking advantage of these efficiencies.

4 Potential antitrust concerns raised by B2B marketplaces and portals

Potential antitrust concerns raised by B2B marketplaces and portals

As explained above, the New Economy can lead to the creation of new products (electronic information products), services (comparison-shopping search engines) or marketplaces (online exchanges and auctions) and portals. In this respect, antitrust concerns may arise concerning the access to such new markets or services, as is the case for online marketplaces.

Risk of second-tier or small third-party buyers or sellers being denied access to the market, or being given access only on unfavourable terms

Where 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 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.

Possible anti-competitive effects raised by B2Bs:

- The risk of dominance of the market place or portal;
- This dominance can lead to monopsony power;
- This market power may foreclose the market;
- This dominance can lead to discriminatory practices;
- Competition issues may also arise over the use of intellectual property rights;
- The risk of exclusion;
- The risk of joint buying and joint selling;

As stated above, joint buying and joint selling may lead to efficiencies, but they can also lead to antitrust concerns. Indeed joint buying may cause a certain degree of commonality in costs, allowing exchange participants to co-ordinate their prices in a downstream market. Excessive buying power may lead to inefficiencies in the upstream markets such as quality reductions or lessening of innovation.

Joint selling agreements may infringe article 81 and are likely to involve customer allocation and/or price fixing elements, usually considered as hardcore restrictions.

These points will not be further assessed, since the aim of this report is to assess the anticompetitive effects of vertical agreements and not horizontal agreements in the New Economy.

4.1 The risk of dominance of market place or portals

The risk of dominance of market place or portals

When a marketplace has the most important buyers and/or sellers in a given market, and it cannot face real competition, this marketplace is dominant.

Due to the strong "network externality" of the New Economy and advantages of "first movers"

4.1.1 These problems arise due to the strong "network externality"[226] of the New Economy and advantages given to "first movers". The possible prevalence of network effects is of course related to the nature of the Internet, which could present network externalities in the sense that the value of the network to an individual user increases with the number of users, and thus network effects can lead to potential problems of network dominance.

Networks effect

First-mover advantages

For, example in its decision Vivendi/Canal+/Seagram[227] the Commission considered that this transaction which add Universal's music content to Vivendi's multi-access portal, Vizzavi, raised serious doubts as to the creation of a dominant position on the emerging pan-European market for portals and on the emerging market for online music. Indeed *"The highly attractive content available on Vizzavi combined with the huge mobile and fixed telephony networks and pay-TV network could increase the number of Vizzavi customers.*

[226] "A network externality is a benefit gained by incumbent users of a group when an additional user joins the group. The group can be sought of as a network of users, hence the term network externality. When the economic benefit of an additional user is positive, it is a positive network externality". Mr. Lee W. McKnight, Joseph P. Bailey (eds), *Internet Economics* (Massachusetts Institute of Technology, fifth printing 1999). As a consequence, industries with network externalities are characterised by positive critical mass, i.e., users prefer large networks in order to reap the benefits offered by network externalities, and networks of small size cannot attract a sufficient number of users.

[227] Decision of 13/10/2000 declaring a concentration to be compatible with the common market (Case No IV/M.2050 - VIVENDI/CANAL+/SEAGRAM) *Official Journal C 311 , 31/10/2000 P. 0003 – 0003*.

Consequently, the addition of Universal's music content to the very large distribution structure of Vivendi and Canal+ is likely ***to create networks effect*** *to the detriment of competitors and to customers. Customers risk to be "walled in" and to pay higher price for the services due to the lack of competition. The market investigation has revealed that* ***Vizzavi is likely to obtain significant first-mover advantages*** *due to its large distribution structure and multi-access system. First-mover advantages will concern Vivendi's and Vodafone Airtouch's abilities to introduce the new technologies such as GPRS and EDGE through Vizzavi".*

At term barriers to entry in B2Bs marketplaces or portals could become very high.

Transaction volume is necessary for a marketplace to cover its operating and developmental costs

According to a number of authors, the most important requisite for a marketplace to function on a long-term basis is to have sufficient transaction volume.[228] Transaction volume is necessary for a marketplace to cover its operating and developmental costs. In order to achieve this objective, B2B marketplaces must attract additional participants, in order to get more customers, and thus greater transaction volume.[229] Moreover, the greater the volume of transactions on a given marketplace, the lower the transaction costs, which attracts other participants.

Online marketplaces are characterised by network effects

These antitrust concerns were also stressed in the OFT's report. According to this report, online marketplaces are characterized by network effects. In such markets, the strong players become stronger and the weak become weaker, as consumers refine their search for the technology that will ultimately prevail. Such markets are called "tippy", meaning they can tip in favour of one particular firm.

Online marketplaces are likely to be "tippy"

4.1.2 According to the OFT report[230], online marketplaces are likely to be "tippy" mainly for liquidity reasons. The most important factor in the success of online marketplaces will be their ability to generate a high transaction volume. The value of a marketplace to its participants increases with the number of participants and the range of products on the market. For example, no buyer will wish to buy from a marketplace in which just one or two buyers are represented if it can move to a marketplace in which it can choose between, and play off, many sellers. Likewise, most sellers will wish to sell in the

[228] Gray 208 "transaction volume (or spend) of $10 billion is necessary to pay for the creation of the infrastructure".

[229] Gray 344 *"To accomplish getting more volume through the system, you have to have more participants".*

[230] OFT, August 2000, *"E-commerce and its implications for competition policy".*

marketplace with the most buyers. Therefore this can act as a barrier to entry.

On multiple marketplaces or horizontal or vertical portals such as Yahoo, which provides a wide range of products and services, the importance of network effects will be even greater. Indeed, the more buyers a marketplace or a portal attracts, the more likely any given seller will be able to find a buyer. This also holds true for buyers, who will be able to find any good or service they are looking for if there is a large number of participants in the marketplace.

4.1.3 Exclusivity practices, as well as ownership interests giving rise to de facto exclusivity, affect the extent to which participants in a B2B are able to support or patronize a rival B2B or other alternative trading systems. Tying the participants to a single B2B may undermine the ability of alternatives to compete, effectively increasing the B2B's market power. Indeed, adding exclusivity to a setting already characterized by substantial network effects could "tip" the market in favour of a given B2B and impede development of alternatives.[231]

Tying the participants to a single B2B may undermine the ability of alternatives to compete

Indeed, according to some authors[232], "*exclusivity provisions can interact with network effects to create substantial barriers to entry [and] would-be early adopters of the new network are faced with what can be a prohibitive opportunity cost of joining the new network: cutting themselves off from the larger, established network*".

In conclusion, a marketplace or a portal has an obvious interest in concluding exclusive agreements with its suppliers in order to benefit from network externalities and first mover advantage. Likewise, the sooner they have the exclusivity of well-known products, the more buyers they will attract. This, combined with the first mover advantage, can lead in a very short time to market dominance.

Exclusive dealing agreements, are likely to induce

4.2 Market dominance can lead to foreclosure

This dominance can be enhanced when exchange owners conclude exclusivity agreements. Vertical restraints, and more particularly exclusive dealing agreements, are likely to induce significant market

231 See Decision Vivendi/Seagram/Canal+: "*The notifying party and Vodafone Airtouch are likely therefore to be able to propose to their customers via Vizzavi access to the music libraries of the five major music labels; Sony, Time Warner, EMI, Bertelsmann and Universal. In order for competing portals to be comprehensive from a customers' and portals' point of view, a portal would have to be able to offer access to must-stock products , that is to say to the major music libraries. Otherwise customers will turn themselves to the complete music catalogue of Vizzavi. As Universal is vertically integrated with Vizzavi, **competitors are likely to loose access to Universal's music catalogues, and there is a risk that the remaining major music providers will be connected on exclusive or preferential terms to the merged entity***".

232 Carl Shapiro, Exclusivity in Network Industries, 7 Geo. Mason L. Rev. 673 (1999).

significant market foreclosure effects in the case of marketplaces or portals

foreclosure effects in the case of marketplaces or portals, for the following reasons:

- Online retailers may conclude exclusive agreements with their suppliers, thus limiting the ability of new entrants to compete;

- Online marketplaces may also conclude exclusive dealing arrangements with the larger buyer or seller in a given market, restricting the development of competition in these markets;

Suppliers can sign exclusive dealing arrangements with a number of major portals.

The competition can be affected by the use of exclusivity practices combined with the networks affects, which, B2Bs benefit.

Risk of foreclosure among marketplaces or portals

Exclusivity agreements will prevent buyers or sellers from dealing with other B2Bs

4.2.1 Risk of foreclosure among marketplaces or portals. Exclusivity agreements or vertical mergers can affect competition among marketplaces. Indeed, B2Bs can undermine the development of competition in the market for B2Bs, since exclusivity agreements will prevent buyers or sellers from dealing with other B2Bs.

In its report, the FTC also stated that B2Bs can capture business by using a wide variety of incentives, "*such as promises of rebates, revenue-sharing, or profit interests for committing some amount of volume to the B2B, or restrictions, including rules imposing minimum volume or minimum percentage requirements, bans on investments in other B2Bs, or pressure on suppliers and buyers to urge them to trade on a particular B2B. Indeed, exclusivity practices could exacerbate potential effects from network or other scale economies that may make it difficult for an entrant to start small, attract the necessary volume, compete effectively, and grow to become a significant factor in the market*".

Thus, online marketplaces may sign exclusive dealing agreements with the larger buyers or sellers in a given market, thereby restricting the development of competition in the electronic market.

This type of issue has already been stressed by the Commission in the decision British Interactive Broadcasting/Open of 15 September 1999[233], related to the creation of digital interactive television services to customers (providing the following services: home banking, home shopping, holiday and travel services, downloading of games, learning on-line, entertainment and leisure, etc.) in the UK named BiB, between British Telecom and BskyB, a broadcaster of pay-TV services. These

[233] Case IV/36.539, JO L 312, 6/12/1999 p.1.

two parent companies are present in the market, which are closely related to one or more of the products.

Retailers offering goods or services over this infrastructure, have confirmed to the Commission that "***it is the breadth of the package of services which will attract them to a digital interactive television services Platform, as they believe that it is the availability of a broad range of services which will increase the number of potential customers for the content providers services***". According to the Commission's experience [234], in order to be a successful pay-TV operator, it is essential to include films and sports channels as part of the service.

Concerning BSkyB, the Commission stressed that it is dominant in the supply of sports channels in the UK pay-TV market and has pay-TV rights to first run films under exclusive dealing agreements major Hollywood and independent studio films.

According to the Commission, "*the* ***extent and duration of BSkyB's exclusive film contracts and sport rights contracts prevent the emergence of any significant competition to BSkyB in the supply of pay TV films and sport channels***".[235]

The Commission stressed out that agreements by competitors as the creators of the exchange to restrict participants' use of other exchanges, by contractual or perhaps, technical means, could well have harmful anti-competitive effects.[236]

However, certain restrictions, are likely to be permissible. In *MyAircraft.com*, the Commission permitted restrictions on the parents of the B2B venture preventing them from setting up or participating in competing B2B exchanges for an initial period.[237] This was justifiable as a restraint related to and necessary for the success of the venture, requiring the parent entities to concentrate their resources on their joint enterprise.

Further, the BKA did not comment adversely upon the proposal by the parties in *Covisint* that each of the parent auto-manufacturers would be entitled, independently of one another, to require their suppliers to use the *Covisint* exchange. Such an obligation would be unlikely to raise competition issues, absent individual market power on the part of each of the manufacturers concerned. It is likely also to be permissible to require participants in an exchange to participate for a minimum period

234 See Bertelsmann/Kirch Première, recitals 34 and 48.

235 Recital 79.

236 OECD report on Electronic Commerce, 12 october 2000, §19-25.

237 M 1969 *UTC/Honeywell/i 2/MyAircraft.com* [2000], paragraphs 22-24.

of time or undertake a minimum volume of transactions, on the basis that there are costs associated with providing each participant with access to the B2B exchange.

Risk of foreclosure on the upstream market

The impact of exclusive dealing agreements

4.2.2 Risk of foreclosure on the upstream market. As stated above, "the first mover advantages in both B2B and B2C could become quite significant if the parties owning them have the power to insist on exclusive arrangements. For example, if all the major buyers in a certain industry set up a B2B exchange and they all agree to buy only on that exchange, they could effectively force suppliers to participate in it. They could then take things a step further by insisting that the suppliers in turn agree to deal exclusively on the exchange". [238]

The risk of "Holp up effect"

Suppliers may also wish to sign exclusive dealing agreements with a non-compete clause. To sell their products on a marketplace or a portal may require specific investments (for example, buyers and sellers wishing to integrate their IT systems with an online marketplace may need to invest in systems[239]). In this case the supplier may be reluctant to make the investment without insurance of a downstream market, where he will be the only one to sell a certain type of product. Moreover, the other side effect of this important investment is that if the supplier wishes to obtain return profits, he must stay as long as possible on the marketplace, and sign an exclusive dealing agreement. This is what is called the "hold up effect". [240]

As a consequence, suppliers that do not participate in the B2B marketplace will not be able to reach the main buyers and sell their products. After a short period they will be completely excluded from the market.

The risk of elimination of inter-brand competition

Thus, there will be less competition regarding the offer of products. Moreover, in the case where a horizontal marketplace or portal selling a wide range of products has signed exclusive dealing agreements with only one supplier for each product, this has the effect of reducing inter-brand competition.

This issue is emphasized by the Commission in its guidelines, *"the combination of exclusive distribution with single branding may add the problem of foreclosure of the market to other suppliers*"(point 171).

The Commission adds in its point concerning single branding that *"a non-compete arrangement is based on an obligation or incentive scheme which makes the buyer purchase practically all his requirement on a particular market from only one supplier*". The

[238] OECD report "Competition issues in electronic commerce", p.25.

[239] OFT report "E-commerce and its implications for competition policy" n°6.106.

[240] OFT report "E-commerce and its implications for competition policy" n°6.107.

possible competition risks are foreclosure of the market to competing suppliers and potential suppliers.

According to the BER, single branding is exempted from the Regulation when the supplier's market share does not exceed 30% and subject to a limitation in time of five years for the non-compete obligation. The question regarding an e-commerce portal or marketplace is to know how this market share can be determined.

Risk of foreclosure on the downstream market caused by non compete clause

4.2.3 Risk of foreclosure on the downstream market. If the main suppliers sign an exclusive dealing agreement with a non-compete clause, which prevents them from buying the products on other marketplaces or portals, the question is whether buyers that do not belong to this marketplace will be supplied in products.

Such a clause is allowed for a five-year period.

There is a risk of market foreclosure, which makes it more difficult or costly for downstream competitors to obtain access to the products that they require. According to the BER, such a clause is allowed for a five-year period. Nevertheless, in a market such the e-economy, which is moving very fast, and where network externalities and first mover advantages are very important, this period can be too long for the buyers before getting alternative sources of supply. As a consequence, their products could become too high, and they would be evicted from the market.

Oligopolistic marketplace or portal owned by the major buyers can also lead to monopsony power

4.3 The risk of monopsony power or buyer power. An oligopolistic marketplace or portal owned by the major buyers in a given industry can also lead to monopsony power.

According to some sources[241], one of the competition issues than can be raised by marketplaces or portals is the exercise of monopsony power. Monopsony is *"market power exercised on the buying side of the market"*, a power that lets a buyer or buyer group "*reduce the purchase price by scaling back its purchases*".

In their report on buyer power in 1981, the Committee of Experts on Restrictive Business Practices defined buyer power as "*a situation which exists when a firm or a group of firms, either because it has a dominant position as a purchaser of a product or service or because it has strategic or leverage advantages as a result of its size or other characteristics, is able to obtain from a supplier more favourable terms than those available to other buyers*".[242]

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[241] FTC report p.13.

[242] OECD report 1981; "Buyer power and its impact on competition in the food retail distribution sector of the European Union" report of the Competition DG, 13/10/1999, See also FTC report "under the classical theory of monopsony, a single buyer or a group of firms acting as a single

This monopsony power can increase due to the fact (as discussed above) that, for a marketplace or a portal to be viable, it must generate a high volume of transactions. Furthermore as stated above B2BS can facilitate, and give incentive to their participants to joint purchasing.

E-commerce might be expected to increase businesses' buyer power for the following reasons:

It facilitates searching by buyers and thus increases the credibility of threats to switch suppliers;

E-commerce might be expected to increase businesses' buyer power

It facilitates the creation of buying clubs, whereby purchasers combine their buying needs in order to increase their total buying power with suppliers;

Buyers may be able to design auctions (and specifically reverse auctions) to their own advantage.

Sunk costs, switching costs, transaction costs can be very high, and create a captive supplier. Such a supplier not only lacks seller power; it could be forced to sell some or even all its output (especially in case of exclusive dealing agreements) at a very low price

As a consequence, a B2B could be used by a large buying group to coordinate reduction of its purchases in order to lower prices.

If a B2B marketplace regroups the most important buyers, and does not face real competition from an other marketplace or from other independent buyers, thus the participants to the B2Bs would have the ability to obtain from suppliers more favourable terms than those available to other buyers or would otherwise be expected under normal competitive conditions. "*Apart from the ability to extract discounts on transactions from suppliers, buyer power may manifest itself in the contractual obligations (as vertical restraints) which retailers may be able to place on suppliers*"[243]. These could take a number of forms such as listing charges (where buyers require payment of a fee before goods are purchased from the listed supplier), slotting allowances (where fees are charges for store shelf-space allocation), retroactive discounts on goods already sold, buyer favoured nation clauses (with contractual obligations for the supplier not to sell to another retailer at a lower price).

buyer, in the market seek to lower the price it must pay for a given product through the means of reducing its purchases of that input".

243 See"Buyer power and its impact on competition in the food retail distribution sector of the E.U" by Dobson consulting, may 1999 (available at www.europa.eu.int).

As stated in the Commission's guidelines on horizontal restraints[244] it is quite unlikely that a buying power may exist if the market share held by the parties is below 15%.

The commission has already assessed buyer power in some decisions. In **Rewe/Meinl**[245] the Commission considered '*the exercise of buyer power which leads to the securing of a more favourable purchase deal is not to be considered per se detrimental to the economy as a whole. (…). However, if the powerful buyer himself occupies in his selling market a strong position which is no longer kept sufficiently in check by the competition, any savings can no longer be expected t be passed on to customers*". And added "*Buyer power also gives a trader considerable influence over the choice of products which come to market and hence are obtainable by consumers. Products which are not bought by a dominant buyer have pratically no chance of reaching the final consumer as the supplier laks alternative outlets. Lastly, the dominant buyer determines the success or otherwise of product innovations*".

The Commission has already assessed buyer power in some decisions

The Commission also asked producers what proportion of turnover, with a given customer could not be switched to other sales channel without difficulty, it transpired that on average 22% of turnover is the figure above which a customer can be replaced only at the cost of very heavy financial losses, if at all. The Commission concluded in this case that suppliers were dependant on Rewe/Meinl.[246]

See Rewe/Meinl

Here again the difficulty to assess buyer power lays in the difficulty to define the relevant market. Indeed if good traded on the Internet are substitutables to the ones traded via traditional channels, the risks of market power would be very limited. On the other hand if the market taken into consideration is the one of goods traded via marketplaces, thus buyer powers concerns may arise very quickly.

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[244] OJCE, 06/01/2001,n° C 3/19, point n° 130.

[245] Case COMP n°IV/M.1121, OJ L 274, 23/10/1999 p.1, See also Carrefour/Promodes Case COMP n°IV/M.1684, 25/01/2000.

[246] See also Carrefour/Promodes, point 52: Taux de «menace». "*Lors de son enquête, la Commission a demandé aux fournisseurs d'indiquer à partir de quel pourcentage de leur chiffre d'affaires ils considéraient que la perte d'un client représenterait une menace pour l'existence même de leur entreprise. La moyenne des réponses obtenues fait apparaître un seuil de 22%. Ce seuil de 22% avait été également retenu dans l'affaire Rewe/Meinl. (…) A priori, on pourrait en déduire que lorsqu'un distributeur dépasse un tel seuil dans le chiffre d'affaire d'un de ses fournisseurs, ce dernier se retrouve de facto en situation de «dépendance économique». Le seuil de 22% a également été évoqué pour un fournisseur dans une affaire traitée par le Conseil de la Concurrence français (Décision n° 93-D-21 Cora/SES)*".

The risk of raising rivals' costs

4.4 The risk of raising rivals' costs

Market power held by new intermediaries can also have the consequence of raising rivals' costs

4.4.1 The risk of discrimination. The market power held by these new intermediaries can also have the consequence of raising rivals' costs. Indeed, if a marketplace is dominant, and owned by the major players of the market, these actors could give access to their marketplace at discriminatory conditions.

B2Bs can discriminate against, or exclude rivals of their owner participants

B2Bs can discriminate against, or exclude rivals of their owner participants. Discriminatory practices, such as presenting information on the screen in a way that favours the B2B's owners or using discriminatory operating rules to leave rivals with reduced functionality or higher costs, may raise rivals' costs of doing business and limit their ability to provide effective competition in markets for the goods that they sell.

In some markets, portals may play an important role as gateways to consumers. If a major operator can sign up a number of major exclusive dealing agreements, this will raise the costs faced by alternative operators in attracting customers.

Risk to design the exchange or auction process in order to favour a dominant supplier

Auctions and exchange marketplaces can be designed in many different ways and there is extensive literature on how market design can affect market outcomes[247]. In particular, as stressed in some reports[248], it may be possible to design the exchange or auction process such that it either favours a dominant supplier or can be effectively manipulated by a dominant supplier. The design of a marketplace may therefore itself increase the profits obtainable by a dominant firm, and thus increase the likelihood of excessive pricing.

The Commission has already dealt with this kind of issue concerning Computerised Reservation System (CRS), in the **Air France/Amadeus** decision[249]. In this case the European Commission had decided to open a formal procedure against Air France for possible abuse of dominant position for alleged discrimination against Sabre, an Amrican CRS controlled by American Airlines.

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247 Klemperer (1999), Auction theory: a guide to the literature, Journal of Economic Surveys, vol.13 (3), p.227-286.

248 OFT report, E-commerce and its implications for competition policy, point 6.12.

249 See Commission's press release IP/99/171 of 1999-03-15, IP/00/835 of 200-07-25.

The allegations concerned essentially the airlines' failure to provide Sabre with the same comprehensive and timely flight information as they provided to Amadeus (partly owned by Air France), and their failure to offer to Sabre the same technical possibilities such as on-line confirmation of bookings. Thereby Sabre was disadvantaged.

Finally Air France has declared its readiness to deal on equivalent terms with an other CRS.

An example concerning B2Cs is the creation of the Online B2C Travel agency

An example concerning B2Cs is the creation of the **Online B2B Travel agency**[250] between German Internet provider T-Online, Tui & C&N. Competing online agents have submitted that they depend on TUI's and Neckermann's product offer and brands and they fear that the new company would end up dominating the online segment. They are also concerned about potential discriminatory measures with regard to access to essential content. To address these concerns, TUI and Neckermann offered to conclude supply contracts with any other online agents. But a number of conditions were attached to this general commitment, which would have provided numerous opportunities for circumvention and de-facto discrimination. The Commission, therefore, concluded that the commitments offered did not fully and clearly remove the competition concerns and decided to enter into an in-depth ("Second-phase") inquiry. The parties finally withdrew their project.

4.4.2 The importance of intellectual property rights. The exploitation of intellectual property rights can also lead to excessive pricing, to the disadvantage of competitors. Indeed, a firm that develops a specific patent can either decide not to licence the patent to its competitors or to license it in such bad terms that it would increase significantly their costs and thus the price at which they will sell products to final-end customers. For instance, patent law has enabled Amazon.com to stop its competitors from using its “one-click” technology, which involves storing customer information for rapid re-use later, and allowed Priceline.com to prevent its competitors from applying the technique of reverse auction where customers set the price of goods they want to buy.

4.5 The risk of exclusion

As discussed above many B2Bs are set up by major actors of one or several industries. If these B2Bs are very attractive since they yield substantial efficiencies, the owners' competitors may wish to enter in this B2B.

250 op.cit.

A refusal to access to a B2B exchange may constitute an infringement to articles 81 and 82

If the owners deny their competitor's access to the B2B, it could raise anticompetitive concerns. Il could raise their costs (since they will not benefit from the B2B efficiencies), or make them less competitive. In addition to denying the rivals the cost-savings benefits of B2B participation, exclusionary treatment may impair a rival's ability to continue dealing with suppliers or customers who are committed to a given B2B.

A refusal to access to a B2B exchange may constitute an infringement to articles 81 and 82 of the EC Treaty.

4.5.1 Refusal to access can be an illegal use of a dominant position. The Commission has already dealt with this kind of issue concerning Computerized reservation System (CRS), in the London European/Sabena[251] and Air France/Amadeus decisions.[252]

In the first case London European Airways PLC, alleged that Sabena Airlines, had infringed article 82 of the Treaty by abusing its dominant position on the computerized ticket reservations market in Belgium.

Refusal to access can be an illegal use of a dominant position

London European/ Sabena and Air France/ Amadeus decisions

The alleged abusive conduct was the refusal by Sabena to grant London European access to its Saphir CRS which is managed by Sabena. This system allows travel agents to consult the flight schedules, fares and seat availability of airlines in the system and to make reservations. This system eliminates the need for travel agents to telephone the company concerned for each booking and thus does not compete with the existing traditional services. Such access to a CRM is essential for a company whishing to compete with companies already using such system.

London European claimed that Sabena , by refusing to grant access to the Saphir system, was using its power on the ticket reservation market to impose minimum air fares on London European, or was attempting to make entry to the Saphir system subject to acceptance by London European of services which had no connection with the reservation system (ground handling). The complainant also alledged that Sabena had refused access to the Saphir system on the ground that London European's tariff on the Brussel-Luton route was too low.

The Commission considered that Sabena with Saphir held a dominant position (40-45%) on the market for the supply of computerized reservation services in Belgium, and concluded that Sabena abused that dominant position on that market by refusing to grant London

[251] See Decision of 4 November 1988, n° IV/32.318, London European-Sabena, OJ L317, 24/11/1988, p.0047.

[252] See Commission's press release IP/99/171 of 1999-03-15, IP/00/835 of 200-07-25.

European access to the Saphir system on non justifiable grounds.

Finally Sabena informed the Commission of its decision to accept London European into the Saphir reservation system on normal non-discriminatory commercial terms.

4.5.2 Refuse to access can infringe article 81. Refusal to allow access to a B2B exchange may infringe EU competition rules. Where the operators of the exchange are competitors, a refusal may be seen as a collective boycott of the company seeking access thereby infringing Article 81.

Refuse to access can infringe article 81

A refusal may be seen as a collective boycott of the company seeking access thereby infringing Article 81

Membership rules. In the off-line world, the Commission has examined the rules of a number of trade exchanges. Generally, it has considered that rules providing for clear and objective membership eligibility criteria will not infringe Article 81.[253] Rules requiring past trading experience, credit worthiness, compliance with the exchange's financial clearing system and a bona fide continuing interest in the products in question have been considered legitimate, as have been rules requiring a minimum presence on the exchange (dedicated office space, floor trading staff). Rules limiting access to a fixed number of participants without objective justification and, in particular, rules discriminating against members from other EU states are unlikely to be acceptable[254].

In Volbroker.com

EU competition law concerns with membership rules for B2B exchanges are likely to be similar, especially where the exchange has, or is likely to have, appreciable market power. In ***Volbroker.com***, the Commission received complaints from a number of "voice broker" sellers who act as intermediaries, and occasionally as principals, in the sale of foreign currency options. The voice brokers complained that the exchange, set up by six major market makers in the industry (Deutsche Bank, UBS, Goldman Sachs, Citibank, JP Morgan and NatWest), excluded them from participation. The Commission required that the voice brokers, when acting as a principal, should be permitted access to the marketplace as a condition of issuing a comfort letter under Article 81(3).

In Covisint

In *Covisint*, the parties submitted a memorandum of understanding to the Bundest Kartelant during its investigation setting out the rules under which open and non-discriminatory access to the Covisint platform would be allowed. The rules provided that there would be no preferred access for categories of suppliers or car manufacturers, including the founder members; an exclusivity or preference commitment to Covisint would not be a condition of participation; and

253 See, for example, London Sugar Futures Market OJ [1985] L 369/25; Petroleum Exchange of London OJ [1987] L 3/27; London Meat Futures Exchange OJ [1987] L 19/30.

254 See "Issues for B2B Exchanges under EU Competition Law" Bill Batchelor, Baker&McKenzie, European Law Centre, op. Cit.

Covisint would provide for open interface standards which would allow existing EDI systems and existing auto-networks (the ENX and ANX networks) to connect to Covisint.

4.5.3 Refusal of access to an essential facility. The point is to know whether a portal or a marketplace which is in a dominant position could be considered an essential facility, and whether refusal of access to this essential facility could be considered as an abuse of that dominant position.

Refusal of access to an essential facility

According to the criteria[255] developed by the European Court of Justice, an **essential facility is defined** as an asset or facility to **which:**

access is indispensable in order for an operator to compete in the market, and which would be **impossible or extremely difficult** to replicate.

According to this case law, for refusal of access to be considered as **an abuse**, it must be:likely to **eliminate all competition** in the market on the part of the person requiring access, and the refusal must be **incapable of objective justification**.

Can marketplaces or portals be considered essential facilities?

(i) Can marketplaces or portals be considered essential facilities? As discussed above, when a marketplace or a portal contains the major players or buyers in a specific industry, it is advantageous to be present on it in order to sell or buy its products.

Nevertheless, at this stage of the development of e-commerce there are several marketplaces or portals, therefore the intermediaries who are not present on a specific marketplace still have the possibility to enter another one. Moreover, here again the question of the relevant product market is determinant. If there is not a specific market for this type of new intermediary, but they are considered as competing with the traditional supply chain, then a competitor will still have the possibility to sell its products and to compete on the market. Furthermore, it has to be determined what proportion of transactions are made through marketplaces, if for instance on the product market of "tiers" only 5% of the purchase of this products are made through a B2B marketplace, then there is still a big place for competition on this market.

As a consequence, a marketplace or portal would not be considered an essential facility.

Furthermore, at this stage of the development of e-commerce, which is still not mature, it does not appear to be "impossible "or "extremely difficult" to establish a portal or a marketplace. However, in the future, if there are only one or two platforms with a strong market power combined with the several market to entry assessed above, this access

[255] See Case C-7/79 Oscar Bronner v. Mediaprint.

could be "indispensable" and it could become extremely difficult to enter this market.

Nevertheless, it should be emphasized that these criteria are very strict and are unlikely to be met in many cases.

(ii) Can refusal of access to the essential facility be considered as an abuse of dominant position?

Can refusal of access to the essential facility be considered as an abuse of dominant position?

As stated above (see (i)), the risks of elimination of all competition are very low if goods traded on the Internet compete with the ones traded via traditional channels.

The only problem is that a refusal of access will be difficult to justify since, as stated in section III above, network efficiencies play a very important role for the success of B2Bs, which need a high volume of transactions and facilities to be viable. Thus the refusal of access to a B2B could be assessed as a way to eliminate competitors.

TITLE II

ASSESSMENT OF VERTICAL AGREEMENTS AND MERGERS IN THE NEW ECONOMY

CHAPTER I

COMPARISON AND ADEQUACY OF CURRENT ASSESSMENT OF VERTICAL AGREEMENTS AND MERGERS IN THE NEW ECONOMY

CHAPTER I

COMPARISON AND ADEQUACY OF CURRENT ASSESSMENT OF VERTICAL AGREEMENTS AND MERGERS IN THE NEW ECONOMY

Introduction

Competition in high tech industries is fundamentally different from that in more mature and stable industries. Some of the traditional techniques used to define and measure market power in antitrust analysis may not be appropriate. High tech industries are typically characterised by high levels of product differentiation and dramatic shifts in firms' market positions. Thus applying traditional methods yield narrow market definitions and market power may be exaggerated. Some "new" sets of criteria for antitrust analysis of high technology markets concerning the definition of the markets and the evaluation of market power must be considered. A wide-angle lens is needed to assess competition in dynamic markets. This includes the way technology competition occurs and its several dimensions as customer needs and responses to product innovation. This can help improving the way some traditional criteria are used in practice.

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 in, effect, entirely new advanced products and services. New technologies, particularly in the electronic communications sector have, by their very nature, no or little equivalent in traditional markets (enhanced products with more capabilities and functionalities such as UMTS telephony as opposed to GSM, or entirely new devices such as Internet connectivity by electricity networks as opposed to fibre optics cables). In a fast evolving environment, the leader in a given technology one day may be quickly overtaken by a new product or technology.

Network dynamics and networks effects are of a particular relevance for this analysis.

This requires an informed understanding of the underlying technologies and a qualified apprehension of market dynamic. 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".*[256]

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

The adequacy of the current competition rules to limit anti-competitive effects of vertical agreements and vertical mergers will of course, very much, vary depending on what segment of the New Economy is addressed. This dynamic approach is particularly relevant for the competition analysis of electronic networks.

When addressing e-commerce, that is 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 opened on whether it constitutes a distinct market at all.

This chapter will provide different answers depending on whether it addresses e-commerce or electronic networks, with particular emphasis on the latter where innovative criteria may well need to be identified and applied.

Section I.

Comparison of the competition policy approach toward vertical agreements and vertical mergers and impact of these rules on firm's strategies

1. Comparison of the Competition policy approach toward vertical agreements and vertical mergers

Competition policy approach toward vertical agreements and vertical mergers

The principal competition rules of the EC Treaty that apply to undertakings are first Article 81 of the EC Treaty that prohibits agreements between firms, decisions by associations of firms and concerted practices which may affect trade between member states of the E.U. and which have, as their object or effect the prevention, restriction or distortion of competition, subject to exemption to be granted by the Commission. Secondly, Article 82 of the EC Treaty prohibits any abuse by one or more firms of a dominant position in so far as it may affect trade between member states of the E.U.. Regulation 17 contains the principal regulatory framework for the enforcement of Articles 81 and 82.[257]

A specific merger regulation[258] prohibits concentrations that create or strengthen a dominant position as a result of which effective competition would be significantly impeded within the E.U. or a substantial part thereof.

These regulations are supplemented by specific regulations applying to specific sectors as well as notices and guidelines which do not have the force of law but binds the Commission in its administrative proceedings and are an essential point of reference in any competition assessment.

Finally, decisions from the European Court of First Instance and the Court of Justice provide the substantive law with a framework of important decisions primarily on Articles 81 and 82 assessments since very few merger decisions have been challenged in courts.

257 Council Regulation n° 17: First Regulation implementing Articles 85 and 86 of the Treaty Official Journal 013 , 21/02/1962 p. 0204 – 0211.

258 Council Regulation (EEC) No 4064/89 of 21 December 1989 on the control of concentrations between undertakings, Official Journal L 395, 30.12.1989; L 257, 21.09.1990.

1.1 *The aim of Articles 81 and 82 is to maintain effective competition*

The aim of Articles 81 and 82: Maintaining effective competition

Article 82 prohibits any abuse of a dominant position by one or more firms in a substantial part of the Common Market that may affect trade between member states. Article 82 is to be applied and construed, like Article 81, in the light of the task assigned to the Community by Article 3(g) of the Treaty of instituting a system ensuring the maintenance of effective competition in the Common Market.

Article 81 prohibits the prevention, restriction or distortion of competition by means of an agreement or concerted practice between firms, regardless of whether they have market power. By contrast, Article 82 applies only to firms that have market power and seeks to prevent the abuse of such power for anticompetitive ends. It prohibits the abuse of market power both by the unilateral conduct of a single firm, and by the interdependent action of several oligopolists. In the latter case, no agreement or concerted action between multiple actors must be proved as under Article 81.

New block exemptions on vertical restraints and guidelines

A new specific block exemptions regulation on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices[259] was introduced in December 1999, replacing earlier specific targeted block exemptions regulations (exclusive, selective distribution, franchise). This regulation is supplemented by extremely detailed and useful guidelines.[260] It covers all categories of vertical agreements and concerted practices with the exception of the automobile distribution sector[261] which is still regulated separately and currently under review.[262]

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259 Commission Regulation (EC) n° 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, Official Journal L 336, 29/12/1999 p. 0021 – 0025. Commission Notice.

260 Guidelines on Vertical Restraints, Official Journal C 291 of 13.10.2000 p. 1.

261 Regulation EC 1475/95 of 28 June 1995, application of Article 85(3) of the Treaty to certain categories of motor vehicle distribution and servicing agreements, Official Journal L 145 , 29/06/1995 p. 0025 - 0034.

262 New regulations and guidelines have also been introduced to deal with horizontal aspects:
- Commission Regulation (EC) No 2658/2000 of 29 November 2000 on the application of Article 81(3) of the Treaty to categories of specialisation agreements, Official Journal L304, 05/12/2000 p. 0003 – 0006.
- Commission Regulation (EC) No 240/96 of 31 January 1996 on the application of Article 85 (3) of the Treaty to certain categories of technology transfer agreements, Official journal n° L 031, 09/02/1996 p. 0002 – 0013.
- Commission Regulation (EC) n° 2659/2000 of 29 November 2000 on the application of Article 81(3) of the Treaty to categories of research and development agreements, Official Journal L 304, 5/12/2000 p. 0007 – 0012.
- Guidelines on the applicability of Article 81 to horizontal co-operation agreements, Official Journal C 3 of 06.01.2001, p.2.

The Commission block exemptions and guidelines on vertical restraints apply to vertical exclusive distribution and purchasing agreements and agreements having similar effects, which are concluded between two or more independent companies with less than a 30% market shares. However, exclusive purchasing obligations must not exceed five years, and post-term non-compete clauses must be limited to a period of one year.

The approach provided in these block exemptions do not lead to a fundamental change of the Commission's enforcement policy with respect to vertical agreements which infringe Article 81 and are normally not exemptible. These agreements remain subject to civil consequences before the national courts and to the imposition of fines by the Commission.

The Commission block exemptions and guidelines on vertical and horizontal restraints are part of a broader policy of the Commission to modernise rules applicable to evaluation of Articles 81 and 82 of the Treaty and a fundamental reform of the rules of procedures of Regulation 17[263] by dropping prior notification requirements and shifting the burden of the analysis of the compatibility of agreements or restraints of competition to national courts or competition authorities.

The commission is currently simplifying antitrust rules

Reform of Regulation 17

The Commission's approach aims rather at simplifying supervision by the Commission, stimulating the decentralized application of the EC competition rules by national authorities and courts and allowing the Commission to devote its resources to investigation of serious offences, thereby providing adequate legal certainty. However companies may be reluctant to implement vertical agreements without prior clearance, in particular because of the difficulty of defining the relevant markets in view of the proposed, rather low, 30% market share thresholds and of determining the agreements that are restrictive of competition and need individual clearance. This may be particularly relevant in the New Economy untested environment and the difficulty of determining the relevant product market in this area.

After the contemplated reform of procedures of Regulation 17, lack of prior clearance through a formal notification in the case of high market shares and the risk of challenge by national competition authorities or courts may well increase the tendency towards vertical integration.

263 White Paper on Modernisation of the Rules Implementing Articles 85 and 86 of the EC Treaty.

In the current state of play where Regulation 17 is still in place, the risk of unenforceability and legal consequences under national law and even fines under Community law (which are precluded only in the case of notification) may induce companies despite the specific block exemptions and guidance provided in Commission's guidelines to submit notifications to the Commission whatever the market thresholds, or at least seek clearance through letters of comfort.

1.2 The aim of the merger regulation is to prevent the creation or strengthening of a dominant position

Central criteria of merger control: creation or strengthening of a dominant position

The merger control regulation establishes both the substantive and procedural framework for evaluating mergers, acquisitions and "full-function" joint ventures. The criteria, which the Commission must apply in appraising transactions, are competition oriented. The principal criterion is whether the transaction would create or strengthen a dominant position that would significantly impede effective competition. The "development of technical and economic progress" which is included in the appraisal according to the regulation must also be interpreted in a competition oriented way.

Mergers and full-function joint ventures having a Community dimension must be notified to the Commission in advance of their implementation. Community dimension is based on turnover, not on market share thresholds. Transactions may not be implemented until the Commission has given clearance or the time limit for Commission action has expired.

Balancing pro and anti-competitive effects

The assessment of mergers and joint ventures requires to take into account both pro and anti-competitive effects. The current merger control regulation prohibits large mergers and full-function joint ventures[264] that create or strengthen a dominant position while leaving to assessment under Articles 81 and 82 of other transactions, such as non-full-function joint ventures or other forms of cooperation between enterprises that may coordinate the competitive behaviour of the business entities concerned which remain independent afterwards. Transactions that are too small to be subject to the merger control regulation remain subject to member states competition laws, including member state merger control rules.

[264] Commission Notice on the concept of full-function joint ventures under Council Regulation (EEC) n° 4064/89 on the control of concentrations between undertakings, OJ C 66 of 02.03.1998.

The effects on competition of mergers and joint ventures are as varied as are the types and structures of such transactions. They may bring about substantial competitive benefits or severely restrict competition, or they may be neutral, in their overall effects. The principal benefits are in promoting investments, developing new product or geographic markets, diversification, assuring supplies or outlets, promoting innovation and transfers of technology, achieving economies of scale and costs reductions, restructuring or rationalization of businesses and establishing countervailing market power all of which particularly relevant in the context of the New Economy. The detriments include the reinforcement of oligopolistic market structures, the raising of barriers to market entry, sharing markets, and strengthening market power, which can be exploited against competitors, suppliers or customers.

The evaluation of mergers and full-function joint ventures requires a detailed study of the facts of each case. This is often more complex than the evaluation of other restrictive practices for several reasons. First, mergers and joint ventures tend to change the competitive relationship between the parties more radically than other forms of cooperation and often in ways independent of any precisely formulated contractual obligations. Secondly, the evaluation calls for a prediction of the long-term effects of the transaction. Finally, there is rapidly developing practice of merger control at the Commission level with few precedents in the case law of the Court of First Instance and the Court of Justice, since merger decisions have seldom been challenged in court.

Specific legislation for the telecommunications sector

In the context of liberalisation, specific legislation was introduced for the telecommunications sector to ensure competition between operators. The potential of development in this sector, as well as necessary convergence with the communications sector through vertical multimedia applications can only be achieved with true competition between players in these sectors.[265] In that respect, application of competition rules to the telecommunications sector differs significantly from other sectors through a specific sectorial regulatory framework alongside with the competition rules of the

[265] Since 1990, the Commission has adopted six Directives under Article 86 (3) of the Treaty to open the telecommunications sector with effect for 1st January 1998.

Communication from the Commission - Unbundled access to the local loop: enabling the competitive provision of a full range of electronic communication services, including broadband multimedia and high-speed Internet, Official Journal C 272 of 23.09.2000, pages 55-66.

Access Notice - Notice on the application of the competition rules to access agreements in the telecommunications sector, Official Journal C 265 of 22.08.1998, pages 2-28.

Commission Guidelines on the application of EEC competition rules in the telecommunications sector, Official Journal C 233, 06.09.1991, page 2.

Treaty.

As a result of effective competition in the telecommunications sector and increasing convergences in the media and information technology sector, a new regulatory framework is currently being considered with the view of introducing a unique framework for all communications services irrespective of the providing infrastructure. All communications services, via telephony, fixed or mobile, satellite, cable, etc… including associated services and infrastructure such as tele-distribution or interface programs will be dealt with a unique regulatory framework.[266]

1.3 Competition policy as applied in the telecommunications sector and the New Economy

Cases referred to the Commission in the telecommunications sector from which analogies can be drawn for the net economy more generally, have been concerned with strategic alliances and abuse of dominant position, the former both under Regulation 17 or the merger control regulation review, depending on the type of transaction, the latter under Article 82 and Regulation 17.

Some strategic alliances in the telecommunications sector have been exempted after being notified under regulation 17 either by negative clearance or individual exemptions. The Commission has considered in accordance with the criteria of Article 81(3) the pro-competitive effects of such ventures in the context of liberalisation of the sector and trans-national cooperation guarantying an effective competition on operators' respective national infrastructure.

Negative clearances were recently granted to the Metroholdings joint venture between Energis, Deutsche Telecom and France Telecom for the joint construction of local telecommunications networks in several cities in the United Kingdom.[267] Negative clearance was also granted for the creation of an european backbone network between British telecommunications, Sunrise, Telfort, Albacom, and VIAG Interkom.[268] The restructuring of Cegetel with BT participation was also cleared.[269]

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[266] See also Title II Chapter I, Section II. § 2.6. Barriers to entry.

[267] IP/99/211 of 31.03.1999.

[268] IP/99/444 of 13.06.1999.

[269] OJ L 218, 18.08.1999.

Most strategic alliances have been notified and approved under the merger regulation as full-function joint ventures. The analysis will therefore be based on whether the alliances would lead on the affected markets to the creation or the strengthening of dominance. However, to the extent that such ventures could have resulted in potential coordination of competitive behaviour between parent companies, these concentrations have also been cleared in the light of the criteria of Article 81 of the Treaty. Some decisions were approved under phase 1 procedure, such as VIAG/Orange, or as in the case of BT/ATMT and to the extent that it raised serious doubt under a phase 2 in depths evaluation. In some decisions, the Commission has imposed important conditions such as unbundling of the local loop and the sale of its cable networks in Sweden and Norway in the Telia/Telenor merger, or the non-discriminatory access to the mobile telephony European networks in Vodafone/Airtouch/Mannesmann.

Most strategic alliances have been notified and approved under the merger regulation as full-function joint ventures

More recently, on 29 December 2000, the Commission adopted a decision repealing the exemption decision it had taken in 1997 regarding Unisource, a broad global telecommunications alliances within three incumbents telecommunications operators, KPL, Telia and Swisscom.[270]

Potential abuse of dominant position is of primarily importance in the telecommunications sector since former monopolistic operators still hold a strategic position in most affected markets as they retain the control of the infrastructure. Access to networks and services of dominant operators at reasonable tariffs and conditions is essential. This access is also essential in order to allow the development of media applications and particularly e-commerce. There have not been decisions as yet on cartel behaviour. In a number of instances, the Commission has opened inquiries, treating with particular attention all forms of abusive practices such as discriminatory pricing, excessive or predatory pricing. Interconnection tariffs between fixed and mobile telephony[271], accounting rates[272], leased lines have been under scrutiny and more recently an enquiry has been launched on roaming charges against, among others Vodafone Orange, BT Cellnet, One2-One, T-Mobil, D2 and E-Plus. An enquiry has also been launched in the Compact Disc sector. Since in some instances, operators have adapted their tariffs and national regulatory authorities have been involved, some of these proceedings have not been subject to a formal decision.

Potential abuse of dominant position is of primarily importance in the monopolistic telecommuni-cations sector

270 Press Release IP/01/1, 03.01.2001.

271 Such as IP/98/141 of 09.02.1998; IP/99/298 of 04.05.1999.

272 Such as IP/99/279 of 29.04.1999.

B2B

B2B cases referred to the Commission have been notified both under Regulation 17 and the merger control regulation. Most B2B ventures have been notified under the merger control regulation with the exception of Volbroker.com, cleared by comfort letter under Article 81 (3) and Covisint, which is still under review under Regulation 17 (it is worth noting that Covisint has been reviewed both by U.S. and German authorities as concentrations).[273]

Portals

Few portals cases have been reviewed by the Commission, the Vodafone/Vivendi/Canal+, as well as Telia/Oracle/Drutt portal were both cleared under the merger control regulation.[274]

[273] For reference to B2B decisions cleared, see Title I. Chapter II. Section III.

[274] COMP JV 48, COMP. M/1982.

2. Impact of these rules on the strategies, which a firm will tend to adopt to ensure the distribution of its products in the New Economy

2.1 Merger Cases

Impact of Competition rules on firm's strategies

Companies forming strategic alliances to underwrite the high costs of developments of new technologies must consider regulatory concerns as premature and overbroad cooperation may threaten competition between them or foreclose potential arrivals of new entrants. Innovative companies that hold a strong market position may find that they operate on a special regulatory constraint to conduct themselves so as not to hinder the emergence or maintenance of effective competition. It is hoped that the Commission will pay ever closer attention to technology developments in its merger analysis.

Merger Cases

Firms should account for the risk that competition authorities may show a reluctance to clear mergers or alliances which could reduce the benefits of innovation to customers where leading innovators with valuable known-how could diminish competition in the developments of new technologies. The same would equally apply where companies would be tempted to extend their dominance or acquire a gatekeeper role with respect to important technologies or infrastructure, all of which will need to be considered before appraising any such venture.

Conditions often imposed for clearance

The Commission imposes, more than often, conditions for clearance, which will need to be offset against the potential benefits of the contemplated alliance. This sometimes-difficult assessment and judgment call needs to be addressed as part of the overall strategy driving the alliance and not as a last minute unbalanced concession purely driven by timing constraints and the need to obtain clearance.

As mentioned above, the Commission has imposed important conditions such as unbundling of the local loop and the sale of its cable networks in Sweden and Norway in the Telia/Telenor merger.

Illustrations

British Interactive Broadcasting /Open Decision

British Interactive Broadcasting/Open decision of 1999 provides a good example of Commission action taken to ensure that market power is not extended from one arena into another without imposing undue constraints whilst preserving effective competition. That case involves a joint venture between BT, the UK leading telecommunications carrier, and BSkyB, a broadcaster of analogue pay-TV programming to promote digital interactive pay-TV. As a condition to clearance, BSkyB agreed to distribute films and sports channels on a non-discriminatory basis and at the choice of individual customers in order to prevent possible wholesale bundling to the detriment of the joint venture competitors and BskyB own competitors.

Companies will also need to consider the negative impact of a possible negative decision both in terms of image and future alternative strategies. Precedents in this area should be analysed well in advance in the decision making process.

MSG Media Services

In MSG Media Services[275], the Commission blocked the formation of a joint venture between Bertelsmann, Germany's largest media company), Kirsh (a broadcaster and leading supplier of film entertainment) and Deutsche Telekom (the owner/operator of nearly all German broadband networks) for the development of a digital pay-TV administrative and technical services to other broadcasters. The Commission concluded that a durable dominant position would arise as a result of the proposed venture's infrastructure development and vertical integration. The venture was deemed both to threaten potential competition between the co-venturers and to foreclose potential entrants who would not undertake the investments required to develop competing networks. In this regard, the Commission treated the parties' anticipated economies of scale and scope (and consumer benefits resulting from them) as exacerbating the likely anti-competitive effects of the venture, since they could deter others from entering. It also expressed concern that the venture, as suppliers of essential infrastructure to other pay-TV providers, might engage in opportunistic behaviour through, for example, the provision of access on discriminatory terms, technological bias in future developments, cross-subsidisation among different elements of the system, and misappropriation of competitively sensitive information. In sum, the Commission concluded that although the proposed venture might create demand for new services, it was likely to be so anti-competitive as to hinder technical and economic progress in the long run. Notably, the decisions appear to turn on a comparison of the proposed venture with a hypothetical, competitive market without regard to whether competition between multiple providers was in fact sustainable.

MCI / WorldCom

MCI/WorldCom provides another notable example in this area. In that case, the parties proposed a concentration that would give them control of approximately 50 % of the Internet backbone, high-speed data lines with a system of routers that direct traffic across a variety of media and provide universal Internet connectivity. The Commission expressed concerns that the merged parties could charge monopoly rates for interconnecting the thousands of small services providers that must operate via transit agreements with backbone operators, thereby jeopardising competition both in upstream markets for universal connectivity and in downstream markets for retail and value added services. The Commission was also concerned that a merged WorldCom/MCI would raise its rivals' costs by degrading the quality of their interconnections or biasing system improvements to favour its own services. On of the most notable facets of WorldCom/MCI is the

[275] Commission Decision of 9 November 1994, 94/922/EC, IV/M.469 - MSG Media Service, Official Journal L 364, 31/12/1994 p. 0001 – 0021.

Commission's apparent adoption of the theory of network externalities, whereby a product becomes more attractive to customers as the size of its existing customer base grows. Where a party controls a bottleneck in proprietary standards of infrastructure, networks externalities can create a snowballing effect as ever-greater numbers of users are drawn dominant networks. The Commission's recognition of this phenomenon may well play a significant role in future cases involving information technologies. The Commission imposed as a condition to clearance the divestment of MCI Internet business activities.

These general considerations lead to a word of caution when dealing in still relatively untested territories with little innovative criteria being applied in a dynamic approach. **The fact that the Commission does not apply a formal "innovation market" analysis may be most significant from a tactical perspective.**

2.3 Analysis under Regulation 17

Companies creating B2B platforms or portals will need to determine whether it qualifies for block exemptions or requires notification under Regulation 17 or the merger regulation. It is too early to assess whether B2B platforms and portals will always be viewed positively.[276]

B2B and Portals analysis under Regulation 17

The fact remains that B2B platforms that have been notified so far do not seem to create any major concerns and are still viewed as pro-competitive by nature. The competition authorities are still in the very early stage of discovery and analysis of these platforms and tend to react on a case-by-case basis. There are still very little if any barriers to entry and to the extent that access, boycott, exclusivity and exchange of information are so far not restricted, the competition authorities are likely to be cautious in their assessment before defining a general policy as it may impact on the overall application of competition rules.

Ultimately, it is doubtful that most B2B platforms will be set up as full-function joint venture because of the very high number of participants in most platforms. It is not surprising that these B2Bs, which have been notified, are only those, which are clearly full-function joint ventures, set-up by small groups of large manufacturers in a dedicated industry, thus compelling formal notification under merger control regulation.

[276] See Title I. Chapter II. Section III on B2B marketplaces and portals.

B2B fall under block exemptions regulations on vertical restraints to the extent the 30 % market thresholds are met

Most agreements will therefore need to be analysed under Article 81 and Regulation 17 set of rules. For the time being, the view is that B2B is still substitutable with other types of distribution. Most cases will therefore likely be considered by operators as falling under block exemptions regulations on vertical restraints of 22 December 1999 to the extent the 30% market thresholds is considered as being met. There will be a significant level of uncertainty, which will depend very much on the definition of the relevant product market and whether the geographical market is deemed to be worldwide, national or otherwise. This will in particular depend upon whether platforms submitted to the Commission will or will not be considered as a separate market from other business-to-business traditional systems of distribution.

For so long as they are multiple platforms either developed by manufacturers or suppliers this may not be so much of an issue. However, it is likely that market forces will not allow more than a few players in each sector of activity and that B2B platforms will be viewed at some juncture as markets in their own rights hence potentially raising the thresholds and potentially require notification. In the meantime, and unless platforms are opened to all third parties without restrictions as a "public marketplace", uncertainty will remain. The risk assessment to be made before determining the need to notify or not in order to avoid the risk of challenge of the validity of the platform, will depend on the level of restrictions imposed on participants.

In B2B, free access is likely to be an essential criterion

B, free access is likely to be an essential criterion, unless objective criteria such as entry costs justify otherwise. A standard, which would render a platform inaccessible, is likely to be challenged as well as refusal of access in the absence of any viable alternative. Exchange of information is likely to be another area of concerns to the extent that such information might lead to anti-competitive behaviour to the sole benefits of the participants and become a powerful purchase vehicle.

nalysis under Article 81, and the same reasoning equally applies to the setting up of portals, medium size agreements between intermediaries or start ups or the creation of e-distribution networks, creates a great level of uncertainty. Short of a notification, companies will be required to assess the application of the Block exemptions regulation on a case-by-case basis with little visibility in a fast evolving and dynamic environment. As explained above the relevant market assessment will be difficult. There are further risks attached to the possible future challenge by the Commission or national courts.

This risk will be amplified after the contemplated reform of competition law where the intervention of national courts and national authorities will become central to the process. Companies will need to rely heavily on existing or new guidelines which no doubt will be issued as matters clarify and, to the extent available, on previous decisions including concentrations decisions.

Major difference between merger control and agreement notification:

Ex ante notification Ex post challenge

One of the major and most significant difference between a concentration or an agreement falling under Article 81 and Regulation 17 is that the former, be it at Community level or national level depending on the size of the transaction, requires a formal notification ex-ante, where the challenge of the latter will often be ex-post, to the extent challenged, unless it has been notified and exempted.

Another interesting difference will be that a concentration will be approved once and for all where a clearance under Article 81(3) will be subject to review after a period of time.

There is therefore a risk, well identified by third parties consulted for the purpose of this report, that the Commission might unexpectedly request changes or impose conditions many months or years after the agreement has been implemented without necessarily accounting for the competitive environment at the time of implementation of the agreement. Not to mention the risk of the agreement being found null and void or possible fines.

The analysis of e-commerce transactions and the potential impact of competition rules is probably less of an issue for the time being in the sense that e-commerce is likely to remain considered as an additional distribution channel in addition to existing channels.

Companies involved in exclusive or selective distribution will need to determine whether they fall within the new general framework of Regulation 2790/1999 and the guidelines on vertical restraints and equally whether there is a need to notify the amendments of their existing distribution arrangements to encompass the addition of e-commerce.

There has been hardly any e-commerce agreements notified and exempted under Article 81 (3) with the exception of the amendment to the Yves Saint Laurent selective distribution agreement[277] and the proceedings opened by the Commission against the distribution practices of B&W Loudspeakers.[278]

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[277] IP/01/713, 17.05.2001.

[278] IP/00/1418, 03.12.2000.

The Commission warned B&W that its distribution system contains restrictions on retail prices and on cross supplies to and between authorised distributors and a prohibition on distant sales including through the Internet.

Yves Saint Laurent Perfumes (YSLP) was authorized, on the 17th May 2001, to approve selective retailers to sell via Internet as well after submission of an amendment of its selective distribution system approved in 1997 when another exemption expired, recognizing the importance of Internet for the competitiveness of the European economy.

In large merger cases involving old economy brick and mortar players such as retailers it is likely that e-commerce will be treated as an additional distribution channel alongside with the current distinction made between hypermarkets, supermarkets, "superettes", hard discounts stores.[279]

Automobile e-commerce requires a specific analysis given the current automobile distribution system still subject to the specific block exemptions. For the time being and unless and until new regulation is implemented it is unlikely that automobile manufacturers will envisage direct online sales.[280]

Finally, there may be instances where a project might be the result of a series of distinct yet inter-related agreements between various parties to achieve a common goal around the development and sale of an entirely new or enhanced product which may ultimately be challenged if determined to be a distinct market from any previous product (for instance an advanced telephony product encompassing a dedicated portal, access to Internet, voice telephony, access to music and preloading of films, etc…). Each set of agreement taken separately in their own markets may well individually qualify under the block exemptions regulation whilst clearly the ultimate product could be dominant in its own market or held a high market share. The question arises as to whether the "bundle" of agreements should be notified as one single agreement.

The concept of " agreements" under Article 81 (1) is an autonomous concept, which does not fully correspond to the concept of agreement in different national systems. The minimum requirement is an expression of joint intention of conduct on the market in a specific way, the object or effect of the conduct being the prevention, restriction or distortion of competition (which, as negative as it may sound, does not preclude the application of Article 81(3)).

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279 Carrefour/Promodès, COMP/M.1684.

280 See Title I. Chapter II. Section II.

In order to find Article 81 applicable, the Court of Justice requires evidence of co-ordination or co-operation between firms that is likely to influence their conduct so as to restrict or distort competition. Likewise, the Commission tends in complex cases to be content with finding a combination of agreements and concerted practices that have led to "*institutionalised and systematic collusion*" and does not attempt to distinguish between them.

The key distinction is therefore not between the various forms of possible collusion, be it agreement, decision or concerted practice, but rather between collusion and independent, "mere parallel behaviour with no element of concertation".

Would the various agreements be viewed as stand alone agreements on a one to one basis supporting the contemplated project or do they together constitute one "agreement" for the development and sale of a product, which will ultimately have a high market share? Should it be notified?

Non-compete provisions, which would appear systematically in one form or another in all the agreements and the exchange of information provisions are by way of illustration elements that could be viewed as a presumption of some concerted action in order to gain a competitive edge.

Section II.

Adequacy of current competition assessment to limit anti-competitive effects of vertical integration in the New Economy

1. Specific issues raised by electronic networks (Towards a more dynamic approach)

1.1 Definition of the relevant market: the adequacy of the traditional criteria

Issues raised by electronic networks

Definition of the relevant market is the primary important step in any competition analysis. The traditional criteria found in the Commission notice on the definition of the relevant market defines a relevant product market as a product market which *"comprises all those products and/or services which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use."* [281]

The task of defining the market on which a company is operating is one of the most important issues in competition law as it permits to assess its market power and to identify who are the competitors capable of constraining it.

Definition of the relevant market

To offer more transparency on its competition policy, the Commission adopted a notice on the relevant market[282], which is intended to set out the economic principles on which the Commission bases its approach.

Adequacy of the price-based substitutability test

This approach shows that the most important traditional test is that of demand substitutability, which in principle, can be assessed by referring to the product functional characteristics, its intended use, its performances, its presentation aspects and so on. However, in the majority of cases, price tests measuring demand responsiveness to a price increase, such as demand elasticity or cross-price elasticity, represent the best indicator for testing demand substitutability, since prices reflect all the market information pertaining to the product characteristics in a single variable.

A question, which arises when dealing with the definition of markets in the New Economy, is whether the price remains the most reliable criterion or whether other elements (functional characteristics, intended use, etc…) would appear to be more adequate.

Taking into

The Internet infrastructure is made of a multitude of operators (IBPs,

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[281] Commission Notice on the definition of the relevant market (OJ C 372 on 9/12/1997), § 7.

[282] Commission Notice on the definition of the relevant market. See previous footnote.

account functional characteristics and intended use of the product

ISPs, resellers, local loop operators), which enable end-users to have access to on-line services and products. All these operators are closely linked to one another in order to provide a reliable and quality access over all Internet: the ISPs need the backbones to offer access to the Internet at large and they need the local loop to reach the end-users.

When there is a vertical integration between two of these operators, there would be an incentive for the merged entity to discriminate in favour of its own services; for example, by raising rival costs for the access to its local loop (if one of the parties to the merger is a telecom operator) or to its backbone network (if one of the parties is an IBP).

Therefore, to assess the potential anti-competitive effects, the identification of separate markets in the Internet infrastructure is crucial.

End use test enshrined in Commission Guidelines

To start the exercise of defining the relevant product or service market, the Commission's draft guidelines on market analysis in the electronic communications networks and services proposes to group together products or services that are used by consumers for the same purpose (end use).[283] For instance, end-users can use different services to access the Internet, such as cable and satellite connections. In this case, both services should be regarded as included in the same product market.

Application of the hypothetical monopolist test to demand substitutability

This approach may, however, not be sufficient according to the Commission notice since, for a given product or service, differences in prices and offerings may imply different groups of consumers and, consequently, separate markets. It is also necessary to analyse demand substitutability by applying the "hypothetical monopolist test". In order to do so, in traditional markets, the National and European Authorities make use of any previous evidence of consumer's behaviour. But what is adequate in the traditional market may not be relevant in the Internet infrastructure. The electronic communications sector is newer than the telecommunications'; it has its own specificities, facilities and operators, and it is not mature (new technologies are currently being developed which should be able to replace the local loop in the near future). It may not be possible, therefore, due to a lack of available information, neither to examine historical price fluctuations in potentially competing products nor records of price movements. Analogies can be drawn from the telecommunications sector however.

283 Commission working document on draft guidelines on market analysis and the calculation of significant market power under Article 14 of the proposed framework Directive on a common regulatory framework for electronic communications networks and services. See § 35 and 36.

In this context and by way of illustration, it is interesting to look at the markets identified thus far by the Commission and the methodology used by the Commission in recent decisions relating to the service for the provision of connectivity and to the local loop.

Illustrations of market definition:

The Internet Network

The service for provision of connectivity: the Internet network. As different types of operators are involved in the service for the provision of connectivity to the Internet (IBP, ISP, resellers), there is a question as to whether they are substitutable to one another or whether they constitute distinct markets.

From an Internet user point of view, the main concern is to have access over all Internet at appropriate standards of quality, speed and reliability. Therefore, the connectivity service has to be obtained from operators who are capable of providing such a service, namely the IBPs, which provide "top-level connectivity".

In the WorldCom/MCI decision, the Commission took the view that *"the providers of such Internet access* [namely the top-level connectivity access] *services could be vertically integrated to a greater or lesser extent, and might be top-level networks in their own right, secondary peering ISPs or resellers"* and asked the following question: "*The issue for the purposes of market definition is whether ISPs all compete against one another to provide the same connectivity services, or whether there are any distinct and narrower markets within the sector."*

The WorldCom / MCI Decision

In its analysis of the WorldCom/MCI merger, the Commission identified the market for the provision of “top-level or universal Internet connectivity” as a separate market from the connectivity provided by ISPs and resellers.

Indeed, it considered that neither the secondary peering ISPs nor the resellers were capable of significantly constraining the behavior of the top-level networks and preventing them from acting independently.

First, the Commission considered that the connectivity service offered by each operator is unique. It, indeed considered that "each one offers a blend of, on the one hand, direct access to their own directly connected customers and customers of subordinate networks, and on the other, interconnection with other ISPs' networks, their customers and subordinate networks".

Furthermore, it acknowledged: "Hence the content and price of the product on offer from any given ISP will depend on factors such as the size of the ISP's network, and the precise nature of the relationships it has with other networks. The offerings might also be differentiated to some extent in terms of quality, as a network which routes messages in a way which requires many hops will not be able to offer the same standards as a network able to deliver messages with very few hops[284]".

The Commission considered that the only organizations capable of delivering complete Internet connectivity on their own account are the top-level networks; it indeed considered that *"secondary peering ISPs may be able to deliver some of their own peering-based connectivity (or "second-tier" connectivity), but have to supplement it through bought transit. Resellers can only supply resold connectivity, although depending on who it is bought from, it might be a combination of first and second tier connectivity. The products offered by the top-level networks are differentiated in that the connectivity is supplied entirely by peering agreements between those top-level networks or internally".*

Secondly, in order to assess the independence of each type of provider (top-level providers, secondary peering providers and resellers) and to distinguish potential separate markets, the Commission analyzed the effects onto the secondary peering ISPs and the resellers of an increase of 5 to 10% in the price of the top-level Internet connectivity (The so-called "hypothetical monopolist test").

i) With respect to the resellers, such an increase in the price of the Internet connectivity will inevitably ultimately have to be borne, end, by the consumer. A pure reseller, in the sense that it does not provide its own connectivity but only resells it, cannot provide a competitive constraint on the prices charged by the top-level networks.

ii) With the respect to the secondary peering ISPs, as they own a collection of peering agreement, they can provide access to some sites without having to transit the networks of the top-level ISPs. These secondary peering ISPs may offer some limited substitutability in the provision of access, but there will be gaps in their coverage. In WorldCom/MCI the Commission stated that *"In no case can the second tier connectivity offered by a secondary peering ISP provide a service which is a sufficient substitute for the first tier connectivity provided by the top-level network to be considered as part of the same market".*[285]

Moreover, the Commission considered that *"secondary peering ISPs who wanted to offer complete connectivity could not avoid continuing to buy some transit from the top-level networks, and their cost base is therefore captive to the extent that they continue to have to do so. There is no evidence that customers would accept a limited-access*

[284] WorldCom/MCI decision, § 64.

[285] WorldCom/MCI decision, § 68.

service as a substitute for a full service, and a price increase of say 5 to 10 % is unlikely to be sufficient to encourage switching".[286]

"Applying the hypothetical monopolist test, if the top-level networks were to act as one unit, then there is no one capable of providing an adequate substitute service in response to price increases. If all top level ISPs were to increase their transit interconnection charges by say 5 %, the ISPs outside this group could still provide a competitive constraint to the extent that they were able to use their peering agreements with some of the top-level networks to avoid the impact of the increase in transit charges. However, if faced with such a challenge to their price increase strategy, the top-level networks could react by charging for any interconnection, whether described as peering or transit. If this were to happen the unequal bargaining power of the secondary peering ISPs would not permit them to offer an effective competitive response".[287]

The approach taken by the Commission in WorldCom/MCI did not fundamentally differ from the approach used in defining traditional markets.

1.2 Relevance of the substitutability test

Relevance of the substitutability test

In accordance with the notice on the definition of the relevant market for the purposes of Community Competition Law, '*the assessment of demand substitution entails a determination of the range of products which are viewed as substitutes by the consumer. […] Supply-side substitutability may also be taken into account when defining markets in those situations in which its effects are equivalent to those of demand substitution in terms of effectiveness and immediacy."* [288]

Price not necessarily a sufficient indicator

However, the examination of the physical characteristics may have a greater importance as the electronic communications market is not mature and as, unlike in most traditional markets, data on historical price fluctuations are generally not available. The price tests may not be as a decisive indication as it is in other sectors. The Commission appears indeed more cautious, in using price tests. As mentioned in the WorldCom/MCI decision, the Commission indicated that *"a price increase of say 5 to 10 % is* ***unlikely*** *to be sufficient to encourage switching".*[289]

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286 WorldCom/MCI decision, § 69.

287 WorldCom/MCI decision, § 69.

288 Commission Notice on the definition of the relevant market (OJ C 372 on 9/12/1997), § 15.

289 WorldCom/MCI decision, § 69.

These differences in the determination of the relevant markets in the Internet infrastructure may progressively disappear when the sector becomes more mature. In the future, therefore, the approach in the electronic communications sector may be similar to the approach in the telecommunications.

Examination of physical characteristics is essential

The local loop infrastructure allows end-users to access the Internet since it is the first physical link that exists between him and the provider. However, this infrastructure is not specific to the electronic communications sector but directly refers to the telecommunications'. The main concern in this paragraph is to wonder whether the local loop is substitutable in providing Internet access.

1.2.1 The Commission has taken the view that the provision of local loop infrastructure is a separate market within the telecommunication sector. It requires specific facilities, which make it a distinct market from the provision of long distance and international infrastructure. In the Telia/.Telenor decision, the Commission considered that *" before he or she can access any higher level telephone services, a subscriber has to be physically connected to the PSTN, which is usually done by allocating him or her a twisted copper pair to his nearest local exchange. There is accordingly a demand on the part of subscribers and telecom entrants for connection to the local loop".*[290]

Indeed, to have access to telephone services, a subscriber must be physically connected to the Public Switched Telephone Network, which is done by allocating him a twisted copper pair to his nearest local exchange (the so-called local loop).

The long distance and international infrastructure, on the other hand, permits to connect local exchanges together within a country and to bring traffic to and take it from the international gateways. This infrastructure requires a physical network of cables and a means of switching between them.

Each service, the provision of local loop infrastructure on one hand and the provision of long distance and international infrastructure on the other, have their specificities in terms of functionality and facilities. They constitute two separate markets clearly distinguishable, as they are not used for the same purpose.

[290] See the Commission decision "Telia/Telenor", § 76.

1.2.2 The Commission further considers that the local loop is not substitutable in the provision of access to the Internet. To access the Internet, the local loop is, for the time being, still the most developed and reliable device offered to end-users. It is not the only technical infrastructure available. There already exist new alternative devices such as cable TV networks, fibre optic networks, or emerging technologies such as wireless loops and electricity networks (See Annex VIII, for the presentation of these devices).

Local loop is not substitutable in the provision of access to the Internet

However, from both a technical and economical point of view, the Commission has considered, in its notice on the access to the local loop[291], that these alternative devices cannot be considered as equivalent.
As it was explained in the Commission's notice, Cable TV networks have been designed for one-way TV, therefore, they need costly upgrades for the provision of two-way telecom services. Moreover, this infrastructure requires customers to share the capacity of a cable channel, whereas the copper pair upgraded with DSL technologies is dedicated to every single end-user and therefore offer better capacity for high-speed data. Finally, cable networks do not have the same nation-wide coverage as the incumbents. As to fibre optic networks, the Commission considered that they offer only limited competition on upstream transmission links and in special niches like networks connecting office buildings. They cannot, therefore, be regarded as equivalent to the local access networks.

Main issue: potential replacement of existing technology and products

Even though wireless loops appear to be the most suitable alternative in the future in order to address the specific needs of business and individuals end-users, the view was that they would remain uneconomic for serving the large majority of the residential clientele.

Similarly, electricity networks were apparently not yet a viable alternative from both a technical and economical point of view. In a fast technologically moving environment, these conclusions, reached over a year ago, may well need to be reconsidered.

Traditional substitutability test may not be sufficient

New technologies such as high speed Internet optical transmission system and electricity networks, when available, will replace previous technologies and could potentially go as far as ejecting from the market place a leading operator in a then available technology (high speed Internet optical transmission system) by a new and more performing infrastructure.

Market analysis by the Commission primarily concerned with making the

The issue is not just one of whether a technology is or will be substitutable in terms of characteristics and price, but also **whether it**

291 Commission notice: "Unbundled Access to the local loop: Enabling the competitive provision of a full range of electronic communication services including broadband multimedia and high-speed internet", 26.04.2000 COM(2000) 237 final.

differentiation in the functionality of New Technologies

actually or could potentially replaces an existing technology and product. It follows that the traditional substitutability test may not be sufficient in these circumstances. Typically, in the electronic networks, we are likely to witness the creation of entirely new products rather than the improvement of existing substitutable products. This confirms the need to apply new sets of criteria for the analysis of competition implications in that the leader in one given technology may well be the looser of tomorrow in an environment, which compels continued innovation. The relevance of market share in such an environment may be questionable as it may well be temporary.

1.2.3 With respect to broad-band access / narrow-band access; dial-up access / dedicated access markets. First, the Commission has considered the broad-band Internet access as separate from the narrow-band access as it provides high speed Internet access and delivers greater audio and visual functionality. According to the Commission inquiry in the AOL/Time Warner case, streaming video and audio, video e-mail, interactive advertising and video conferencing cannot effectively be delivered over traditional narrow-band lines, making narrow-band access different from broad-band access.

Secondly, in the supply of Internet access services, the Commission identified, in Telia/Telenor, a demand for the supply of Internet access services and distinguished between dial-up and dedicated access. It indicated that *"obtaining access to the Internet means getting access to an ISP. This can be done by "dedicated access", that is to say, a dedicated fixed line cable link between the final user and his ISP, or by "dial up" access over a normal PSTN line"*.[292] In AOL/Time Warner, the Commission took the view that from the demand point of view these types of access are two separate product markets: *"dial up access is targeted at residential and business (i.e. small and medium enterprises) customers, while dedicated access is requested mainly by large corporate customers"*.[293] In BT /ESAT, it emerged in the course of the market investigation that within dial-up access it could be possible to distinguish between residential and business (large companies) dial-up access, the latter being provided on the basis of more sophisticated dial-up mechanisms. However, this question was left opened by the Commission.[294]

Even if both dial-up and dedicated access can be provided through narrow-band and broad-band, in practice, dial-up is associated with narrow-band and dedicated with broad-band.

292 See Telia/Telenor, § 60.

293 See AOL/Time Warner, § 33.

294 See BT/ESAT, case COMP/M. 1838.

It is interesting to note that the analysis of the markets by the Commission, in decisions involving undertakings of New Economy, is primarily concerned with making differentiations in the functionality of new technologies (such as, for example, the difference in the electronic network between dedicated access and dial-up access; and the difference regarding new products between streaming and downloading music). However, the WorldCom/MCI decision in which the Commission has applied the traditional substitutability test by reference to the monopolist test indicates that these traditional criteria may remain of a particular relevance. **At this stage, however, it is too early to assess whether the Commission will revert to its traditional market criteria in order to determine if they are adequate benchmarks for any new markets emerging in the New Economy.**

Too early to assess whether traditional criteria are adequate benchmarks

The electronic communication sector being dynamic and shaped by constant technological changes and innovation, the Internet infrastructure is not yet mature. Therefore, the conclusion would be that, when the Internet infrastructure become more "stable", the traditional criteria would certainly remain adequate, as they were to define the different markets in the telecommunication sector. It is not possible to say, however, whether the price tests criteria will be as decisive as it is today in traditional markets.

1.3 Calculation of market share

Calculation of Market Share

Certain specificities of the Internet raise problems concerning the calculation of market share on the relevant market. Indeed, basing this calculation on turnover does not seem appropriate in every case. In some cases, the Commission has already considered more appropriate to base the calculation on other measures, such as production capacity[295], fleet capacity[296], orders firmly booked[297] or advertising revenue of TV broadcasters.[298]

Insufficiency of turnover criteria

Similarly, in the Internet context, other criteria, such as the traffic on a website or on the network infrastructure, the quantity of registered users on a marketplace or a portal, may be more relevant than the turnover.

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[295] Cargill/Unilever, D.Comm.Dec 20, 1990, M.26; Agfa-Gevaert/Dupont, D.Comm.Feb. 11,1998, 1998 OJ L 211/22, point 59.

[296] Delta Airlines/Pan Am, D.Comm.Sept 13,1991, M.130; Air France/Sabena, D.Comm.Oct.5, 1992, M.157.

[297] Aérospatiale-Alenia/DeHavilland, Oct.2,1991 OJ L 334/42, points 21-25; Ericson/Kolbe, D.Comm. Jan. 22, 1992,point 23.

[298] Bertelsmann/News International/ Vox, D.Comm.Sept.6,1994, point 22; RTL/Veronica/Endemol, D.Comm, Sept.20,1995, points 30, 69.

This section will focus on the operators, which are specific to the Internet infrastructure, namely the IBPs and the ISPs. In measuring the market shares of IBPs or ISPs, some commentators, according to the Commission in MCI/WorldCom, thought that it is a combination of revenue and traffic flow, which might offer the best picture.

Relevance of use of a combination of revenue/traffic flow and other indices

In the Internet industry, there is no preferred unit of measurement but there is a consensus that a reasonable picture might be produced by using more than one index. Apart from revenue and traffic flow, possible measurement indices are:

- The number of subscribers,
- The number of addresses reachable,
- The size of installed capacity links,
- The actual bandwidth used for traffic exchange,
- The number of points of presence.

Taking into account only one unit may not reflect accurately the strength of a network.

As regards the number of subscribers for instance, the problem is to identify how many real users there are. For example, a network, with a large proportion of corporate subscribers might register a low number of individual subscribers, but each company customer might have their own private internal network with many connected users. The same problem arises when using the number of web sites, as some web sites are important and frequently visited whilst others are unknown to most subscribers. The Commission has indicated in WorldCom/MCI that *"different websites could have widely varying degrees of importance, which would not be reflected in a simple tally count. Accordingly, no attempt was made to use these data in order to draw conclusions."*[299]

Similarly, with the respect to points of presence, there is, in principle, a correlation between the network size and the number of points of presence because backbones would deploy a point of presence where they have a critical mass of customer to reach. However, this index is one of the less reliable, according to some commentators (see the Commission's decision on MCI/WorldCom), as the number of point of presence will rather depend on the architecture than on the network size. Moreover one network may have a wide number of points of presence with a large volume of low-usage subscribers, whilst another network may have a small number of points of presence with few high-usage subscribers. In WorldCom/MCI, the Commission indicated that *"although the number of point of presence may equate to the number of subscribers in a given region, the number of subscribers may not itself be an accurate indication of network size (for example, one network might have large volumes of low-usage subscribers and many points of*

[299] WorldCom/MCI, § 100.

presence, whilst another might have comparatively few high-usage subscribers and a small number of points of presence)".[300]

A cautious assessment is required, the market not being mature

Therefore, the market being not mature, the measurement of market shares must be assessed with caution by using several criteria. Traffic flow appears in practice to be the most relevant measurement. Nonetheless, as the Commission acknowledged *"the figures might be affected by sudden surges, such as short-term interest in a particular web site".* Besides, as little statistics are available on the overall traffic volume, it is the combination of these criteria that will best reflect the exact strength of the network.

1.4 Geographic market

Geographic market

In accordance with the Commission Notice on the definition of the relevant market *'The relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas."*[301]

One global top-level connectivity market

1.4.1 As regards the geographic extent of the top-level connectivity market, it is likely to be global due to the worldwide dimension of the backbone networks. The Commission considered in the WorldCom/MCI case that there is one global market. In this decision, the Commission indicated that *"the international nature of the Internet becomes more marked with larger ISPs, who often operate on a national or international level. Although the top-level networks, which have emerged so far, have their centres of operations in the United States of America, they are the only providers who can provide transit to all parts of the Internet. This can be contrasted with conventional voice telephony, where traditionally operators have tended to focus their activities in a particular territory, and to relay traffic, which has to pass across that territory. The terms on which any ISP anywhere in the world can operate depend upon the terms on which it can obtain transit directly or indirectly from these providers. They are in the event highly vertically integrated. For example, UUNet has retail level subsidiaries in many European countries".* It further explained that *" a rise in prices for access to the top-level networks would affect consumers everywhere in the world".*[302]

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300 WorldCom/MCI, § 101.

301 Commission Notice on the definition of the relevant market (OJ C 372 on 9/12/1997), § 8.

302 WorldCom/MCI, § 82.

1.4.2 Concerning secondary peering ISPs and resellers' services, the geographic scope may be narrower, either national or regional, due to the need for local loop services or the installation of a fixed line in order to connect physically the subscribers with their customers. In WorldCom/MCI, the Commission stated that *"the geographic extent of the different markets for Internet services depends on which level is being looked at. Physical connection from the final user to the ISP, whether by dial-up or dedicated access, can only be provided locally, by a supplier active at the local level, and in any event is not usually part of the ISP's service offering. Such a connection could be provided by a local telephone company, or indeed by any other supplier of such cabling facilities. The geographic markets at this level are thus regional or national, depending on the scope of the supplier's cable network".*[303]

A national or regional secondary peering ISP's market

However, some alternatives devices may replace this physical facility; consequently, the geographic scope may become wider than regional or national.

Provision of local loop long distance and international infra-structure:

A national or wider market

1.4.3 The provision of local loop infrastructure, as well as the provision of long distance and international infrastructure, has been considered by the Commission, in the Telia/Telenor merger, to be national in scope. However, in this case, the Commission took the view that *"if the local loop under the control of one operator were enlarged to cover an area that was wider than national, and if the network is reconfigured to reflect that fact that it is now all under the control of the same operator, then the geographic reach of the market could be wider than national."*[304]

Narrow band Broad band Access:

A national market

1.4.4 Dial-up (narrow-band) access, dedicated (broad-band) access markets should be based on the same criteria: the need for the installation of a physical connection. For dial-up and narrow-band access, this installation is generally the local loop service, which is national in scope. For the dedicated and broad-band access, the installation is either the telephone line (for the Digital Subscriber Line technology -DSL-) or the cable (for cable modem) and therefore the geographic scope is essentially national. In the UGC/Liberty Media merger, the Commission has found that *"existing access markets are essentially national in scope due to the necessity for local loop access and the availability of free-phone/local call rate numbers to the nearest point of presence (POP) and the existing regulatory framework".*[305]

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[303] WorldCom/MCI, § 80.

[304] Telia/Telenor, § 119.

[305] UGC/Liberty Media, case n° COMP/M.2222, 24.04.2001, § 12.

1.5 Barriers to entry / Foreclosure

Barriers to entry and foreclosure are of central concern

As developed earlier, the barriers to entry are the most important concerns when tackling the Internet infrastructure. With regard to the essential function of the local loop and of the backbones in the Internet infrastructure, it is crucial for Internet operators, especially ISPs, to receive access to these facilities on fair conditions.

If a telecom operator merges with an ISP or with an IBP, the ISP or the IBP concerned would be in a favouring position to benefit from preferential conditions of access to the local loop and, conversely, competitors would be in a disadvantageous situation.

A regulatory framework is under preparation in the electronic communica-tions sector

;ulatory framework exists in the telecommunications sector and a new one is under preparation in the electronic communications sector which both tend to prevent companies from imposing barriers to entry.

1.5.1 Is regulation an adequate response to foreclosure? In Europe monopolist operators have in most Members States, during a long time, controlled the telecommunications sector. Despite the liberalization of the sector, in practice, the incumbent market power remains today often unchallenged.

ECMR and article 82 are indispensable to prevent risks of foreclosure

This situation of dominance has a direct incidence in the electronic communications sector since the telecommunications operators usually own the local loop infrastructure and also develop their own activities in the New Economy. There is, therefore, the same risk in the Internet infrastructure that the telecommunications operators abuse of their dominant position, with the notable difference that the consequences may be much important in the Internet industry due to the phenomenon of "first mover advantage".

Even if in both sectors of telecommunications and electronic communications, a regulatory framework exists or is under preparation, the general competition rules, and more particularly, the Merger Control Regulation and Article 82 of the Treaty may remain indispensable to prevent all risks of foreclosure.

1.5.2 A regulatory framework may not be sufficient to prevent all risks of foreclosure

When the telecommunications sector was re-regulated, divestiture by the monopolist telecommunications organizations was not required to eliminate vertical links with downstream business activities. The incumbent operator, owner of the infrastructure can, therefore, at the same time provide telecommunications services.

A regulatory framework may not be sufficient

Instead, a regulatory framework was adopted to ensure that vertically integrated operators could not derive unfair competitive advantages over competitors and foreclose the market. This framework (known as "Open Network Provision", ONP rules) establishes the conditions under which the telecommunications operators must provide their infrastructure to their competitors.

It requires operators to offer access to their network infrastructure under transparent and non-discriminatory tariffs and pursuant to specified terms in relation to delivery period and quality of services.

In addition, in order to accelerate the Member States actions in overcoming the limited current competition in the local access network, the Commission has issued a Recommendation and a Communication concerning the full unbundling of the local loop.

An example: the telecommuni-cations sector

The Recommendation, dated on the 26th April 2000[306], required Member States, where full unbundled access was not yet available, to adopt appropriate legal and regulatory measures to mandate, by 31st December 2000, full unbundled access to the copper local loop of telecom operators under transparent, fair, and non-discriminatory conditions. This text also recommended national regulatory authorities to ensure that the telecom operator provides its competitors with the same facilities, under the same conditions and time scale, as those that it provides to itself.

In the Communication[307], the Commission sets the dominant operator's duties to grant access and the conditions of access and pricing. It considers that refusing to grant access to competitors is likely to imply various forms of abuses of dominant position under Article 82 of the Treaty. Other abuses may occur which would as well constitute infringements of Article 82 of the Treaty:

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[306] Commission Recommendation on Unbundled Access to the local loop: Enabling the competitive provision of a full range of electronic communications services including broadband multimedia and high speed Internet, 26/04/2000.

[307] Communication from the Commission: Unbundled Access to the Local Loop: Enabling the competitive provision of a full range of electronic communication services including broadband multimedia and high speed Internet, 26/04/2000.

- Delays in granting access,
- Delays in remedying technical problems related to the access,
- Discrimination,
- Price abuses.

Such regulatory framework reduces the risk of possible anti-competitive practices in the access to telecommunications facilities, but it certainly cannot eliminate this risk completely. The importance of this regime has, however, been outlined in BT/MCI[308] where, concerning the assessment of a transaction containing vertical aspects, the Commission stated that *"the existing regulation to which BT and/or MCI are subjected in their respective countries prevents such cross-subsidization and/or discrimination from taking place".*

Five new directives and several guidelines are under preparation in the electronic communi-cations sector

In the electronic communications sector, a new framework, which comprises five new Directives[309] (Framework, Access, Authorisations, Universal Service and Data Protection) is currently under preparation. This new policy framework, which delegates to National Regulatory Authorities (NRAs) the competition assessment, seeks to reinforce competition in all market segments. It is designed to cater for new, dynamic and largely unpredictable markets with many more players than today.

More particularly, the Directive on access and interconnection will tend to ensure that, during a period of converging technologies and services and strong market growth, the market for electronic communications services will continue to develop in a manner, which stimulates competition. However, like the ONP rules, this new framework will likely be insufficient to completely eliminate all possible negative consequences of vertical integration.

308 Commission decision of 27 July 1994 relating to a proceeding pursuant to Article 85 of the EC Treaty, O.J. L 223 27/08/94 p. 36, § 57.

309 The new regulatory framework is constituted of the following texts:

- A directive on a common regulatory framework for electronic communications networks and services, which sets out the horizontal provisions of the new electronic communications regulatory framework of the European Union.
- A directive on the authorisation of electronic communications networks and services which harmonises the rules for authorising provision of such services.
- A directive on access to, and interconnection of, electronic communications networks and associated facilities, which establishes a framework for access and interconnection agreements across the EU.
- A directive on universal service and users' rights relating to electronic communications networks and services, which sets out the rights that users have in respect of electronic communications services, in particular in respect of universal service.
- A directive on the processing of personal data and the protection of privacy in the electronic communications sector, which updates the current directive.

To complete this framework, draft guidelines on market analysis and the calculation of significant market power (SMP), are currently under review.[310] These guidelines will be applied by NRAs. It is worth mentioning that in their current form, the sets of criteria to be applied to define the relevant product / services as well as SMP follow strictly the traditional criteria developed and applied by the Commission in its decision making process and by the European Courts case law, with no real consideration for any new dynamic criteria.

As a result, the general competition rules, especially the Merger Control Regulation and Article 82 of the Treaty will remain the reference.

Characteristics of the Internet Industry: first mover advantage and strong network effects

1.5.3 General competition rules must continue to fully apply. One of the characteristics of the Internet industry, that makes it distinguishable of the telecommunication industry, is the first mover advantage phenomenon. The "Internet market" is a fast moving market characterized by strong network effects.

Accordingly in order to benefit, it is important in order to these network effects and consequently acquire a critical market power, to be among the first movers, which enter into this market. Therefore, it is clear that the telecommunications operators' position, as well as some IBPs', is very favourable and the risk that a merger involving these companies creates or strengthens a dominant position is important.

General Competition rules must continue to fully apply

s context, it is crucial, even more notably in the Internet industry than in other sectors, to have adequate tools that prevent these effects. The Merger Control regulation may fully continue to apply despite the existence of specific regulatory frameworks, as mere ex-post regulations would be insufficient. The Commission in 'Telia/Telenor" has underlined this need. The regulatory systems in Sweden and Norway, where Telia and Telenor are respectively active, are designed to control the behaviour of the incumbent telecommunications companies and to protect consumers. However, the Commission stated that *"even on the assumption that these regulatory systems are effective, they cannot be expected to prevent the creation and/or strengthening of a dominant position that the combined entity will enjoy as a result of the merger. Telecommunications regulation is a complex task, which requires careful consideration by the regulator and extensive consultation of the industry. Regulation cannot be expected to address the structural competition problems raised by the merger"*. The Commission considered that *"merger control and not ex-post regulation is the only adequate tool"* to prevent the creation and/or strengthening of a dominant position.[311]

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[310] Draft guidelines on market analysis and the calculation of significant market power. COM (2001)-175.

[311] Telia/Telenor, § 137.

In addition, it indicated that *"regulation in Norway and Sweden with regard to interconnection is ex-post and cannot thus be considered for the purposes of merger control as an effective constraint on the market behaviour of dominant companies".*[312]

If, nevertheless, a company enjoys dominance and abuse its dominant position Article 82 of the EC Treaty will provide the basic set of rule to control this abuse by referring to the duties imposed by the regulations. In conclusion, the general rules on competition and the regulations, both on telecommunications and electronic communications, are complementary in the view of preventing potential situations of abuses.

[312] Telia/Telenor, § 169.

2. The specific issues raised by e-commerce, portals and marketplace

2.1 Definition of the relevant market

Specific issues raised by e-commerce, portals and marketplace

The definition of the relevant market is the primary important step in any competition analysis. The traditional criteria found in the Commission notice on the definition of the relevant market defines a relevant product market as a product market which "*comprises all those products and/or services which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use*."[313]

Definition of the relevant market

E-commerce, probably does not raise new issues that cannot be dealt with under the existing framework or market definition. In some instances, e-commerce is simply an additional channel to sell similar products and will be part of the same market as the traditional sale channel, unless it can be characterised as sufficiently distinct in its characteristics and depending on the degree of competition between the two channels.

In other instances, e-commerce creates entirely new intermediaries, such as for instance portals, marketplaces or comparison-shopping search engines. Their unique character is obvious, since they do not have any true equivalent in the traditional market.

Using existing frameworks / considering new ones

Regarding the sale of products over the Internet, whether goods or services, it seems that the consumer attaches a certain value to the mere fact of purchasing it on the Internet. For most consumers, purchasing on the Internet saves time, for others, the Internet provides easier access to information, and therefore to products; it enables consumers to have wider choices; and allows consumers to compare prices, and then benefit from price differences between Member States.

The gain (or opportunity cost) resulting from these factors can then lead one to consider that the products purchased on the Internet may have different characteristics than equivalent products sold on the traditional market. Thus, it may be considered that the Internet adds a service to the purchase of a product. For instance, the consumer does not only buy a good, he also buys its delivery at his place at a fixed hour.

[313] Commission Notice on the definition of the relevant market (OJ C 372 on 9/12/1997), § 7.

The same reasoning could be applied to portals. A thematic portal, such as *Alafolie.com* (a portal related to weddings), can have an equivalent on the traditional market, in this case a magazine (*A La Folie* magazine) on the same subject. Nevertheless, the portal would enable its customers to have access more rapidly to a greater content, and maybe at a lower price (if any). The gain (opportunity cost) resulting from the use of a thematic portal could mean that the portal does not compete on the same market as its traditional equivalent.

Regarding a generalist portal such as *Yahoo!,* since there is no traditional equivalent, it would be logical to consider that there is a specific market.

As for marketplaces, they were until recently assessed along with (or like) EDI systems. The projected trend showed that while EDI systems represented more than 90% of B2B transactions in 1999, they will represent only 30% in 2003.[314] The development of Internet marketplaces may have contributed to this trend and may eventually lead to the disappearance of EDI systems. At that point, B2B marketplaces would constitute a new market on their own.

2.2 Relevance of the substitutability test

Relevance of the substitutability test

In accordance with the notice on the definition of the relevant market for the purposes of Community Competition Law, '*The assessment of demand substitution entails a determination of the range of products which are viewed as substitutes by the consumer. […] Supply-side substitutability may also be taken into account when defining markets in those situations in which its effects are equivalent to those of demand substitution in terms of effectiveness and immediacy."*[315]

As to e-commerce, including portals and marketplaces, the substitutability test will be no relevant although with some qualification to account for the specificities of Internet may add value to products. Substitutability will then differ between a traditional product and the same product Internet added value.

E-Commerce

With respect to goods and services with their equivalent on the traditional market a product sold on the traditional market will be substitutable with one simply sold over the Internet. In this case the Internet is merely a new sales channel. The only potential difference is that the Internet might increase the number of substitutable products, since, theoretically, products from all over the world may be offered to consumers.

314 BCG & Shop.org study – The state of online retailing.

315 Commission Notice on the definition of the relevant market (OJ C 372 on 9/12/1997), § 15.

As to goods and services with no equivalent on the traditional market, products with Internet added value will not be substitutable with those sold on the traditional market. However they will be substitutable with the same products sold over the Internet (with the same added value).

As for products and services specific to the Internet, the traditional assessment of substitutability on the market will apply. It might nevertheless be difficult to assess, given the wide variety of services offered over the Internet.

Substitutability between portals must be carefully assessed. On the one hand, there are some thematic portals, and on the other hand generalist portals. The substitutability within a single thematic category (e.g., wedding-related portals) raises no particular issues. The same conclusion can be given for generalist portals (such as *Yahoo!*).

Portals

A problem arises when it comes to examining the substitutability between a thematic and a generalist portal. The latter theoretically offers the same services as the former. However, it may be considered that a thematic portal offers a wider variety of services and references than a generalist portal. The answer to the question of substitutability will therefore depend on a careful analysis of the particular portals involved.

The same reasoning can be applied to B2B marketplaces. Generalist marketplaces will be substitutable with one another, as long as their structures (on the buyer and seller side) are the same. A marketplace involving all the major suppliers of a sector may not be substitutable with one containing only the smallest.

B2B Marketplaces

Thematic marketplaces could also be deemed substitutable with one another under the same provision as for generalist marketplaces. Generalist and thematic marketplaces might be substitutable, in so far as the offers or demands are similar. A case-by-case analysis will then be necessary.

2.3 Relevance of the price elasticity rule

Relevance of the price elasticity rule

In accordance with the Commission Notice on the definition of the relevant market *'Own price elasticity of demand for product X is a measure of the responsiveness of demand for X to percentage change in its own price. Cross-price elasticity between products X and Y is the responsiveness of demand for product X to percentage change in the price of product Y."*[316]

[316] Commission Notice on the definition of the relevant market (OJ C 372 on 9/12/1997).

The price-elasticity rule must be applied when talking about the sales of products, portals and market places or the structure of the Internet acquire with specific qualifications to account for the very nature of Internet sales.

As to goods and services having their equivalent on the traditional market, the degree of price dispersion on the Internet is greater than on the traditional market. This price dispersion can be explained by a multiplicity of concurrent factors.

It is generally agreed that the European market is not mature (for the assessment of maturity, *see infra, paragraph 2.6.2*, both on the consumers' side and on the undertakings' side). It can be deduced from this lack of maturity that selling and purchasing behaviours are not well established.

Goods and services having their equivalent on the traditional market

On the consumer's side, it means that the consumer might buy a product on the Internet regardless of its price on other websites or on the traditional market. On the sellers' side, one should bear in mind that many firms offer the same goods or services throughout the world. One would traditionally consider that for the same product offered with the same conditions, only a few e-enterprises can survive on a given market.

Indeed, due to network effects, the first mover advantage and to some extent the worldwide dimension of the market, the acquisition cost of a customer makes it difficult for a new entrant to compete with older ones. Therefore, the price will be driven up or down depending on the ability of a new firm to compete with older entrants.

It can be considered that the price will be driven up because the Internet consumer is ready to pay a high price for the use of the Internet; therefore, sellers will not be tied only by competitiveness to determine their prices. The price adjustment is done from the top, maximising profits for older entrants, whereas new entrants might even be forced to operate below profit.

Nevertheless, as the market becomes more mature, it can reasonably be foreseen that prices between products in traditional and Internet markets will become closer and price dispersion will therefore be less.

As to goods and services with Internet added value, this category refers to traditional goods or services sold with an Internet added value, and goods that simply do not exist on the traditional market.

Goods and services with Internet added value

(i) The reasoning held for traditional goods sold on the Internet can be held for goods with Internet added value. It results from the *hold up effect* that consumers may continue purchasing on a website regardless of a price increase, as long as they believe that the service they receive is worth it. In fact, consumers are ready to overpay for a good on the Internet, since it does not have an exact equivalent on the traditional market. This behaviour should nonetheless soon disappear, as purchasing behaviours become more mature.

On the sellers' side, even though the prices are high, they are not too dispersed. The sellers, competing with each other, will evaluate the same amount of service offered to the customers in the same measure.

For instance, the website *Anyway.com* will sell a trip to the Bahamas also sold by *Degriftour.fr* at roughly the same price; both sites are discounters. Those two websites do not offer the same product as *Reductour.fr* or *Havasvoyages.fr,* which will also have the same prices; both are regular travel agencies.

Here again, the hold up effect plays an important role, since customers get accustomed to shopping on a limited number of websites. Nevertheless, shop bots such as *Kelkoo.fr* might eventually change this habit. The price elasticity between goods or services with Internet added value is then low, and the criterion still seems to be relevant.

(ii) As for products that can only be found on the Internet, such as electronic mailboxes, personalized news, access to on-line encyclopedias, etc., price dispersion is not a real problem. Even though they do not have equivalents on the traditional market, they have competitors on the Internet. Therefore, a classical assessment of the price-elasticity rule should lead to relevant results.

The assessment of price elasticity for products in general is therefore still relevant.

Specific issues raised by portals and market places

Specific issues raised by portals and marketplaces. A portal generally is a combination of a content website and a merchant website. For example, a portal such as *Alafolie.com* will reproduce roughly the content of the *A La Folie* magazine (content), but also allow users to buy products online (merchant website). Other portals, such as *Yahoo!* will have content but no direct sales activity. Instead, *Yahoo!* provides would-be customers with links to other merchant websites.

The merchant part of a portal has to be assessed like merchant websites (the distinction being made between traditional sale of products and sale of products with Internet added value). As for the content part of a portal, the price elasticity rule does not seem to play any role, since no product is sold. It therefore seems that price elasticity has no relevance in the assessment of the market definition for a portal.

Nevertheless, that analysis appears to be valid only on the consumer's side. As there are enterprises that deal with a portal, either through advertisement, or either needing to be referenced to, there might be price differences between enterprises and portals.

Due to the network effect, the cost for an enterprise willing to deal with a portal such as *Yahoo!* may be higher than the same deal with *Rezo.net*. Moreover, regardless of *Yahoo!*'s price policy, websites still have to be among its references. Price-elasticity might therefore not play a significant role, since a website will have to be referenced to by the portal or advertise on it. The problem of price-elasticity for portals is closely linked to the substitutability of portals.

As marketplaces do not have a direct selling activity, the same conclusion can be reached regarding price elasticity for consumers as for portals.

Likewise portals, B2B marketplaces deal with enterprises willing to offer their products (or buy products) through them. Therefore, price elasticity might play a role in market assessment. Marketplaces set up by buyers do not raise any particular issue, the price elasticity rule being inapplicable to them.

As for B2B marketplaces set up by sellers, the question of price elasticity will be closely linked to the substitutability between marketplaces. Nevertheless, a price increase made by the members of such a marketplace could indicate price coordination, leading to the application of Article 81.

2.4 Calculation of market share

Certain specificities of the Internet raise problems concerning the calculation of market share on the relevant market. Indeed, basing this calculation on turnover does not seem appropriate for every situation in the Internet context.

Calculation of market share

Other criteria, such as the traffic on a website or on the network infrastructure, the quantity of registered users on a marketplace or a portal, may apply to specific situations.

Calculation of the market share of a merchant website. Concerning traditional sales of products, the turnover criterion seems to be the most relevant for situations where the traditional market competes with the Internet market. The traditional market and the Internet market will be affected in the event of a sale of goods or services to which the Internet does not add any value. The criterion of turnover is the only one that could apply to such a situation, since sales of products cannot really be assessed differently.

Merchant websites

As to the sale of products with Internet added value the reasoning being the same, turnover seems to be the only relevant criterion.

As content websites and portals are not engaged in any sales activity, the criterion of the turnover can lead to false or irrelevant results. Indeed, these websites can have a vast audience, but make no direct profit from it. Portals make profits from advertisement, by offering research tools or by redirecting users to other websites.

Their fees will be based on the number of people who 'clicked' on the banners or on the links. Consequently, their profits are based on the traffic they generate. The turnover criterion thus seems irrelevant. On the contrary, the market share in traffic would much more reflect the situation of the portal on the market.

Websites and portals

In the *Drutt* [317] case, the Commission assessed the market share of *Halebop.se* as the percentage of registered users as compared to the total number of people connected to the Internet in Sweden. Therefore, *Halebop.se*, with 75,000 registered users out of 4 million people connected in Sweden, has a 2% market share. This reasoning was held in the *Vizzavi* [318] case, leading to comparable results.

B2B Marketplaces

B2B Marketplaces do not themselves engage in any sales activity. The role of a marketplace is to act as an intermediary between buyers and sellers. We can distinguish between two types of marketplaces:

Private Market places

The first are called "private marketplaces": in this situation, the marketplace is set up by enterprises willing to unify their purchases and the marketplace is mandated by the buyers to buy goods for them. The second are called "public marketplaces": in this instance, the marketplace is set up by a third party to the benefit of buyers and sellers and the marketplace acts as an intermediary, with buyers and sellers dealing directly with each other.

[317] Telia/Oracle/Drutt, 11/09/00 Case n° COMP/M.1982.

[318] Vivendi/Canal+/Seagram, 13/10/00 Case n° COMP/M.2050.

The second type does not raise any particular competition issue, as the marketplace's role is limited to intermediary and its market share is therefore irrelevant. On the contrary, the first situation raises the problem of "buyer power".

In the Carrefour/Promodès merger [319], the Commission examined this issue with regard to two mechanisms:

Spiral effect

The "spiral effect": given that discounts are generally related to volumes purchased, the greater the size of an enterprise, the greater the discount will be. This discount will enable the enterprise to offer lower prices, ultimately increasing its market share in volume. The enterprise will then increase the volumes, getting a bigger discount, and so on. It nevertheless seems that the spiral effect only starts when a minimum market share is already held.

Threat point

The "threat point" is defined as the maximum share of revenues that a supplier can afford to lose without a very serious risk of being driven to bankruptcy. The threshold was set at approximately 22%.[320] It should still be noted that it is not in the buyer's interest to drive a supplier to bankruptcy. The practical threat point should then be when a supplier cannot grant any more discount.[321]

The situation of a marketplace set up by buyers could lead to such an effect. In fact, the "spiral effect" resembles closely the network effect, and the "threat point" to a point of foreclosure on a market. **Considering that a private marketplace could be assessed like a purchasing group, its market share could be calculated accordingly.** Even though the criterion of turnover is applicable to the sale of products on the Internet by merchant websites or private marketplaces, it does not give positive results for the other situations (content websites, portals and public marketplaces). It seems that an assessment of the market share via the angle of the audience (traffic or number of users) of those websites would be more relevant.

319 Carrefour/Promodès, 25/1/00 Case n° COMP/M.1684.

320 This 22% threshold was also used by the French Competition Council to assess abuse of economic dependence.

321 Lexecon Competition memo on *Buyer Power*, 31st January 2001.

2.5 Geographic market

Geographic market

"The relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas."[322]

Sale of goods or services on the Internet. When it comes to assessing the market geography of the Internet, the inevitable answer is that the market *is global*. If this is true for that part of the Internet that is purely virtual, it must not be forgotten, however, that logistics remains the main concern in the e-economy.

(i) The category Physical products sold over the Internet includes traditional products both with and without Internet added value. Even though both the offer and the demand for products and services have become global, the demand can only be satisfied if the seller is able to deliver the goods at a reasonable price.

Sale of goods and services do not necessarily constitute a global market

Consequently, it might be considered that on the demand side, the market is a global market, but on the offer side, it depends on the logistics set up by the seller. For example, a French consumer may not care whether the products he buys are from China or France, as long as he can get them at a comparable price in the same amount of time.

However, some websites, such as *eBay.com* leave it to the consumer to arrange for the delivery of the products. For websites that do not undertake delivery themselves, the geographical market should be considered as worldwide, since a consumer from any part of the world faces the same price conditions.

Another factor to take into consideration is the language barrier. Even if a product sold on a Finnish website can be delivered throughout the world at a reasonable price (and assuming that the product is substitutable with one sold on an English-language website), it is highly unlikely that non-Finnish speaking people will ever purchase anything from this site. The market may then be significantly reduced to a language-based market.

(ii) As to virtual products, they include purely virtual goods or services sold over the Internet. The logistics problem seems to be irrelevant regarding these kinds of goods or services. However, the language problem may still arise, for the same reasons as for the sale of 'real' products. Therefore, the market for virtual products might also be

322 Commission Notice on the definition of the relevant market (OJ C 372 on 9/12/1997).

language-based.

Portals and marketplaces

Specific issues raised by portals and marketplaces. There are no specific issues raised by portals and marketplaces other than logistics and language; therefore we can reach the same conclusions as above.

2.6 Barriers to entry / Foreclosure

Barriers to entry / Foreclosure

The assessment of barriers to entry in the market of sales of products on the Internet varies if one considers a content website, a merchant website, a portal or marketplace, and the Internet's structure. The cost of entry, the structure and maturity of the market, regulations and technical standards as well as upstream and downstream entry barriers are all relevant factors to be taken in consideration.

Several relevant factors to be taken in consideration

2.6.1 The costs. Businesses willing to offer goods or services have two strategies: either setting up theirs own website; or participating in an existing website (either through referencing on a distributor's website, or through a partnership with a marketplace).

In setting up a website, the pre-requisite is to own a domain name. The cost of such a name is theoretically the same for everyone, but some difficulties may nevertheless arise[323] (such as already attributed domain names, equivalence between the enterprise's name and the desired name) that will raise the cost.

Once the name is acquired, the site has to be designed. The prices vary from very inexpensive (a home-made website) to quite expensive (a website designed by a web agency).

The costs of setting up or participating in a website

An important issue is to have a website that can be read using a maximum of digital means. This raises a software compliance issue.[324] Then, for content websites and portals, it will be necessary to acquire content, and maybe research tools and links to other websites. For merchant websites and marketplaces, it will also be necessary to include an online payment module. The price may vary depending on the level of security of payments and the types of payments accepted by the site (such as Visa Card or American Express).

Then, the website will have to be referenced on search tools and portals. Until recently, being referenced was free, since it was to the benefit of portals and search tools to have as many links as possible. Now, however, the trend seems to be reversing, and enterprises must generally pay to be referenced. Last but not least, it will be of vital importance to advertise the website. This is the most important part of the budget (due to first mover advantage and network effect).

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323 See under, 2.6.3. Regulations and technical standards.

324 See under, 2.6.3. Regulations and technical standards.

It should also be noted that manufacturers such as car manufacturers would , in some instances, prefer to develop an Internet site to display their products with no intention to sell directly online but rather for the benefit of their distribution network (at least in the current state of the regulation applying to the car sector[325]).

On the other hand, if a manufacturer sets up standards for the digital use of its products and trademarks, this might raise the prices for the website for its distributors.

In participating in an existing website, the other solution offered to an enterprise wishing to sell its products on the Internet is to enter into partnership with an existing web site.

The modalities vary whether we are considering a portal (or another content website) or a market place, but the objective is the same - getting referenced. For instance, a bookseller willing to sell its products on the *Amazon.com* website will have to spend between 100,000 and 400,000 Euros to be in a position to do so.

It thus appears that the referencing cost can be extremely high, and even higher since a seller will need to be referenced in order to reach customers on the Internet.

The structure and maturity of the market

2.6.2 Structure of the market: Maturity of the market and degree of competition on the market. It is generally agreed that the market is not mature whether on the consumers' side or on the enterprises' side. The following figures are illustrative: in France, 26% of households have a computer, 14% are connected to the Internet and 2% (roughly 130,000 households) shop online, whereas in the United States, 53% of households have a computer, 34% are connected to the Internet and 17% (roughly 45 million households) shop online.[326]

With respect to enterprises, there are at the same time too many sellers and not enough. For example, too many sellers are present and active in the same sectors (such as online sales of books), while some sectors are completely unexploited (such as sales of cosmetics on the Internet).

As previously stated, analysts tend to consider that only a few enterprises can operate on the same market. As a consequence, in sectors where too many enterprises compete, the prices may be artificially driven down. In the same manner, in sectors where not enough enterprises compete, prices can be artificially high. It thus seems that not

[325] Regulation 1475/95 on the application of Article 85 §3 of the Treaty to certain categories of motor vehicle distribution, OJ L 145; 29June 1995.

[326] Ernst & Young study, 1999.

all Internet-related markets are mature. A vast movement of mergers and alliances, at all levels of the chain, characterises the Internet market. It is also characterised by a significant number of enterprises competing in the same sector.

The degree of competition is high. Nevertheless, the first mover advantage and the network effect might modify this position. The number of competitors may then be high, but competition low and/or difficult.

2.6.3 The Regulations and technical standards play an important role. From the point of view of software compatibility, compatibility of technical standard raises different issues.

First, a website must be designed in a way that allows a large number of people to access it. For instance, a website designed with Netscape's creation tools will be less easily viewed with a Microsoft browser than with a Netscape browser. Nevertheless, commercial websites (merchant websites, portals and market places) are generally designed using specific tools, thus ensuring a higher compatibility.

The regulations and technical standards

Secondly, a merchant website will require more complex modules than a content website (for instance, an online payment module or a protected area for the collection of business information). It should nevertheless be noted that technical standards tend to unify, and their price to go down. Technical standards therefore do not seem to raise particular issues.

As to specific regulations, there is no general trend to adopt regulations restricting the use of the Internet. On the contrary, most countries adopt favourable regulations, in order to facilitate the creation of e-businesses.

Nonetheless, general regulations are applicable to all websites. In particular, a merchant website or a marketplace must comply with the system of VAT. Recently, multinational companies expressed their concerns regarding the need for an international standard regarding the implementation of taxes.[327] No such unified regulation could lead to price increases or partitioning of markets.

In the same manner, the proposed regulation [328] concerning the use of digital signatures to ensure the application of the VAT system in Europe raises concerns, since other countries do not have such a regulation. In this case, the proposed regulation requires from enterprises making more than 100,000 Euros of sale within the EC to register for the VAT in a

327 See Reuters News of 29/3/01: *Businesses fear effect of the EU VAT rules on e-invoicing.*

328 COM(2000)650.

Member State. This obligation to register for VAT could create a restriction to trade with the EC.

National regulations may also create restrictions on the attribution of domain names. In France for instance, in order to have the right to use a *.fr* domain name, the proposed name must be part of the enterprise's commercial name (and trademarks, brands, etc.).[329]

This might raise problems for enterprises owning internationally known brand names (such as *eBay.com* [330]), requiring from them a geographic localisation in a country in which they want to do business.

National regulations may also constitute a barrier to entry when they apply to content or goods sold on the Internet. In the *Yahoo!* case [331], *Yahoo.com* was condemned for offering Nazi objects for auction in France (even though the website and company are located in the United States). The court held that this was an infringement of anti-racist French laws, and ordered *Yahoo!* to act so that this content could not be viewed on French territory.[332]

Downstream and upstream barriers to entry

2.6.4 Downstream and upstream barriers to entry. Upstream barriers for merchant websites (and to a minor extent marketplaces) principally concern supply. The compliance of distribution networks has been analysed above (Question II), therefore the problem concerns other products. As for them, there does not seem to be real problems, since regulations generally prohibit the refusal to sell.

Another problem concerns the use of intellectual property rights for the sale of products. Indeed, the sale of products to a distributor does not imply the licence of the intellectual property rights attached to them. The supplier and the distributor therefore will have to agree on the use of those IP rights.

329 For a recent example, see Tribunal de Grande Instance de Nanterre, Ordonnance de référé du 19/2/01, Sony.

330 See Cour d'Appel de Paris, 1/12/00 – eBay.com. In this case, the name *eBay.fr* has been registered by eBay's French competitor, iBazar. eBay was denied the right to the name *eBay.fr* as the action had not been opened rapidly enough.

331 Tribunal de Grande Instance de Paris, 18/11/00.

332 For considerations on the regulations applicable to the compliance of e-commerce with selective or exclusive distribution networks, see Title I. Chapter II.

As to downstream barriers, the major concern lies in a hypothetical right to be referenced to. A number of authors [333] have raised the question, but not given any clear answer. Resulting from an extensive interpretation of the network effect and the need for a seller (or else) to be referenced to on portals and search tools, a positive answer could be given.

The question should nevertheless be closely examined, since recognising such a right would lead to the creation of a new type of essential facility (not meeting the Bronner criteria, and thus potentially dangerous).

[333] *Le droit au référencement* by Eric Barby – Journal du Net of 6/3/01 ((available at http://www.journaldunet.com).

3. Relevance of entirely new sets of criteria towards a dynamic approach (an analysis of economic literature)

(References of this literature are provided in ANNEX V.)

Towards a dynamic approach: Relevance of entirely new sets of criteria

Competition policy has been traditionally based on static analyses of industrial organisation. Recent developments in the industrial organisation literature have provided some advances moving beyond this traditional approach and the preoccupation with price competition.

Analysis of economic literature

Audretsch, Baumol and Burke (2001) provide[334] a framework linking what is known in industrial organisation literature on the dynamics and evolution of markets to competition policy. They explain how the core of the game and non-game theoretical contributions to industrial organisation entailed a new emphasis on dynamics. For example, dominant firms do not necessarily adopt prices that maximize immediate monopoly profits, since they consider its dynamic implications and the possibility that it would encourage entry and competition in the future. They are also recognized to pursue long-term goals in conducting non-price strategies in activities such as R&D and advertising. These authors explain that *"…This new emphasis was to prove important in terms of reliance of the design of competition policy upon the concept of perfect competition as the model for maximisation of welfare – making it almost the raison d'être of antitrust law."* They add that the reference to perfect competition as the most illuminating model for guidance in policy formulation is probably due to the economists' concern about allocative inefficiency, and the fact that the presence of monopoly profits encourages rent seeking.[335]

In the new dynamic models of industrial organisation the usefulness of the perfect competition model is questionable. The first to have criticized it is the Austrian school (von Mises, Schumpeter, and more recently Demsetz, Shackle and Kirzner). Contrary to the neoclassical use of competition as a "state" of affairs, this school considers competition rather than as a process of creative destruction. For them, firms earn temporary monopoly profits as their reward for innovative activity. Thus the Austrian prescription for competition policy is that industries with low barriers to entry be left to operate without constraint. The intuition is the following: when a government intervenes to reduce the profits of the winners this will reduce the incentive for existing firms and prospective entrants to engage in competitive innovation. This opinion is partly

334 Audretsch, D., W. Baumol and A. Burke (2001): *"Competition policy in dynamic markets"*, *International Journal of Industrial Organization*, Vol. 19, n°5, pp. 613-34.

335 Moreover, in an analysis of the EU law, they note: *"…two shortcomings form the viewpoint of dynamic efficiency in EU law: lack of clarity on the social welfare objective of the laws and an emphasis on static efficiency."*

shared by the Chicago School and its *laissez faire* advocated approach to regulation, supported by the contestable markets theory.[336]

Most recent economic contributions on competition policy in dynamic markets deal with the core of the Austrian approach: technological change, innovation, R&D and diffusion.

Some authors show that the threat of entry can stimulate incumbents to increase innovative activity but a potential entrant (whilst having innovated) have little incentive to enter if barriers to entry for subsequent imitators are sufficiently low to cause low *ex post* profits. Audretsch et al. (2001) plead then for a sophisticated approach to property rights. "*On the one hand it must preserve these so that the incentive to engage in dynamic competition is maintained and on the other it must ensure that these rights are not employed to block entry to further rounds of dynamic competition.*" The most interesting example is probably the possibility of the lock-in phenomenon, which can occur under network externalities. The dilemma is then without more information on the economic benefits of these innovations and the minimum reward necessary to stimulate them, one cannot determine whether a public intervention will enhance or decrease economic welfare.

A more dynamic approach required

This line of research, consisting in a disparate body of literature, refutes the assumption according to which an increase in entrepreneurial activity is always welfare enhancing.

A recent special issue of the International Journal of Industrial Organization, composed by various contributions within this line of research, raises doubts about the efficacy of current competition laws. More specifically, the articles are concerned with competition issues raised by three phenomena: variations in the capabilities of different firms, mergers and inter-firm coordination, and the beneficial externalities generated by investment in R&D.

Three insights can summarize these analyses:

1- The dynamics of the competitive process are more complex than its static structure. Dynamic welfare optimisation does not lead to simple rules to be applied. Competition policy should take into account this heterogeneity and adopt clear welfare objectives that allows for flexibility in applying the law to dynamic markets.

[336] See Baumol, W., J. Panzar and R. Willig (1982): *Contestable Markets and the Theory of Industry Structure*, Harcourt Brace Jovanovich.

2- The capability of firms plays critical role in dynamic market performance according to this literature and explains the complexity of dynamic competition comparatively to the static competition.

3- The consequences of mergers, alliances and cooperation among firms induce a re-examination in a dynamic context.

For example[337], Malerba, Nelson, Orsenigo and Winter (2001) examine the role of increasing returns and the evolution of firm's capabilities in a model of the US computer industry. Using a "history friendly model" in the tradition of evolutionary models, they ask the questions of how antitrust policy affects industry structure over the course of industry evolution, whether the timing of intervention is important, and do policy interventions have indirect and unintended consequences on different markets at different times. They particularly focus on antitrust and interventions aiming at supporting the entry of new forms in the industry. The analysis based on simulations, and not always convincing, show that if strong dynamic increasing returns are operative, there is little that antitrust and entry policy could have done to prevent the rise of a dominant firm. Moreover, if the lock-in effects had been smaller, market concentration would have been lower, albeit a dominant firm would emerge anyhow even under antitrust and entry encouraging policies. In this last case, the relative market power would be reduced.

The most importance attribute that differentiates the dynamic approach to competition policy is a focus on innovation rather than prices and profits and on flexibility in resource utilisation rather than static efficiency in their

Pleatsikas and Teece (2001) give a critical assessment[338] of the traditional methods of analysing market definition and market power. Arguing that competition in high tech industries is fundamentally different from that in more mature and stable industries, they review and evaluate some of the traditional techniques used to define and measure market power in antitrust analysis. Their main argument is that high tech industries are typically characterised by high levels of product differentiation and dramatic shifts in firms' market positions. Thus applying traditional methods yield narrow market definitions and market power is exaggerated. They suggest some "new" indicia for antitrust analysis of high technology markets concerning the definition of the markets and the evaluation of market power. They argue that a wide-angle lens is needed to assess competition in dynamic markets. This includes the way technology competition occurs and its several dimensions as customer needs and responses to product innovation. This can help improving the way some traditional indicia are used in practice. For assessing market power, they argue for an analysis of rents in order *"…to identify whether market power is in fact potentially*

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337 Malerba, F, R. Nelson, L. Orsenigo and S. Winter (2001): *"Competition and industrial policies in a `history friendly' model of the evolution of the computer industry", International Journal of Industrial Organization*, Vol. 19, n°5, pp. 635-64.

338 Pleatsikas, C. and D. Teece (2001): *"The analysis of market definition and market power in the context of rapid innovation", International Journal of Industrial Organization*, Vol. 19, n°5, pp. 665-93.

assignment at a given moment

troublesome or simply the outcome of innovation, entrepreneurial efforts, and/ or natural scarcity."

Up to now and according to the most recent economic analyses, it would be premature to provide a menu of policies for regulation and antitrust activity in dynamic markets where evolution and change are present. The recent contributions in the economic literature argued that the most importance attribute that differentiates the dynamic approach to competition policy is a focus on innovation rather than prices and profits and on flexibility in resource utilisation rather than static efficiency in their assignment at a given moment. Within this line of research, Audretsch et al. (2001) add: "*Increased attention to innovation may make inter-firm coordination and bigness less undesirable that it would be in an economy in which change is rare and insignificant.*" They also give rise to some issues on which the economists have to do much more research to understand the way competition policy should be designed in dynamic markets.

1. ***Appropriate ease of entry*****:** what kind of arrangement or intervention the competition authorities should put into action in order to ease entry in such markets. Should the authorities allow (or even encourage) the use of enterprise policy to increase the capability of new entrants? Should they restrict the incumbent's response to entry?

2. ***Appropriate inter-firm coordination*****:** the desirability of preventing coordination is not clear when innovation rather than price is the prime means by which welfare can be increased. Theory suggests that there are disincentives for investment in innovation due to the importance of spillovers. Coordination between firms can be a solution to internalise these negative externalities.

Analysis of dynamic markets is more complex than that of static markets

3. ***Innovation, trade and monopoly power*****:** how rivalry from abroad should be taken into account in competition policy?

4. ***Anti-competitive innovation*****:** what rules and procedures are appropriate to deal with the firms' spending so much on R&D that rivals cannot enter a market?

5. ***Monopolisation in an innovative market*****:** should competition policy include the innovativeness of the industry (with ease of entry and absence of concentration) as evidence that monopoly power is unlikely, as argued by some economists?

6. ***Price discrimination where R&D costs are substantial and continuing*****:** how competition policy should adapt itself to the fact that uniform pricing based on marginal cost may prevent recovery of the innovation?

***Divestiture and market structure*:** should the competition authorities oblige merging firms to sell some of their assets to their competitors in order to make the market more symmetric in terms of capacities of production or do they have to encourage the emergence of asymmetric firms?

All these issues, and the list is not exhaustive, suggest that the design of competition policy for a dynamic economy is far from being well understood. Analysis of dynamic markets is more complex than that of static markets. Much work is still needed before economists could provide a justifiable and comprehensive set of rules for an economy with rapid change due to the innovative process.

An application: the Microsoft case

In May 1998, the U.S. Department of Justice filed suit against Microsoft claiming a number of violations of the Sherman Act. The basic economic issues raised during this case can be summarised in four questions.[339]

An illustration: The Microsoft case

1. Did Microsoft possess monopoly power in the market for personal computer operating systems (OS)?

2. Did Microsoft maintain its monopoly power by anticompetitive conduct?

3. Did Microsoft use its monopoly power in an anticompetitive way to distort competition in markets other than the market or markets for personal computer operating systems?

4. Did Microsoft engage in unreasonable restraints of trade?

The answers of the economists working for the DOJ were that:

Severe anti-competitive behaviours found

- Microsoft achieved monopoly power in the market for OS for Intel-compatible desktop personal computers.
- Moreover, it foresaw the possibility that the dominant position of its Windows OS would be eroded by Internet browsers and by cross-platform Java.
- Microsoft took anticompetitive actions to exclude competition in Internet browsers in order to protect the dominance of its OS.
- Microsoft also took anticompetitive actions to retrain the use and availability of the cross-platform Java technology in order to protect the dominance of the Windows OS. It further engaged in

[339] See Fisher, F. and D. Rubinfeld (2001): *"U.S. v. Microsoft – an economic analysis", The Antitrust Bulletin*, Vol. XLVI, Spring, pp. 1-69, for a detailed analysis of these economic issues. A shorter and less technical discussion of the economic issues raised by this case can be found in Shapiro, C. and H. Varian (1999) : *Information Rules. A Strategic Guide to the Network Economy*, Harvard University Press, pp. 289-95.

anticompetitive acts and solicitations designed to convince other firms not to compete against Microsoft in platform-level software.

- Microsoft used its monopoly power over PC OS to distort competition in Internet browsers.
- Microsoft used different anticompetitive practices to preserve and increase barriers to entry into the PC operating system market: tying of its browser to its Windows OS, imposition of agreements requiring original equipment manufacturers (OEMs) it neither remove Microsoft's browser, nor to substitute an alternative browser, etc…

These economists emphasised the fact that the key distinguishing feature of a monopoly is its durability, which is the case for a software company like Microsoft. They also stressed the fact that network externalities (or effects) exacerbate some features like the barriers to entry and from the fact that programs written to run on a given operating system will generally not run on others unless considerable expenditures are undertaken (the so called *applications barriers to entry*). Furthermore, these network effects and scale economies create a positive feedback: the more users an OS has, the more applications will be written for it; the more applications written for an OS, the more users it will acquire. In these circumstances, markets with strong network effects where firms can choose their own technical standards are "winner-take-most" markets. The fact that Microsoft gained from this 'natural' barrier to entry was not at the heart of the antitrust case. But this never justifies its taking anticompetitive acts to extend that power to another market or protect its dominance in the original market.

Most economists justified Microsoft practices as quite normal

The opinion of Microsoft and the economists supporting it on these facts is of course negative. Klein (2001) justifies[340] most of the practices engaged by Microsoft as quite normal in a competitive market. They were justified, according to him, by the fears of Navigator/Java threat to Microsoft platform dominance. The same kind of analysis is developed in Economides (2001) who adds: *"In network industries, we often observe Schumpeterian races for market dominance. This is a consequence of the winner-take-most natural equilibrium combined with the high intensity of competition that network externalities imply."*[341] He more particularly criticized the way the authorities and the District's Court defined the relevant market, the barriers to entry, the proof of existence of market power and pricing of the OS, and the exercise of market power.

Moreover, both sides seem to agree that Microsoft's pricing of Windows OS does not correspond to short-run profit maximisation by a monopolist. Microsoft used this argument to deny that it has a

340 Klein, B. (2001): *"Did Microsoft Engage in Anticompetitive Exclusionary Behavior?", The Antitrust Bulletin*, Vol. XLVI, Spring, pp. 73-113.

341 Economides, N. (2001): *"The Microsoft Antitrust Case"*, forthcoming in *Journal of Industry, Competition and Trade: From Theory to Policy*, August.

monopoly power. Indeed, Schmalensee's direct testimony argues that Microsoft lacks such power since the short-run monopoly was about 1800$ in excess of the actual price (60$).[342] This analysis has been seen controversial by some commentators (Hall et Hall, 1999)[343] and incorrect (Fisher and Rubinfeld, 2001). Bresnahan (2001) argues that Microsoft does not act as a monopolist in the short-run but it does in a long-run view.[344] His very interesting paper is based on internal Microsoft documents made public in the antitrust trial. He shows how Microsoft views the industry equilibrium, the network effects, lock-in, first mover advantages, installed base effects, etc…

Fudenberg and Tirole (2000) provide[345] a formal model of pricing in order to deter entry by a sole supplier of a network good. Their model makes sense to the "limit pricing" practice by Microsoft in order to discourage other firms to develop competing OS. They show that the installed base of a network good can serve a pre-emptive function if the entrant's good is incompatible with the incumbent's good and there are network externalities in demand.

An interesting bundling issue

Another interesting issue, which could have been raised by the Microsoft case, is that of bundling two products together so as to leverage an existing monopoly. Fisher and Rubinfeld (2001) write: *"The government did not claim that Microsoft attempted to utilize its existing monopoly power over PC OS to monopolize the market for Internet browsers for its own sake. Rather it claimed that Microsoft's goal was to maintain its OS monopoly."* As we have mentioned it before this issue of leverage theory is controversial among the economists. In favour of leverage theory, one can cite the contributions[346] of Carbajo, De Meza and Seidmann (1990), and Mathewson and Winter (1997). Whinston (1990) is one of the most influential articles[347] against the leverage theory (but not in the case

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342 See the site http://www.neramicrosoft.com/ for analyses supporting the Microsoft's point of view and more particularly Reddy, Evans and Nichols (1999): *"Why does Microsoft charge so little for Windows?"*, for this aspect.

343 Hall, C. and R. Hall (1999): *"National Policy on Microsoft: A Neutral Perspective?"*, *mimeo* available at http://www.NetEcon.com/.

344 Bresnahan, T. (2001): *"Network Effects in the Microsoft Case"*, *mimeo* presented at the conference *"The Economics of the Software and Internet Industries"*, Toulouse (IDEI), January 18-21, available at http://www.idei.asso.fr/.

345 Fudenberg, D. and J. Tirole (2000): *"Pricing a Network Good to Deter Entry"*, *Journal of Industrial Economics*, Vol. 48, n°4, December, pp. 373-90.

346 Carbajo, J., D. De Meza and D. Seidman (1990): *"A Strategic Motivation for Commodity Bundling"*, *Journal of Industrial Economics*, Vol. 38, n°3, pp. 283-98. Mathewson, F. and R. Winter (1997) : "Tying as a Response to Demand Uncertainty", *RAND Journal of Economics*, Vol. 28, n°3, Autumn, pp. 566-83.

347 Whinston, M. (1990): *"Tying, Foreclosure, and Exclusion"*, *American Economic Review*, Vol. 80(4), pp. 837-59.

where tying can induce foreclosure).[348] Carlton and Waldman (1998) also point out that tying may foreclose competition in evolving industries.[349] They more specifically examine the role of "inter-temporal economies of scope" in entry deterrence. Choi and Stefanadis (2001) provide a dynamic analysis in favour of leverage theory.[350] They show that when an incumbent monopolist faces the threat of entry in all complementary components (OS and browsers), tying may make the prospects of successful entry less certain, discouraging rivals from investing and innovating.

An interesting approach towards remedies

The final issue we develop on the Microsoft trial concerns the remedies imposed by the District Court.[351] First of all, it should be emphasised that dominant firms in major industries create a dilemma for policy makers. Indeed, as Comanor (2001) claims: *"On the one hand, these firms have surely passed a market test for they have flourished where others have failed. Dominant positions are not so easily gained: "they must have done something right." On the other hand, whatever competition may once have existed has now been limited by the firm's reaching a monopoly or near-monopoly position. In particular, prices are generally higher than they would otherwise be. In such circumstances, what if anything should be done?"*.[352] Before proposing a remedy, it is important to understand that network effects are an important feature of software markets.[353] Various remedies have been proposed before the Court gave its own. They deal with both the conduct and the structure of the software market.[354] The structural remedy debate was essentially based on fragmentation and incompatibility, which can have harmful effects on computer users. The argument is the following: each rival would seek to introduce an "improved" version of the Windows software that would invariably be

348 See also the position of the Chicago school on this issue developed in this report.

349 Carlton, D. and M. Waldman (1998): *"The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries"*, *NBER Working Paper* n° 6831.

350 Choi, J.P. and C. Stefanadis (2001): *"Tying, investment, and the dynamic leverage theory", mimeo* presented at the conference *"The Economics of the Software and Internet Industries"*, Toulouse (IDEI), January 18-21, available at http://www.idei.asso.fr/.

351 On June 28, 2001, the Appeals Court reversed a June 7, 2000, lower Court decision to break up Microsoft.

352 Comanor, W. (2001): *"The problem of remedy in monopolization cases: The Microsoft case as an example"*, *The Antitrust Bulletin*, Vol. XLVI, Spring, pp. 115-33.

353 See for example Katz, M. and C. Shapiro (1999): *"Antitrust in Software Markets"*, Chapter 5 in J. Eisenach and T. Lenard eds., *Competition, Innovation, and The Microsoft Monopoly: Antitrust in the Digital Marketplace*. Proceedings of a conference held by the Progress and Freedom Foundation in Washington, DC, February 5, 1998, Kluwer Academic Publishers.

354 See for example Litan, R., R. Noll, W. Nordhaus and F. Scherer (2000): *United States v. Microsoft Corporation*, Remedies Brief of Amici Curiae, April 27.

incompatible with the products of others.[355] According to Comanor (2001): "*There are reasons to believe that network effects will promote greater compatibility across the products of rival firms.*" According to Economides (2001), what was intended in the break-up of Microsoft could have been accomplished by conduct restrictions without the cost and the disruption of the break-up. These proposed conduct remedies have serious drawbacks according to Levinson, Craig Romaine and Salop (2001). They claim: "*First, Microsoft is unlikely to behave procompetitively following the imposition of conduct remedies. Microsoft has proven adept at circumventing antitrust conduct restrictions and could easily invent new ways to enhance and extend its monopoly power. Second, conduct remedies are highly intrusive and would require ongoing, intensive regulation of Microsoft's conduct for an extended period of time. It is unlikely that the courts would be well suited to taking on the role of regulating Microsoft's prices, for example.*"[356]

At any rate, Microsoft case will bring for sure in the future many other contributions which could help us improve our knowledge about the design of competition policy in dynamic markets.

[355] "*…the Microsoft break-up is likely to lead to incompatibilities and further loss of efficiency*". Economides (2001).

[356] Levinson, R., R. Craig Romaine and S. Salop (2001): "*The flawed fragmentation critique of structural remedies in the Microsoft case*", *The Antitrust Bulletin*, Vol. XLVI, Spring, pp. 135-62.

TITLE II

ASSESSMENT OF VERTICAL AGREEMENTS AND MERGERS IN THE NEW ECONOMY

CHAPTER II

METHODS FOR IMPROVEMENT OF COMPETITION CONCERNS IN THE NEW ECONOMY AND RECOMMANDATIONS

CHAPTER II.

METHODS FOR IMPROVEMENT OF COMPETITION ASSESSMENT IN THE NEW ECONOMY AND RECOMMANDATIONS

New Economy industries Present specific features: Network effects; High risks for all; High rewards only for winners; First mover advantage; Soft durable goods; Generally high fixed costs and low marginal production costs.

New Economy industries present specific features: Network effects; High risks for all; High rewards only for winners; First mover advantage; Soft durable goods; Generally high fixed costs and low marginal production costs.

New Economy industries' characteristics therefore require a dynamic analysis.[357]

These features require a dynamic approach

Antitrust analysis traditionally pays particular attention to whether any firms have significant market shares. The Commission customarily heavily relies on the dominance test of Article 2 ECMR. However, the specific characteristics of New Economy industries make it doubtful that the traditional approach is still justified. In the context of New Economy a more dynamic analysis rather appears to be the best answer in order to assess the competitive forces of the markets concerned and to ensure and maintain effective competition between the players.

Innovative environment makes market leadership positions fragile

As to the dominance test approach, indeed, in the New Economy, today's sales and market shares tend to be driven by the quality of today's products, perhaps amplified by network effects, not so much by durable assets like production capacity and distribution systems. Today's sales do not say anything about the value of intellectual capital, the quality or popularity of tomorrow's products, or the changing nature of the markets in which they will compete. Market positions based on high technology are fragile as innovation is rapid. The winner today may be the looser tomorrow.

Static dominance is not necessarily a useful test in high technology industries

Static dominance, even if measured accurately by reference to a proper relevant market definition and assessment of market share, is not necessarily a useful test in high technology industries. First, market share tests do not provide a useful screen in New Economy industries, since most leading firms have market power in the static sense. Thus a consistent application of this approach would imply that their business practices would always be subject to regular inquiries. Indeed, in many high technology industries a single firm has a high share of whatever category it serves. Given the historic fragility of market leadership positions in New Economy

[357] Contributed from David S. Evans and Richard Schmalensee, *"Some economic aspects of antitrust analysis in dynamically competitive industries"*, National Bureau of Economic Research.

industries, there is no economic basis for treating leading firms in these industries as if they had the sort of durable market position that would be associated with, for instance, large shares of automobile manufacturers, chemical plants or oil-refining capacity. The second related problem with reliance on market share in New Economy industries is that static power does not provide a useful measure of the constraints that market forces place on efforts by a firm to take anticompetitive actions. In many New Economy industries, leading firms are constrained mainly by rivals that are investing or could easily invest in drastic innovations. They are not constrained much by the pricing or production decisions of existing firms, because they typically face few if any contemporaneous rivals, and scale economies and network effects are often effective barriers to the entry of comparable products.

Market power inquiry must include a serious analysis of the vigour of dynamic competition

As a result, a proper competition assessment in New Economy industries must include a serious analysis of the vigour of dynamic competition. This requires looking beyond current market figures. It is important for instance to examine ownership of and investment in relevant intellectual property. If for instance, the current market leader owns all intellectual property necessary for radical innovation, dynamic competition will not be effective. Similarly, foreclosing rivals from important distribution channels is likely to restrain dynamic as well as static competition as well as the restriction of access to the local loop by monopolists. If, on the other hand, several firms are making significant R&D investments in order to obtain or retain leadership positions, dynamic competition is likely to be healthy regardless of current market shares. Similarly, the ability of new firms to enter into dynamic competition can impose significant constraints on the behaviour of current market leaders. In sectors where capital requirements are small and the supply of skilled labour is deep, this constraint is likely to be particularly important.

The traditional definition of the markets may provide a misleading picture

As to the definition of the markets, the traditional analysis, which concentrates on the substitutability and the hypothetical monopolist test, can present a seriously misleading picture of competitive relations in the New Economy. The leader in a given market constantly has to face the threat that another firm will come up with a drastic innovation that causes demand for the leader's product to collapse. The new product can be a better version of the old product or it may be an entirely different product that eliminates the demand for the old product. These threats force New Economy firms to invest heavily in R&D and to bring out new versions of their products, including versions that lead to the demise of their old versions. In New Economy industries, an essential element of market power is an examination of actual and potential innovative threats to leading firms. This cannot be a simple exercise in drawing boundaries and computing shares or even looking at traditional barriers to entry, which concern non-innovative entry. It generally involves the exercise of judgement regarding the likelihood of future races for market dominance and the likely nature of those races. Examination of innovative threats also generally involves consideration of competitive threats based on technologies and design approaches that differ radically from those used by the incumbent.

A comprehensive rule of reason approach would appear to be more adequate

One can argue against the use of classical standards of competition analysis of antitrust policy and in favour of widespread use of specific dynamic analysis. However a dynamic analysis tends to be time-consuming and to imply access to specialised technical knowledge. One can cast doubts as to the possibility for Commission Officials to access the technical information necessary for sound analysis at all and especially in a concentration assessment under ECMR within limited time frame. The only apparent approach to the mitigation of these problems is to develop presumptions and structured guidelines that reflect New Economy realities and that are designed to lighten the Commission's analytical burden. "*When the world is changing rapidly, an approximate analysis of today's conditions is much more likely to be useful than an exact analysis of conditions a decade ago".*[358] In that regard, we would like to formulate some proposals to make this dynamic analysis operable under EC Competition law.[359]

[358] David S. Evans, Richard Schmalensee, previously cited.

[359] See infra Section II. §3 *"Relevance of entirely new sets of criteria towards a dynamic approach".*

Section I.

Comparison between the U.S. and E.U. assessment of vertical mergers and agreements

1. Evolution of US and EU policies in merger assessments

1.1 Evolution of U.S. policy

Comparison between the US and EU assessment of vertical restraints

The history of the control of concentrations in the U.S. is relatively long when compared with the E.U. The principal U.S. antitrust provision governing mergers, acquisitions and joint ventures is Section 7 of the Clayton Act (enacted in 1914 and amended in 1950), which prohibits concentrations that may reduce competition. Mergers, acquisitions and joint ventures may also be challenged under Sections 1 and 2 of the Sherman Act as unreasonable restraints or as attempts at monopolization.[360]

The US merger test: Does it lessen competition or tend to create a monopoly?

In general, these statutes prohibit acquisitions of assets or stocks where ***"the effects of such acquisition may be substantially lessen competition, or to tend to create a monopoly"*** (Section 7 of the Clayton Act).

In addition, the Department Of Justice (hereinafter referred as DOJ) and the Federal Trade Commission (referred as the FTC) have issued a set of written guidelines, which provides a structure within which one can evaluate the legality of a particular transaction.[361]

Among the different steps that are necessary for the evaluation of a merger (identification of the relevant products and geographic markets, assessment of the market shares, etc…), there is one that we mentioned earlier, that must be particularly underlined as being emphasized in the U.S., which is the **evaluation of efficiencies**.

More specifically with regard to vertical mergers, the U.S 1984 Merger Guidelines on Non-Horizontal Mergers describes the principal theories likely to create harm to competition. These theories mainly refer to foreclosure and collusion.

Regarding foreclosure, three conditions are necessary, but not sufficient, for this problem to exist:

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[360] A comparison between the US and the EU regulatory approach is provided in **Annex IX**.

[361] "Antitrust Guidelines for Collaborations Among Competitors" 4 Trade Reg. Rep. (CCH) 13,161 (April 7, 2000); U.S. DOJ/FTC 1992 Horizontal Merger Guidelines, The 1984 Merger Guidelines, U.S. DOJ, 4 Trade Reg. Rep (CCH) 13,103.

- *"The degree of vertical integration between the two markets must be so extensive that entrants to one market (the primary market) also would have to enter the other market (the secondary market).*
- *The requirement of entry at the secondary level must make entry at the primary level significantly more difficult and less likely to occur.*
- *The structure and other characteristics of the primary market must be otherwise so conducive to non-competitive performance that the increased difficulty of entry is likely to affect its performance".*[362]

In practice, the antitrust enforcement of vertical mergers in the U.S. can be considered as vacillating by comparison with other jurisdictions. Prior to the late 1970s, a wide number of vertical mergers were prohibited whereas they presented relatively small foreclosure effects.[363] Then, in the late 1970s, the courts' analysis began to change, being less reluctant as with vertical mergers even where the market shares were relatively significant.[364] In 1982, the revision of the Merger Guidelines by the Department of Justice resulted in a significant liberalization, and almost no vertical mergers were challenged during this period. More recently, the U.S. authorities have restated a critical approach in several cases[365], due in particular to a renewal in the economic analysis of the effects of vertical mergers.

1.2 Evolution of E.U. policy

The E.U. merger test: Does it create or strengthen a dominant position

The history of the control of concentrations in the E.U. is much shorter than the U.S., as no legal instrument allowing the Commission to control systematically this type of operation existed before 1989, when the Council adopted the Merger Regulation. Under this Regulation, a concentration is authorized if it ***does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded.***[366] This test is known as the dominance test.

Even though the Commission experience is shorter it is possible to analyze the evolution over the time of the E.U. policy approach with regard to vertical aspects of concentrations. The experience that the Commission has gained in this area permits to compare its approach with that of the U.S.

[362] § 4.21 of the 1984 Merger Guidelines.

[363] See for example Brown Shoe Co. v. United States, 370 U.S. 294 (1962); and Ford Motor Co. v. United States, 405 U.S. 562 (1972).

[364] See Fruehauf Corp. v. FTC, 603F.2d 345 (1979).

[365] See Cadence Corp., Docket n° C-3761 (Aug. 7, 1997); Silicon Graphics Corp., Docket n° C-3626 (Nov. 14, 1995).

[366] Regulation 4064/89, Article 2.

For example, it can be noted that the merger legislation focuses almost as much on vertical aspects as on horizontal aspects. For instance, the information requirements imposed on the notifying parties cover explicitly and quite extensively any vertical and horizontal relations between the parties.[367]

Foreclosure is the central issue in the approach of the EU towards vertical mergers

Moreover, vertical aspects are among the main concerns of the Merger Regulation. Article 2 shows; indeed, that foreclosure is the central issue in the approach of the E.U. to vertical aspects of mergers. It indicates that, when the Commission makes its appraisal of the transaction, it must take into account *"the market position of the undertakings concerned and their economic and financial power, the alternatives available to suppliers and users,* ***their access to supplies or markets, any legal or other barriers to entry****…*

In the 21st Annual Competition Report in 1991, the Commission has made its first policy statement with regard to vertical integration. It considered that the main area of concern is the conditions of access to inputs and outlets and the risk that the merged entity might affect these conditions through vertical integration. By restricting the access to inputs or to downstream outlets, the merged entity might become dominant or reinforce its dominance.

Therefore, the Commission concern is placed within the traditional approach to the exclusionary effects resulting from a vertical merger, but only in so far as these effects might create or reinforce a dominant position.

The creation or strengthening of a dominant position is, indeed, the only relevant test in assessing a merger in the E.U. The prevailing of this test in the E.U. has a direct consequence on the E.U. approach to the efficiency doctrine.

1.3 Efficiencies as a mitigating factor in the U.S and the E.U.

Efficiencies as a mitigating factor

In certain competition enforcement regimes it is recognized that a merger that may have significant anti-competitive effects should nevertheless be permitted if it also would result in improvements in efficiency that are greater than the anti-competitive effects of the transaction. In practice, efficiencies are usually relevant in merger analysis only when there is concern that the transaction is otherwise anti-competitive.

Both the E.U. and the U.S. have been concerned with the question of the extent to which efficiency claims should be allowed in defence of mergers. However, in practice, it is clear that efficiency claims face more opposition in EU merger enforcement than in the U.S.

367 See Form CO relating to the Notification of a concentration.

Efficiencies as a mitigating factor in the U.S. Today in the US efficiency claims constitute a factor that must be weighed when appraising the effects of a merger. However, U.S. policy has considerably changed over the years. For example, in the case *FTC v. Procter and Gamble Co*. (1967)[368], the Supreme Court stated *"possible economies cannot be used as a defence against illegality.* ***Congress was aware that some mergers which lessen competition may also result in economies but it struck the balance in favour of protecting competition".***

US competition agencies recognize that the primary benefit of mergers is to generate efficiencies

The current framework for analyzing efficiencies is set forth in the U.S 1992 joint Horizontal Merger Guidelines, as revised in 1997. **The agencies recognize that *"the primary benefit of mergers to the economy is their potential to generate such efficiencies".*** In assessing the impact of efficiencies, the agencies must consider only those efficiencies that are "merger-specific" and "cognizable".

- Merger-specific efficiencies are those that are realizable only through the proposed merger,

- Cognizable efficiencies are merger-specific efficiencies that *"have been verified and do not arise from the anti-competitive reductions in output or service".* They include, for example, achieving economies of scale, better integration of production facilities, lower transportation costs.

When cognizable, merger-specific efficiencies exist, the agencies require them to be passed on to the consumer, and eventually to be sufficient to reverse the merger's potential anti-competitive effects.

The taking into account of efficiencies is limited to the fact that they may almost never justify a merger to monopoly or near monopoly. The difference with the E.U. is therefore strong where, as mentioned earlier, the EC Merger Regulation states that "e*fficiencies are assumed for all mergers up to the limit of dominance”.*

Concerning vertical mergers, even though the appraisal is similar[369], the Non-Horizontal Merger Guidelines give the efficiency defense a greater importance than in the case of horizontal mergers. These guidelines indicate that *"an extensive pattern of vertical integration may constitute evidence that substantial economies are afforded by vertical integration. Therefore, the Department will give relatively more weight to expected*

[368] 386 U.S. 568, 580 (1967), see also Brown Shoe Co. v. United States.

[369] As in the case of horizontal mergers, the Department will consider expected efficiencies in determining whether to challenge a vertical merger"; originally issued as Section 4 of the U.S. DOJ Merger Guidelines, June 14, 1984. Section 4 §24.

efficiencies in determining whether to challenge a vertical merger than in determining whether to challenge a horizontal merger".[370]

In conclusion, in the U.S., efficiencies play an important role in defense of mergers. To illustrate this importance, Robert Pitofsky acknowledged: *"I can attest first-hand that there have been cases in which the exercise of prosecutorial discretion not to challenge was influenced by the presence of significant efficiencies"*.[371]

Efficiencies and bundling

Efficiencies and bundling. A vertical merger is likely to bring together undertakings which products are complementary. As a result, this integration may offer the merging parties the opportunity to bundle their products and sell packages to the customers and, accordingly, confer them an advantage on their competitors.

For example, this issue has played a prominent role in the European Commission opposition to the GE-Honeywell merger. Indeed, one of the principal ground in this case was the fear that the merged company would gain an unfair advantage over competitors by bundling GE engines with Honeywell avionics.

In the Microsoft case the Court of Appeals ruled that bundling is not per se illegal.

In the U.S., the practice of bundling has recently been given a new approach in the ***Microsoft case***.[372] In this decision of June 28th, 2001, the judges of U.S. District Court of Appeals found that tying one product to another – the Windows operating system and the Web browser in this case – is not illegal per se. Rather the Court of Appeals ruled that a rule of reason standard must be applied to bundling cases.[373] Accordingly, Microsoft may be allowed to tie together two previously unrelated products unless the prosecution can show that the action would unreasonably restrain competition and cause harm to consumers.

This decision is a reversal of Judge Thomas Penfield Jackson's order to break up Microsoft, and provides a clear illustration of the importance given to innovation in U.S. Competition Law. Making bundling as per se illegal *"could only have meant that Microsoft's market power in the operating systems should prohibit it from adding further value to a product that has evolved continuously for 20 years. This in turn cast into*

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370 Section 4§24 of the U.S. DOJ Merger Guidelines, June 14, 1984.

371 Robert Pitofsky, "EU and US Approaches to International Mergers", views from the U.S. FTC, EC Merger Control 10th Anniversary Conference, 14-15 September 2000.

372 United States Court of Appeals, District of Columbia Circuit, n° 00-5212, United States of America Appellee v. Microsoft Corporation, Appellant.

373 See The Wall Street Journal Europe, Friday – Saturday, June 29 – 30, 2001, *"Microsoft Avoids Breakup But Isn't Off the Hook", "for the Software Giant, Windows Opens Doors"; "The Rule of Reason"*.

doubt the legality of the very innovation and integration that drives technology forward".[374]

As a result, this decision does leave open the possibility for the government to find in the Microsoft case that efficiencies, and particularly the benefits to consumers of integrating features that they are looking for in Microsoft's software, outweigh anticompetitive effects.

Even though this case does not concern a merger, this approach to bundling practices may certainly have an impact on the assessment of the effects of a merger, especially when it involves undertakings in the sectors of the New Economy - medias, Internet, telecommunications - where interoperability between products and innovation are great.

Efficiencies as a mitigating factor

Efficiencies as a mitigating factor in the E.U. While Article 81(3) of the EC Treaty requires, before granting exemption to agreements, the balancing of anti-competitive harms with pro-competitive efficiencies, the Merger Regulation does not provide for such an analysis.

Robert Pitofsky, chairman of the FTC, considered, nevertheless, that *"the EC Merger Regulation left ample room to take technical and economic progress into account "provided that it is to consumers advantage and does not form an obstacle to competition""* (Article 2.1(b) ECMR).[375]

In the case *Aerospatiale-Alenia/De Havilland* in 1991[376], the Commission addressed the question of efficiency for the first time. However, it did not decide whether it would admit the efficiency defense in the E.U. merger control as it just dismissed the existence of the efficiencies alleged by the parties. The Commission considered, indeed, that *"without prejudice as to whether such considerations are relevant for assessment under Article 2 of the Merger Regulation "* the costs reductions concerned were of little magnitude in relation to the total turnover of the merged entity and that it was unclear whether those costs savings were attributable to the merger.

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[374] The Wall Street Journal Europe, *"The Rule of Reason"*, see the previous footnote.

[375] Robert Pitofsky, "EU and US Approaches to International Mergers", views from the U.S. FTC, EC Merger Control 10th Anniversary Conference, 14-15 September 2000.

[376] Case N° IV/M.53, OJ L 334/42 (1991).

In the MSG case the Commission has rejected the efficiency defence argument

Later, in 1994, in the *MSG* case[377], the Commission rejected more clearly the efficiency defense argument advanced by the parties. In this case the parties point out that the rapid acceptance of digital television will be promoted by the services offered by MSG. It is true, says the Commission, that the successful spread of digital television presupposes a digital infrastructure and hence that an enterprise with the business object of MSG can contribute to technical and economic progress. However, the Commission considered that *"the reference to this criterion in Article 2(1)(b) of the Merger Regulation is subject to the reservation that no obstacle is formed to competition".*

In the E.U. efficiencies are assumed up to the limit of dominance

Furthermore, the Commission made it clear in a Competition Policy Roundtable of the OECD that *"there is no real legal possibility of justifying an efficiency defense under the Merger Regulation. Efficiencies are assumed for all mergers up to the limit of dominance - "the concentration privilege". Any efficiency issues are considered in the overall assessment to determine whether dominance has been created or strengthened and not to justify or mitigate that dominance in order to clear a concentration which would otherwise be prohibited".*[378]

It seems that in the EU preservation of competitive markets still prevails over other considera-tions, including economic efficiencies

In conclusion, in the E.U. the text of the Merger Regulation and the case law suggest that the Commission is not prepared to balance efficiencies with dominance, they rather reveal that the maintenance and preservation of competitive markets prevail over any other considerations, including economic efficiency. Indeed, the Commission applies the dominance test while efficiency gains may never justify the creation or strengthening of a dominant position. To characterize how the Commission treats efficiency claims, Frédéric Jenny commented, *"far from allowing an efficiency defense for mergers, the EC Commission has so far considered mergers which contribute to economic efficiency more likely to create a dominant position than other mergers"*.[379]

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377 Case n° IV/M.469, OJ L 364/1 (1994), MSG Media Service.

378 OCED/ GD(96)65 "Efficiency claims in Mergers and other Horizontal Agreements".

379 Competition and efficiency, 1993, Fordham Corporate Law Institute 185 (B. Hawk ed. 1994).

2. U.S. policy approach toward vertical agreements and differences from E.U. policy

2.1 The application of the per se rule and the rule of reason in U.S. law

In U.S. law, the principal statutory provision with regard to agreements prohibits *"every contract, combination or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations"* (Section I of the Sherman Act).

The U.S. law governing agreements is not structured around a framework of notification and exemption

In contrast with E.U. law, the U.S. law governing agreements, either horizontal or vertical, is not structured around a framework of notification and exemption. It is only possible to apply to the DOJ or the FTC for formal advice, but this procedure does not provide immunity against fines.

Instead, to evaluate the reasonableness of particular restraints of trade, the courts have developed two distinct analytical methods: the *per se rule* and the *rule of reason* analysis.

There are two distinct analysis: the per se rule and the rule of reason.

Under the ***per se rule***, restraints such as price fixing, customer allocation agreements, group boycotts and certain tying arrangements, are deemed to be unlawful without to elaborate inquiry as to the precise harm they have caused or the business excuse for their use. Those agreement which do not fall within the category covered by the per se rule are evaluated under the ***rule of reason***. This rule requires to look at whether the restraint imposed is such as merely favors and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. The rule of reason consists, therefore, in the balance of efficiencies with anti-competitive effects.

In applying the rule of reason, similar to the E.U. Commission's approach, the courts start by identifying the product and geographic market affected by the agreement, and then evaluate the impact of the agreement on price, output and quality in this market. In addition, the courts also consider whether the market identified is concentrated and whether the parties concerned possess a significant market power.

If the transaction is judged to be significantly anti-competitive, expected efficiency gains must, therefore, be evaluated and compared to its negative effects.

The U.S. analysis of agreements, either horizontal or vertical, is apparently similar to Article 81(3) of the EC Treaty, which provides for the evaluation of the pro-competitive benefits of the challenged agreements. The difference between the U.S. and E.U. approaches regarding to vertical agreements is, therefore, not as apparent as it is with regard to vertical mergers.

2.2 A limited application of the efficiency defence in E.U. law

The EC Treaty clearly provides for an efficiency defence; but it is limited by the fact that it is irrelevant to address elimination of competition.

Article 81(1) of the EC Treaty prohibits "*all agreements between undertakings, decisions by associations of undertakings and concerted practices, which may affect trade between member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market*".

This prohibition is tempered by Article 81(3), which states the possibility of an exemption where the agreement brings about economic benefits, such as to contribute to improving the production or distribution of goods or to promoting technical or economic progress, and to allow customers a fair share of the resulting benefit. These benefits must outweigh the reduction in competition in order to qualify for an exemption. Efficiencies are, therefore, taken into account under Article 81(3).

Unlike US, Art 81(3) provides a clear limit to the efficiency defence

However, unlike U.S. law, there is a clear limit to the efficiency defense. First, according to Article 81(3), to be exempted, the agreement must not afford the parties the possibility of eliminating competition in respect of a substantial part of the products in question. Secondly, the agreement must not impose restrictions, which are not indispensable to the attainment of the above-mentioned efficiencies. Moreover, Article 3(g) of the EC Treaty indicates that one of the means of attaining the goals and tasks of the Community is *"a system ensuring that competition in the internal market is not distorted"*.

Consequently, this means that efficiency gains are relevant to qualify for an exemption up to the limit where effective competition, or a substantial part of the products concerned, is eliminated. Maintaining effective competition remains the decisive criterion in E.U. law.

Similar to the E.U. approach in merger cases, the efficiency defence is relevant up to a certain point. This is the creation or strengthening of a dominant position for the evaluation of merger cases, and is the elimination of competition for the evaluation of agreements.

3. Application of the rule of reason and the *per se* rule to vertical agreements in the U.S.

Typically, vertical agreements are assessed under the rule of reason while the per se rule is rather used for the evaluation of horizontal agreements. However, minimum resale price agreements have been held to be illegal per se.[380]

Resale price agreements are illegal per se under US law

Resale price agreements. A minimum resale price agreement concluded between a manufacturer and a dealer is considered as illegal per se. However, a manufacturer is entitled to suggest prices and stop its contractual relationships with its dealers who discount these prices, provided that it does so unilaterally. This is known as the "Colgate doctrine".[381] With regards to maximum resale price maintenance, it is no longer illegal per se since 1997 in *State Oil Co. v. Khan*.[382] It is now subject to the rule of reason examination.

Non price vertical restraints are examined under the rule of reason

Non-price vertical restraints. Non-price vertical agreements mainly include exclusive dealing and exclusive distribution agreements, which are both examined by the FTC under the rule of reason. In an exclusive dealing agreement, a dealer or retailer commit itself to a single manufacturer, while in an exclusive distribution agreement a manufacturer commits itself to a single retailer or dealer. Territorial restraints are also treated under the rule of reason.[383]

Pro-competitive effects. Exclusive dealing may generate pro-competitive benefits. Efficiencies of such agreements have been recognized early in U.S. law. In 1949, in *Standard Oil Co. v. United States*[384], the Supreme Court stated that this type of agreement *"may well be of economic advantage to buyers as well as to sellers, and thus indirectly of advantage to the consuming public. In the case of the buyer, they may assure supply, afford protection against rises in price, enable long-term planning on the basis of known costs, and obviate the expose and risk of storage in the quantity necessary for a commodity having a fluctuating demand. From the seller's point of view, [the contracts] may make possible the substantial reduction of selling expenses, give protection against price fluctuations, and - of particular advantage to a newcomer to the field to whom it is important to know what capital expenditures are justified - offer the possibility of a predictable market"*.

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380 See Business Electronics Corp. v. Sharp Electronic Corp., 485 U.S. 717 (1988); Dr Miles Medical Co. v. John D. Park & Sons, 220 U.S. 373 (1911).

381 United States v. Colgate & Co., 250 U.S. 300 (1919).

382 Case N° 96-871, reprinted in 73 Antitrust & Trade Reg. Rep. (BNA) 452 (Nov. 6, 1997).

383 Continental T.V., Inc v. GTE Sylvania Inc., 433 U.S. 36 (1977).

384 Supreme Court, Standard Oil Co. v. United States, 337 U.S. 293, 306-07 (1949).

More recently, some cases suggested a "safe harbor" for exclusive dealing contracts that foreclose less than 20% of the market and probably even 30%.[385]

FTC Commissioner, Sheila F. Anthony, explained *"when Ford Motor Company requires its dealers to sell only Ford cars and trucks, generally this would be pro-competitive because General Motors has a similar arrangement with its dealers; thus, there is more aggressive competition between the Ford and GM retailers. Similarly, exclusive distributors can be pro-competitive and normally are permissible, particularly when competing manufacturers, selling through other retailers also are present in the market".*[386]

Exclusive agreements can present free riding

As another potential benefit, is that exclusive vertical agreements, while limiting intra-brand competition, can prevent free rider problems and thereby increase overall inter-brand competition. For example when a manufacturer has invested in retail equipments for the sell of its products, an exclusive agreement will ensure that the retailer only sells its brand of that product and that a competitor will not take advantage of its investments.

Anti-competitive effects. Anti-competitive effects may arise from exclusive dealing agreements if they are used to raise rival's costs, foreclose competition, or facilitate tacit collusion. More particularly, exclusive dealing agreements are likely to be prohibited, where manufacturers own a large percentage of market shares, and where the duration of these contracts is important.[387]

Concerning exclusive distribution agreements, Sheila F. Anthony noted that *"a retailer may effectively raise a rival's costs by securing commitments from a sufficient number of manufacturers to prevent a rival from: (i) attaining economies of scale or scope; (ii) obtaining low-cost supplies; (iii) obtaining products necessary to satisfy consumer demand".*[388]

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[385] Jefferson Parish Hospital District, n° 2 v. Hyde, 466 U.S. 2 (1984); Sewell Plastics Inc. v. Coca Cola Co., 720 F. Supp. 1196 (WDNC 1989).

[386] 13th Annual Advanced ALI-ABA Course of Study – Vertical issues in Federal Antitrust Law - Remarks of Commissioner Sheila F. Anthony, March 19, 1998.

[387] See for example Waterous Co. and Hale Products, in which the two dominant manufacturers of fire-engine pumps (both companies represent 90% of the U.S. fire pump market) each entered into exclusive dealing agreements with manufacturers of fire engines. Through these agreements, both companies could charge supra-competitive prices, as each of them could act as a monopolist with regards to its own customers. Thus, these contracts facilitated market division. Moreover, they created barriers to entry, as almost no customers would be available to a potential new entrant (Docket n° C-3693 and C-3694, Nov. 22, 1996). The consent orders prohibited all present and future exclusive dealing arrangements.

[388] 13th Annual Advanced ALI-ABA Course of Study – Vertical issues in Federal Antitrust Law, Remarks of Commissioner Sheila F. Anthony, March 19, 1998.

Non-price vertical agreements on the Internet. The first question at issue is whether the rule of reason, which applies to traditional commercial transactions, is applied in the same way to exclusive agreements concluded between a manufacturer and several ISPs for the sale of its products over the Internet. Some commentators argued that, except if a large part of the market is foreclosed to competitors, an exclusive dealing contract on the Internet usually will not be anti-competitive.[389] The approach should therefore be the same.

For instance, at present the amount of the Internet foreclosed by the exclusive dealing contracts entered into between Amazon.com and several ISPs for the sale of books over the Internet does not raise competitive concerns, even if sales over the Internet is considered as a separate market.

David A. Balto, from the FTC, suggested, however, that the analysis of the degree of foreclosure must be made carefully, as a mere comparison between the percentage of ISPs involved in exclusive agreements with the percentage of those "available" to competitors would deny the fact that some ISPs are far more essential than others. Exclusive agreements can, indeed, be anti-competitive even though a little number of ISPs are concerned.

Furthermore, the analysis must take into account the fact that some products have value only in an Internet marketplace and, consequently, foreclosure of a part of the Internet will pose more risks than foreclosure of a market of products which can also be found on the traditional market.

Another issue is whether a manufacturer can lawfully prohibit its distributors, who sell its products on the traditional market, from selling its products on the Internet.

First, under the "Colgate doctrine", a manufacturer is entitled to deal only with the distributors he wishes. As a result, he may lawfully refuse to supply products to one of its distributors if this one did not respect the prohibition not to sell on the Internet.

The second argument would be that the restriction imposed on the distributors eliminates the risk of free riding and protects the brand. For instance, Tupperware has prohibited all Internet sales by its distributors for the reason that personal demonstrations are necessary for proper sales. Similarly, Levi Strauss has, for a while, reserved all Internet sales to itself, and Nike appointed one retailer to be the exclusive Internet seller of its products.

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[389] David A. Balto, Assistant Director, Office of policy and Evaluation, Bureau of Competition, FTC, "Emerging Antitrust issues In Electronic Commerce", November 12, 1999.

4. U.S. evaluation of efficiencies regarding B2B marketplaces: an example of application of the rule of reason

US evaluation of efficiencies regarding B2B marketplaces

In a workshop organized by the FTC on June 2000, participants characterized B2Bs as both *"the result of and contributing to larger trends in the economy that are already in progress, such as the advent of new technologies and the increasing globalization of markets. The Internet technology that powers B2Bs is potentially Tran formative in that it can speed business-to-business communications into real-time transactions, conducted globally, with heightened accuracy and reduced waste, thus increasing the nation's productivity".*[390]

Efficiencies generated by B2B market places may be tremendous

Participants analyzed the efficiencies generated by B2B electronic marketplaces. These efficiencies may be tremendous, as they can help reduce administrative costs, cut search costs, create new markets, check unmonitored corporate spending, aid efficient joint purchasing, facilitate supply chain management and facilitate efficient collaborations for such projects as joint product design.

(i) Reductions in administrative costs. One of the efficiencies in B2Bs that can ultimately lead to the greatest cost savings for end users is the reduction in business costs made possible by processing administrative transactions electronically. For example, instantaneous, “real-time” online transactions can replace lengthy and expensive phone and fax communications. Naturally, these savings will ultimately be passed on to the consumer, in the form of lower cost products. Another example is the reduction of the cost of remedying incorrect transactions, such as inaccurate orders or replacing faulty goods.

(ii) Reductions in search costs. Because of the Internet, B2Bs can significantly reduce the costs incurred by both buyers and suppliers in locating each other in order to do business. Another aspect is that buyers can more easily comparison shop, which obviously leads to the best prices for them and encourages competition.

(iii) Creation of new markets. An added benefit of the reduction in search costs is that new markets could be created, since previously unviable sales channels could become viable. An example is the market for certain business surplus, especially that of smaller businesses, which would not otherwise have been profitable for the company to try to sell.

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390 FTC report "Entering the 21st Century: Competition Policy in the World of B2B Marketplaces", October 2000, p.1.

See also the FTC Public Workshop on *"Emerging Issues for Competition Policy in the World of E-commerce"*, May 7th and 8th, 2001, available on the FTC website.

(iv) Prevention of "maverick purchasing". "Maverick purchasing" is simply buying that occurs outside of normal channels – it poses a significant problem for business. For example, buyers unaware of a company's volume contracts will make their purchases outside the contract. The advantage of the online nature of a B2B is that centralized purchasing information would make more buyers aware of prior volume contracts, so that they do not buy outside the contracts.

(v) Advantages of joint purchasing. Joint purchasing can reduce company (and customer) costs by leading to economies of scale in purchasing, and by reducing manufacturing costs, for example.
In addition, the purchasing needs of entirely separate businesses can be aggregated, thereby bringing cost savings for the smaller businesses participating.

(vi) Benefits of systems integration. The newest systems can be integrated into a company's older IT and administrative systems so that the entire system operates seamlessly and efficiently. Thus, for example, pre-existing customer order information stored in the company files would not have to be re-entered into the new systems.

(vii) Facilitation of supply chain management. The greater interaction between buyers and suppliers made possible by the new technology can facilitate supply chain management, and thereby enable businesses to focus more accurately on buyer needs. For example, businesses can avoid being overstocked or under stocked, both of which are costly.

(viii) Benefits of collaboration. Outsourcing and collaboration with other businesses can allow the B2B to concentrate on its core activities, thereby avoiding such elements as the direct sales process. The B2B can focus its resources on those areas where it is most effective. In addition, collaboration can facilitate aspects such as joint product design and reduce the time needed to develop, produce and distribute new products.

(ix) Role of middlemen. While a main feature of B2Bs is their elimination of the necessity for middlemen in supplier/buyer transactions, new kinds of middlemen have evolved in the world of B2Bs. The services of these new middlemen generate efficiencies because they allow prospective B2B customers to evaluate the quality of the B2B and whether they want to do business.

However, participants to the workshop noted that *"markets for goods traded on B2Bs (or derived from those traded on B2Bs) might be affected by information-sharing agreements that could facilitate coordination, the exercise of monopsony power by large buying groups, or agreements among competitors to exclude or discriminate against rivals of a B2B's participant-owners. In addition, the health of competition among marketplaces themselves might be affected by exclusivity, either de facto through over-inclusive ownership structures* *or through rules or incentives that keep a B2B's participants from using or supporting a rival exchange".*

B2B Market places are subject to traditional antitrust analysis

Nevertheless, the workshop participants did not consider that these characteristics raised new competition issues. Commissioner Thomas B. Leary mentioned *"the issues in the B2B area are the same kinds of issues that the FTC dealt with in joint venture analysis"*. The participants agreed that B2B marketplaces are subject to traditional antitrust analysis, considering that the *"joint venture analysis and the Competitor Collaboration Guidelines are appropriate in this framework"*.

The FTC practice: the Covisint case.[391] Covisint was the first B2B venture to be reviewed by the FTC. It is a proposed joint venture created between five automotive manufacturers: General Motors Corp., Ford Motor Co., Daimler Chrysler AG; Renault SA and Nissan Motor Co. Ltd; and two information technology firms: Commerce One, Inc and Oracle Corporation. The five automotive manufacturers account for approximately 50% of the total worldwide auto production.

Covisint operates an Internet-based business-to-business exchange (a B2B marketplace) providing services for firms in the automotive industry supply chain. These services include services to assist in product design, supply chain management and procurement functions performed by auto manufacturers and their direct and indirect suppliers.

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[391] See the press release dated September 11, 2000, " FTC Terminates HSR Waiting Period for Covisint B2B Venture"; see also Closing Letter to Counsel for General Motors Corp., Ford Motor Co., and Daimler Chrysler AG; Closing Letter to Counsel for Renault SA; Closing Letter to Counsel for Nissan Motor Co. Ltd; Closing Letter to Counsel for CommerceOne, Inc; Closing Letter to Counsel for Oracle corporation.

For a detailed study of the Covisint case, see paper from David Baley (Harvard Law School) *"Antitrust Implications of B2Bs: Covisint – A Competitive Collaboration?"* on the FTC website. The teaching of this case study is that antitrust should be sensitive to the underlying characteristics of B2Bs, dynamic inter-network rivalry and particular ongoing attention should be given to the way Covisint is utilized.

See also S.DeSanti, *"The Evolution of Electronic B2B Marketplaces"*, SF63 ALI-ABA 201, p 204, American Law Institute - American Bar Association Continuing Legal Education, Sept. 14 2000, (“what is new here? The answer is: the technology”).

In the US Covisint case, the Commission reserves the right to take future action

In notifying the parties, on September the 11th, 2000, that it has closed its investigation of whether Covisint violates Section 7 of the Clayton Act and terminated the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act, the FTC noted that *"this action is not to be construed as a determination that a violation may not have occurred, just as the pendency of an investigation should not be construed as a determination that a violation has occurred*___. Because Covisint is in the early stages of its development and has not yet adopted bylaws, operating rules, or terms for participant access, because it is not yet operational, and in particular because it represents such a large share of the automobile market, we cannot say that implementation of the Covisint venture will not cause competitive concerns. In view of the undeveloped status of Covisint, the Commission reserves the right to take such further action as the public interest may require".___[392]

FTC Chairman Robert Pitofsky stated, *"As we learned at the FTC's workshop in June, B2B electronic marketplaces offer great promise as means through which* ***significant cost savings can be achieved, business processes can be more efficiently organized, and competition may be enhanced.*** *B2Bs have a great potential to benefit both businesses and consumers through increased productivity and lower prices. Of course, as is the case with any joint venture, whether in the traditional or New Economy, B2Bs should be organized and implemented in ways that maintain competition.* ***The antitrust analysis of an individual B2B will be specific to its mission, its structure, its particular market circumstances, procedures and rules for organization and operation, and actual operations and market performance."***

[392] See the Closing Letter mentioned earlier.

Conclusion

As the analysis of the Covisint marketplace shows, the U.S. authorities seem to favor a dynamic approach to competition issues. Indeed, instead of providing a decisive decision on whether or not to oppose to the implementation of the marketplace, they rather left the question opened to see how it will evolve. In this respect, the E.U. Commission's approach to the Covisint marketplace is clearly different, as it has closed the case by a comfort letter.[393]

Moreover, the U.S. authorities generally give more consideration to efficiencies than the E.U.'s, thus giving undertakings active in the different sectors of the New Economy – where innovation is great - more chance to succeed in their vertical integration.

The US approach to vertical agreements and vertical mergers is more dynamic and gives greater consideration to efficiencies

In comparison, the E.U. approach seems to be much more static. As J.F. Pons, Deputy Director General of the DG Competition[394], indicated *"on the law, if parties are proposing a merger or a joint venture, then we do not have the luxury of being able to see how the market develops in the future. We have to take the view on the basis of what we know today […] Applying competition law in New Economy cases is very difficult. The judgments that have to be made are often fines 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. Having to make these judgments in advance is very difficult indeed".*

A recent illustration of the E.U. Commission practice is provided by the abandoned project of *T-Online, TUI and C&N ("Neckermann")*[395] to provide, through a new entity, online leisure-travel services. The E.U. Commission had concerns that due to the strength of the parent companies, the joint venture could progressively have foreclosed the market for online travel. The venture would have had privileged access to the content of TUI and Neckermann, the leading tour operators in Germany, as well as to T-Online's large Internet customer base. As consequence, T-Online indicated that instead of vertically integrating a travel company, it would plan to develop its own online travel agency, what will not require approval from the E.U. Commission.

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393 See Press Release on Covisint, IP/01/1155, 31 July 2001.

394 Speech, European Competition policy in the New Economy, Jean François Pons, Deputy Director General, DG Competition, European Commission, International Competition Policy Conference 2001, Regulatory Policy Institute, Oxford, Tuesday 26 June.

395 See the Commission Press Releases, 8 May 2001 *"Commission opens in-depths probe into travel joint venture T-Online, TUI and Neckermann"*, and 7 June 2001 *"T-Online, TUI and Neckermann withdraw online project"*.

Section II.

Identification and assessment of appropriate remedies in the New Economy

Identification of appropriate remedies in the New Economy

The question of remedies is perhaps the most complex issue to be faced by competition authorities in the next few years.

With respect to the multiple alliances, either agreements or mergers, that have been concluded between businesses of the New Economy and notified to the Commission, particularly in the telecommunications and electronic communications sectors, terminal equipments sector (be it PC, TV or mobile) and media sector, the main competition concerns identified by the Commission can be summarised in one word, that of access.

Access is the key concern in New Economy

With respect to infrastructure, this concern has been identified at both the global communications networks level through the access to the backbone networks[396], and the local networks level through the access to the local loop.[397] Another example is terminal equipment, which is often produced using closed, proprietary standards.[398]

As for B2B marketplaces and portals, the problem of access is also among the first concerns of the Commission in its assessment.

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396 See the WorldCom/MCI merger.

397 See the Telia/Telenor merger.

398 BSkyB/Kirch Pay-TV merger, 21 March 2000, case n° IV/M.0037, Official Journal C 110, 15/04/2000. The risk here was that the company controlling the technology, for instance the set top box for interactive television, uses that control to leverage its position in related markets, for example the pay-television market. In the BSkyB/Kirch Pay-TV merger, the Commission only allowed the parties to proceed on condition that third parties were given non-discriminatory access to the set top boxes. In this case, one of the undertakings offered was to enable providers of digital interactive television services to establish their own technical platform and to compete with Kirch by giving them access to Kirch's pay-TV services. The parties also offered to manufacture decoder boxes using Kirch's conditional access system in combination with other conditional access systems.

1. Advantages and disadvantages of structural and behavioural remedies in the context of the New Economy

There is traditionally a wide range of remedies in merger cases, of a structural or behavioural nature, available to solve the competitive concerns identified by the Commission during its investigation. Structural remedies usually consist of the divestiture of an entire ongoing business and related assets, while behavioural remedies include, for example, offers to grant access to all competitors on a non discriminatory basis, or contractual arrangements, such as an offer to grant licences for intellectual property rights.

Generally, the Commission favours remedies of a structural nature. Nevertheless, due to the long period that these remedies sometimes require before they can be implemented and the uncertainty attached to the quality of the buyer, they may not be the most appropriate ones in the context of the New Economy.

Structural remedies may not be adapted

Whether a remedy is structural or behavioural, the crucial question is whether or not the undertakings proposed by the parties are appropriate to solve the relevant competitive issues. In 1999, in the Gencor case[399], The Court of first instance stated that *"the commitments offered by the undertakings concerned must enable the Commission to conclude that the concentration at issue would not create or strengthen a dominant position within the meaning of Article 2(2) and (3) of the Regulation. The categorisation of a proposed commitment as behavioural or structural is therefore immaterial."*

There are a number of ways for the Commission to deal with anticompetitive concerns in merger cases or anticompetitive agreements. The Commission may consider that anticompetitive concerns may be resolved by the divestiture of an entire ongoing business or a partial divestiture. Equally, a merger or an agreement could be acceptable subject to some contractual undertakings such as the licensing of intellectual property rights or a supply agreement. It may also be decided to use some form of behavioural relief such as a non-exclusivity undertaking or a guaranty of access to third parties under certain conditions. Some mergers or agreements may be resolved by a combination of these various forms of commitments. There may be cases however where the Commission finds that no remedy will resolve the competitive concerns and blocks the transaction.

[399] Court of first instance, *Gencor Ltd / Commission*, 25 March 1999, T-102/96, JOCE n° C 160, 05/06/1999, paragraph 319.

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The Commission has broad discretion in deciding whether any one of these possible remedies is acceptable in a particular case, so long as the remedy will cure the competitive problem.[401]

The Commission has broad discretion in imposing remedies

A first objective must be to determine which remedies would effectively and fully preserve competition and not just provide a vehicle to reduce market share to an acceptable level to meet the dominance test.

A second objective must be to preserve the efficiency enhancing potential of the contemplated transaction to the extent that there may be a number of remedies available with different implications to meet the Commission concerns, the one to be favoured should always be the one more likely to provide or preserve efficiencies. This requires a prospective and not just purely theoretical analysis, "based on experience", short of risking a failed remedy, which ultimately not only does not address the competition concerns but fails to provide benefits for the consumer. As described below, such an analysis is not without difficulties in the current set of procedures in merger cases with tight limits.

The third objective is to select a remedy that will preserve competition with as much certainty as possible. *"The key to the whole question of an antitrust remedy is of course the discovery of measures effective to preserve competition."*[402] Consumers should benefit from the same degree of competition after a merger as before a merger.

The approach towards

The approach to remedies should evolve, as does the approach to

[400] See MCI-WorldCom/Sprint and GE/Honeywell.

[401] Article 2 (2) ECMR: " a concentration which does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded in the common market or in a substantial part of it, shall be declared compatible with the common market."

[402] United States v. EI du Pont de Nemours and Co, 366 US 316, 326 (1961)

remedies should evolve

merger enforcement generally and particularly in the New Economy. Each case provides guidance of what works and what doesn't work. There are no absolute rules. Remedies should be evaluated based on the facts in each individual case. One should also go back and evaluate earlier decisions and decision-making process if expectations are borne out and the remedies are effective.

It has to be said that conduct remedies "*may be unavailing […] in certain cases because innovation to a large degree has already rendered the anti-competitive conduct obsolete.*"[403]

Divestiture presents important disadvantages

Divestiture presents important disadvantages in the context of the New Economy. As compared with behavioural measures, structural remedies appear to be more efficient[404] to solve problems of dominance and less demanding for the Commission.[405] This is because once the divestiture is made, the risk of dominance on the markets concerned and the risk of its abuse, are deemed to be definitely suppressed, and the Commission is not then required to monitor the firm's behaviour during several years.

Divestiture may be complex

However, in practice divestiture is sometimes very complex (i), as it may require a long period (ii); it is costly for the undertakings concerned and uncertain to solve the relevant problems (iii).

(i) As indicated in the Commission Notice on remedies acceptable, "the divested activities must consist of a viable business that, if

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403 US Court of Appeal USA v. Microsoft Corporation June 28, 2001-10-05

404 The Commission notice on remedies acceptable[404] states that *"where a proposed merger threatens to create or strengthen a dominant position which would impede effective competition, the most effective way to restore effective competition, apart from prohibition, is to create the conditions for the emergence of a new competitive entity or for the strengthening of existing competitors via divestiture."*

In the Gencor case, the Court of First Instance similarly acknowledged that *"it is true that commitments which are structural in nature, such as a commitment to reduce the market share of the entity arising from a concentration by the sale of a subsidiary, are, as a rule, preferable from the point of view of the Regulation's objective, inasmuch as they prevent once and for all, or at least for some time, the emergence or strengthening of the dominant position previously identified by the Commission and do not, moreover, require medium or long-term monitoring measures"*. For example, the merger between WorldCom and MCI, two of the main players in the market for top-level connectivity, was cleared under the sole condition that MCI divested its entire Internet business.

405 As mentioned by Christophe de la Rochefordière, Directorate General Competition, unit C-1: *"regulators are not equipped to monitor the incumbents' detailed behavior and prices. Behavioral remedies lead to a cumbersome set of rules, which can hinder competition, instead of promoting it. In particular they often lead to price fixing policies, which are contrary to basic principles of market economy. Instead of this, structural remedies render most of the regulatory package unnecessary, allow for basic competition rules to apply and reduce the scope for anti-competitive behavior. They may allow for the alleviation or even the cancellation of price regulation on retail prices, and potentially its limitation to a key set of access prices";* Competition Policy Newsletter, Number 2, June 2001, p.11.

operated by a suitable purchaser, can compete effectively with the merged entity on a lasting basis. Normally, a viable business is an existing one that can operate on a stand-alone-basis, which means independently of the merging parties as regards the supply of input materials or other forms of cooperation other than during a transitory period".[406] As such divestiture is a complex process. When submitting a divestiture commitment, the parties have to give a precise and exhaustive definition of the assets concerned by the divestment. The description must contain all the elements of the business that are necessary for the business to act as a viable competitor in the market: tangible (such as R & D, production, distribution, sales and marketing activities) and intangible (such as intellectual property rights, goodwill) assets, personnel, supply and sales agreements (with appropriate guarantees about the transferability of these), customer lists, third party service agreements, technical assistance (scope, duration, cost, quality) and so forth. In addition, to avoid any misunderstanding about elements in the business to be divested, assets that are used within the business but that should not, according to the parties, be divested, have to be identified separately.

Divestiture process may last long

(ii) As for the time taken by a divestiture, the divestiture process can last up to eighteen months from the date of the decision, which means twenty-three months after the notification of the project. In its practice, the Commission usually fixes in its decision a period of twelve months for the parties to find a suitable purchaser, and a further period of six months for an independent trustee to sell the relevant assets, at any price, if no purchaser has been proposed by the parties and accepted by the Commission.

Divestiture may be costly and insufficient

During this period, the business is administered by the trustee. In these circumstances, one can wonder whether the business will remain as competitive as it was before in the markets concerned, and whether the assets will maintain their value. Another risk is that the trustee will sell the assets at a low price. Furthermore, the purchaser may be, in fact, unable to exert effective competition with the merging parties because he would have, for instance, overestimated its ability to manage the business or the real value of the assets. One must also note that the trustee is paid by the parties during the entirety of his work.

illustrate these different problems, Mr Rakovsky, Head of Unit, DG Competition B, stated *"in rapidly evolving markets it is crucial that the divested business be stand alone for the acquirer to establish immediately as a genuine competitor. This is particularly the case in the "new economy" industries where time is of essence as illustrated in WorldCom/MCI: although the acquirer, Cable & Wireless managed to maintain the acquired business it was unable to keep the pace with the tremendous growth of the Internet market; its market share shrinked*

[406] Commission Notice on the remedies acceptable, paragraph 14.

dramatically as a consequence of that failure. That is why, in assessing the remedies proposed by the parties in MCI-WorldCom/Sprint, the Commission gave also a particular attention to the length of the transitional period that would be necessary for a potential acquirer to establish on the market as an effective competitor. Moreover, the longer the transitional period the higher the risk of viability of the assets to be divested […]. Here again this risk is particularly material in emerging, high-growth markets ".[407]

In the U.S., *"A Study of the Commission's Divestiture Process"*[408], prepared by the staff of the Bureau of Competition of the Federal Trade Commission in 1999, found that success in finding a suitable purchaser is more likely with the divestiture of an ongoing business rather than with the divestiture of a single product line or proprietary technology. Likewise, divestiture is more likely to be successful if the business is sold to a firm experienced in the same or a related business than to a new entrant. In addition, the Study has confirmed the importance of an "up-front buyer" approach by which the buyer of the assets to be divested is identified earlier in the process.

Behavioural remedies seem to be more adapted

By comparison, behavioural remedies are not such a threat to the continuity of the competitive power of the business to be divested and to the value of the assets. In sectors involving network infrastructure, behavioral remedies are likely to be better than divestiture. As indicated in the Commission Notice on remedies acceptable *"whilst being the preferred remedy, divestiture is not the only remedy acceptable to the Commission. […] Competition problems can also result from specific features, such as the existence of exclusive agreements,* ***the combination of networks ("network effects")*** *or the combination of key patents".*

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407 Claude Rakovsky, Head of Unit, DG Competition B, Merger Task Force, EC Merger Control 10th Anniversary Conference, Brussels 14-15 September 2000, *"Remedies: finding the right cure, the Commission's evolving practice".*

408 *"A Study of the Commission's Divestiture Process",* prepared by the Staff of the Bureau of Competition of the Federal Trade Commission, William J. Baer, Director, 1999.

2. Towards behavioural remedies: the U.S. policy approach towards remedies

Remedies are an example of convergence between the E.U. and the U.S.

The question of remedies is, today, rather an example of convergence than an example of divergence between the E.U. and the U.S. In both countries, most mergers challenges are settled by agreements that consist in restructuring. It is, indeed, well recognized that the most efficient way to restore competition is divestiture, as it permits the emergence of a new competitive entity or the strengthening of a competing company. For instance, in *MCI/WorldCom*, both the European and the U.S. enforcement agencies considered that it was necessary to create a viable competitor that would replace MCI as a major player in the national backbone market, and therefore, they both required the divestiture of MCI's entire Internet business.

However, divestiture is not an absolute guaranty to address competitive problems, where, for example, the buyer lacks of experience on a particular market and then is not in a position to compete effectively with the seller. In order to prevent this risk, the prior acceptance of the buyer is systematic in the E.U. and it requires a detailed analysis of the buyer's ability to run an effective competitive business. In the U.S., even though most restructuring proposals accepted by the FTC were successful, the agencies had to adjust their procedures by insisting more frequently on "up-front identification" of the buyer or by reviewing the buyer's plan.

2.1 The importance of "up-front divestiture" as a remedy

In the U.S. the enforcement agencies have significantly changed their approach to divestiture by requiring parties to identify buyers in advance of their accepting the divestiture settlement. Up-front buyers were used in about 17% of the FTC divestiture orders in 1995, while in 1997 they account for greater than 85% of such consents. In a study on the Divestiture Process[409] in the U.S., the FTC highlighted the importance of the "up-front buyer" approach, currently being used by the FTC. When an up-front divestiture order is issued, the merging parties have to propose a buyer, which will have to prepare and submit its business plan to the FTC. Similarly to the E.U. the parties are prevented from implementing their operation until the proposed buyer is accepted. According to the FTC study, the up-front identification of the buyer is of great efficiency as it both reduces the likelihood that consumers will be harmed while waiting for the divestiture, and also assures that there will be an acceptable buyer.

[409] "A Study of the Commission's Divestiture Process", prepared by the Staff of the Bureau of Competition of the FTC, 1999.

The E.U.'s concern with respect to "up-front divestiture" is of primary importance according to the Commission notice on remedies.[410] The notice indicates, first, that the divested activities must consist of a viable business, which means an existing business that can operate on a "stand-alone-basis". Secondly, these activities must be transferred to a suitable purchaser accepted by the Commission, and which can compete effectively with the merged entity. In assessing the buyer ability to run the to-be-divested business the Commission verifies that the following "purchaser standards are met":

- The purchaser must be a viable existing or potential competitor,
- The purchaser must be independent of and unconnected to the parties,
- The purchaser must possess the financial resources, a proven expertise and must have the incentive to maintain and develop the divested business as an active competitive force in competition with the parties,
- The acquisition of the business must neither be likely to create new competition problems nor give rise to a risk that the implementation of the commitment will be delayed.

In conclusion, there is currently not a significant difference between the E.U. and U.S. in their approach to divestiture.

In industries such as telecommunications and electronics communications, a combination of structural and behavioural remedies may be the best way to address foreclosure concerns

2.2 Remedies available to deal with problems of access to infrastructure

Divestiture is not the only remedy available to restore effective competition, and it may not be the most appropriate one to address problem of access to infrastructure or key technologies.

In industry involving networks such as telecommunications and electronic communications, the competition problem is created by the control of these infrastructures by a small number of companies. Therefore, the issue is mainly one of access to these infrastructures or technologies.

In this type of industry, it is probably the combination of both divestiture and other remedies based on behavioral duties, which may be the best way to address the relevant competition concerns.

In ***Telia/Telenor***, the parties offered a remedy package, among which, notably, they allowed competitors access to their respective local access networks. This undertaking aimed at enabling competitors to establish a sole customer relationship with telecommunications customers. The EU Commission welcomed this undertaking as well as the different divestitures proposed.

In ***Time Warner/Turner Broadcasting System***, the FTC's concern was to ensure that competing cable operators, new technologies and future programmers could gain access to TW/Turner's customers and programming. To achieve this goal,

410 Commission notice on remedies acceptable under Council Regulation n° 4064/89 and under Commission Regulation n° 447/98.

one of the undertakings was that TW would be barred from foreclosing rival programmers from access to its distribution systems.

Behavioral remedies are likely to become more and more important to address problems of access to the specific infrastructures of the telecommunications and the electronic communications sectors.

The US AOL/TW merger is a good illustration of behavioural remedies

The U.S. agencies showed in *AOL/Time Warner* that they were prepared to accept a variety of non-divestiture remedies. In this case, the proposed merger would have lessen competition in the residential broadband Internet access market, undermine AOL's incentive to promote DSL broadband Internet service as an emerging alternative to cable broadband, and restrain competition in the market for interactive television. The FTC has accepted a consent order containing a wide variety of behavioral remedies by which AOL Time Warner would be:

(i) Required to open its cable system to competing ISPs,

(ii) Prohibited from interfering with content passed along the bandwidth contracted for by non-affiliated ISPs and from interfering with the ability of non-affiliated providers of interactive TV services to interact with interactive signals, triggers or content that AOL Time Warner agreed to carry,

(iii) Prevented from discriminating on the basis of affiliation in the transmission of content, or from entering into exclusive arrangements with other cable companies with respect to ISP services or interactive TV services,

(iv) Required to market and offer AOL's digital subscriber line (DSL) services to subscribers in Time Warner cable areas where affiliated cable broadband service is available in the same manner and at the same retail pricing as they do in those areas where affiliated cable broadband ISP service is not available.

At this point in our discussion of remedies for problems of infrastructure access, it seems helpful to give a brief overview of the regulatory system for telecoms in the U.S.

U.S. telecommunications are regulated by the Telecommunications Act of 1996, the aim of which is to liberalize domestic communication markets and increase competition, encourage convergence, lower barriers to entry, eliminate restrictions on cross-ownership and reduce consumer prices.[411]

[411] Kurtin, Owen D. (1998): "U.S. Perspective on Convergence", Telecommunications, Information Technologies and Multimedia Law: Towards a Common Framework", p. 179.

In the Microsoft case, on the 2nd of November 2001, the US Department of Justice has reached a settlement with Microsoft Corporation on the antitrust lawsuit that it filed against Microsoft on 18 May 1998.[412]

The settlement was finalized on 6 November 2001. It imposes a broad range of restrictions designed to stop Microsoft's unlawful conduct, prevent recurrence of similar conduct in the future and restore competition in the software market.[413] This settlement accomplishes this by:

Creating the opportunity for independent software vendors to develop products that will be competitive with Microsoft's middleware products on a function-by-function basis;

Giving computer manufacturers the flexibility to contract with competing software developers and place their middleware products on Microsoft's operating system;

Preventing retaliation against computer manufacturers, software developers, and other industry participants who choose to develop or use competing middleware products; and

Ensuring full compliance with the proposed Final Judgment and providing for swift resolution of technical disputes.

It is modeled on the conduct provisions in the original Final Judgment entered by Judge Jackson in June 2001, but includes key additions and modifications that take into account the current and anticipated changes in the computer industry, including the launch of Microsoft's new Windows XP operating system, and the Court of Appeal's decision revising some of the original liability findings.[414]

The proposed Final Judgment will be in effect for a five-year period and may be extended for an additional two-year period if the Court finds that Microsoft has engaged in multiple violations of the proposed Final Judgment.

The settlement aims to allow competitors to provide and support non-Microsoft software and not be prevented by Microsoft for doing so. However, nine of the eighteen states prosecuting Microsoft for antitrust violations have rejected the settlement agreement and have decided to continue to pursue the case in court. Federal Judge Kollar-Kotelly has stated that she is willing to allow the case to proceed on parallel tracks, with the Department of Justice and the settling states to partake in a series of review hearings that are due to end in February, and the

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412 In its lawsuit against Microsoft, the Department of Justice alleged that Microsoft had unlawfully maintained its monopoly in computer-based operating systems by excluding competing software products that posed a nascent threat to the Windows operating system. This allegation was upheld by the US Court of Appeals on 28 June 2001. Microsoft appealed the ruling to the Supreme Court. On 6 September 2001, the Department of Justice announced that it was dropping the "tying" charge in its lawsuit in order to resolve the case quickly. The charge had alleged that Microsoft had violated antitrust laws by tying its Internet Explorer web browser to Windows. The Department of Justice also stated that it would no longer seek the break-up of Microsoft as a remedy.

413 The proposed final judgment is available on: http://www.usdoj.gov/atr/cases/f9400/9462.htm

414 US Dept of Justice press release 01-569, 2nd November.

opposing states due to submit a proposed set of restraints on Microsoft's business practices at a hearing to be held on 4 March 2002.[415]

It is not yet apparent whether the settlement reached with the Department of Justice will impact on the European Commission's investigation of alleged anti-competitive practices of Microsoft in Europe. EU Competition Commissioner, Mario Monti, has stated that it is too early to assess to what extent the settlement in the US resolves the Commission's competition concerns. A hearing with Microsoft and interested third parties is expected to be held in late December.

The federal regulatory agency for telecommunications is the Federal Communications Commission (FCC), which is in charge of interstate and foreign communications (the various state public utility commissions regulate intrastate communications). The FCC consists of five Commissioners, including a Chairman, appointed by the President for five-year terms. Although the FCC is an independent administrative agency, it is nevertheless subject to Congressional oversight and receives operating funds from Congress[416].

The FCC has a broad statutory mandate to regulate in the public interest, with broad flexibility to develop communications policy and regulations advancing regulatory objectives. The scope of its powers includes the following[417]:

- Supervision of tariffs, practices, classifications and regulations regarding interstate and foreign communications by wire or radio;
- Frequency allocation among the states and communities, and allocation of radio spectrum for non-federal uses;
- Granting of licenses for all types of communications services, including common carrier, satellite and broadcasting services;
- Regulation of PTOs, or “common carriers” by, among other things, requiring annual reports;
- Monitoring and regulation of tariffs and cost allocation;
- Dispute resolution;
- Initiation of investigations based on public complaints;
- Type approval of telecommunications equipment;
- Ensuring universal service to provide high quality service at reasonable prices;
- Regulation of broadcasting, private radio and cable TV;
- Stimulation of innovation and control of discriminatory practices;
- Approval of terms of interconnection agreements.

As for its relationship with other entities, the FCC works with the National Telecommunications and Information Administration as well as with the Commerce Department Commerce, the Defense Department and the State

415 Financial Times, 6th November, 2001; The New York Times, 9th November, 2001.

416 Stafilidou, Maria (1996): “Cross-Country Survey of Telecommunications Regulatory Structures”, PSD Occasional Paper #24, the World Bank.

417 Id.

Department (when national security or international issues are involved)[418]. The federal courts review the actions and decisions of the FCC, and its decisions can be appealed up to the US Supreme Court[419].

3. Towards sophisticated packages including both structural and behavioral remedies

Recent merger decisions illustrate that the right answer in the New Economy is probably a mix of structural and behavioral measures.

The right answer to competitive restraints: a mix of structural and behavioural remedies

In *Vodafone Airtouch / Mannesmann*[420], the Commission requested divestiture of mobile networks in two national markets to eliminate overlaps, and it also accepted undertakings aiming at enabling third party non-discriminatory access to the merged entities integrated networks and granting access for competitors to the market for competitive seamless pan-European mobile services. In this case the undertakings were limited to three years, given the roll out of third generation mobile networks and the expected growth of real alternatives to Vodafone/Airtouch's network footprint. A similar line was taken in the Telia/Telenor merger where the Commission accepted a number of divestiture commitments and requested additional access commitments regarding local loops in Sweden and Norway.

Similarly, in the U.S., the competition authorities have to deal with more and more complex commitments, quoting Pitofsky: *"in recent years, the enforcement agencies in their merger review have been offered more ambitious and complicated restructuring proposals to address overlaps and other potential anti-competitive effects".*[421]

This approach guaranties:

Competitor market structure

Reward for innovation

This approach should be followed in the analytical process of the Commission in the future. According to Herbert Ungerer, *"In many cases antitrust regulators will search for an optimal mix of structural and behavioural remedies, in order to guarantee the development of competitive market structures on the one hand, and the fair remuneration of the innovator's high-risk investment (the motor of the New Economy) on the other. Antitrust decisions of the future will have more and more global implications and will raise increasingly complex global enforcement issues. Securing access to all levels of the new networked economy for market actors will be in the focus of international antitrust development".*[422]

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418 Id.

419 Id.

420 Commission decision of 12/04/2000, Case n° IV/M.1795 - Vodafone Airtouch/Mannesmann).

421 Robert Pitofksy, Chairman, FTC, *"The Nature and Limits of restructuring in Merger Review"*; Cutting Edge Antitrust Conference, February 17, 2000, New York.

422 Herbert Ungerer, Adviser DGCOMP, European Commission, *"Access issues under EU Regulation and antitrust law – The case of telecommunications and Internet markets"*, Conference, June 23-24, 2000, Washington D.C.

Particular problems arise if complex remedy packages -partly structural and partly behavioral- must be administered. It is crucial whether or not the Commission may reject commitments because their complexity overburdens its administration.

Quoting Mario Monti: *"it is our role to decide whether or not to approve a deal based on an entire package of remedies,* ***parties would be wise to hesitate before making the package too complex. To do so can cast doubt on the viability of the whole exercise, and I therefore urge companies to keep this in mind when presenting their proposals to the Commission****. The issues we face in merger control are already complex enough, without the addition of yet another dimension of complexity"*[423]

Rejection of complex commitment packages should not be at the expense of measures, which, whilst complex to monitor, preserve competition and the efficiency of a merger to the extent that such remedies effectively and fully preserve competition.

Complex packages may be difficult to handle

The best illustration of a complex package and concerns expressed above is the decision prohibiting the merger between MCI-WorldCom and Sprint. In this case, the Commission was concerned that no viable competitor would emerge because Sprint's Internet business to be divested was closely intertwined with Sprint's telecommunications activities. To address this issue, the parties suggested that the acquirer of the assets would enter a series of transitional support agreements with the respondent, such as the collocation of certain facilities, network transport and local access. According to the Commission '*it may be argued that a trustee could be put in place to monitor the proper implementation of the collocation, network transport, local access and other operational support systems agreements and ensure that the merged entity could not hinder in any way the development and independence of the divested entity.* ***However, such a task would be extremely complex and the undertakings would be difficult to monitor. It would require many staff and skills and extended powers would have to be attributed to the trustee. Even assuming that a trustee with such extended talents could be found, the degree of complexity of the task increases materially the uncertainties attached to the effectiveness of the realisation of the remedy".***[424]

Complex commitments should not be rejected merely on the basis of their

Delimitation of Commission discretion to ask for commitment. This raises a number of important questions and imposes a special duty in assessing sophisticated and complex packages, which in some cases are rendered necessary to address problems of market dominance and maintenance of effective competition in proactive markets.

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[423] Mario Monti, Washington, 26 June 2000, *"A European Competition Policy for today and tomorrow"*, Conference jointly hosted by the AEI-Brookings Joint Center for Regulatory Studies, the Section of Antitrust Law of the American Bar Association, and the District of Columbia Bar Association's Antitrust Committee of the International Law Section.

[424] MCI-WorldCom/Sprint, case n° COMP/M.1741, paragraphs 402 and 403.

complexity

The simple fact that behavioural commitments need to be administered and controlled and that they may be more difficult and time consuming to handle and to be followed by the parties, should have no bearing on their legality.

Any arguments that complex divestiture packages do not remove doubts with respect to the compatibility of the contemplated concentration with the common market would not be in our view admissible. It would infringe on the general principle of Community Law that the parties should be treated according to the principle of proportionality basics rights and receive clearance as soon as the issues of dominance and effective competition have been taken care of, irrespective of whether the removal is rather easy or more complex.[425]

Complex commitment packages should not be rejected merely on the basis of their complexity. A prohibition could only be justified if uncertainties remain with respect to the removal of market dominance and maintenance of effective competition, which have not been addressed in the commitments. Uncertainties may arise if the parties do not succeed in implementing a given undertaking.

Time limits are tough for companies

Regulation No 447/98[426] provides for strict time limits in first and second phase proceedings to propose commitments. Even though the time limit for a decision in first phase proceedings has been extended, time limits are tough for companies and put great pressure on them. In practice, first phase commitments have been given if the parties have had extensive discussions with the Merger Task Force before filing a formal notification and before any deadline started running.[427]This is certainly an area where the proposed amendments to ECMR will need to provide adequate answers.

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[425] See art 10 (2) ECMR.

[426] Regulation 447/98 of 1 march 1998 on the Notifications, time limits and hearings.

[427] EC Merger Control Tenth Anniversary Conference 14th and 15th September 2000, *"Remedies: finding the right cure"*, by Cornelis Canenbley, Freshfields Bruckhaus Deringer.

4. The current instruments should be reconsidered

New sets of standards required

New sets of standards required. It follows that New Economy cases require new sets of standards to deal with their very specific nature if sophisticated sets of commitments are the answer to ensuring a fair settlement of these cases. Appropriate administrative procedures and a new approach should be considered. The time frame provided by the ECMR may in many cases be too short for a proper evaluation of the potential impacts of such types of remedies. Whilst structural remedies necessarily need to be addressed within such time frame to provide certainty, efficiencies of behavioural remedies should be allowed to be reassessed overtime and reinforced or strengthened where necessary or equally softened when real effect in the market place can be better evaluated, through time and business conduct.

Need for a separate enforcement division with wide powers

It is acknowledged that this requires close administration and it is important that staff is dedicated to it with a separate enforcement division. This staff, which has recently been constituted in the E.U., must have wide powers to ensure effective implementation of the remedies, such as the possibility to order violations, and a great expertise in this area in order to help to ensure that best practices in negotiating, drafting, and enforcing commitments are developed and followed across the Competition Directorate. Its participation in the decision making process must ensure consistency of approach. The MTF should consider a seamless team comprising those investigating the merger and those evaluating remedies.

Appointment of an independent trustee

Further consideration should be given to systematically appoint an independent trustee, acting on behalf of the Commission, in charge of monitoring and enforcing remedies on an ongoing basis. This releases the Commission from the difficult task of ensuring the implementation of these remedies and, accordingly, offers more guaranty of effectiveness.

Lessons from IBM undertakings

Lessons could also be drawn from the IBM undertaking of 1984[428] whereby IBM was required to disclose interface information to those competitors who asked to be provided with this information and was further required to sign seven technical information disclosure agreements with those competitors who had asked for such agreements as well as three sub-contractor confidential disclosure agreements. Those agreements are believed to contain dispute resolution provisions in order to allow both IBM and competitors to primarily settle in a breach of the relevant undertaking placing the onus on them as to any potential breach hence using claims to the Commission as an ultimate recourse.

However, it did not require IBM to disclose source code or any information about the design or internal operation of its products. Instead, IBM had only to disclose that which “describes function visible to the customer in sufficient detail to permit effective use of the function without describing design or implementation details of a specific realization”. Other protections

[428] 1984 IBM Undertaking at Bull. EC 10-1984, pages 96-103.

reserved to IBM included the right to charge a reasonable royalty, a right to require reciprocal disclosure of relevant non-IBM interface information, and a right to inspect competitor's source code to ensure against copying of protected expression in the event that IBM opted to provide source code in lieu of interface information.

Interestingly, the Commission itself recognized the implications that forced disclosure of information about the design and internal operation of IBM's products would have on the company's incentives to innovate. 212 requests for information, seven contracts and 3 sub-contracts were entered into. The remedy expired in 1994 with effect from July 6th 1995. The Commission reserves the right to pursue any complaint brought by third parties under article 82 (ex 86) with respect to IBM conduct post remedy.

Remedies must be reasonable and duly justified

Remedies must be reasonable and duly justified. Competition is dynamic, however, with specific characteristics, high fixed costs, low marginal production costs, network effects and extreme sensitivity to innovation and fragility of improved new technologies, which may potentially override first mover advantage. Any suggestion to apply remedies, which prima facie would satisfy mitigating the dominance test, should be weighted against their inherent potential adverse effects on the incumbents. As said before in numerous occasions the risk is not just about establishing market dominance but maintaining technological advance and leadership at the risk of being overtaken by others.

Remedies should in no circumstance unreasonably favor competitors to the detriment of first entrant and indeed consumers. If both tests are not satisfied, the proposed remedy should be disregarded.

Any such analysis requires a full competitive assessment of any given situation.

The essential facility doctrine can be easily invoked to justify an obligation for a dominant firm to share its assets with its competitor. However, in a market place where dominance is by essence fragile and temporary,[429] there must be unambiguous evidence that the facility is an essential input access to which it is necessary to access. The fact that it is less costly would not suffice.[430]

Need for a full competition assessment

The key issue should be whether the access is mandatory where entry is commercially unfeasible and inefficient such as access to the local loop in the sense of state monopolies, which are currently under the Commission scrutiny where it is entirely justified.[431] It should not be driven by simple costs efficiency considerations at the expenses of innovator's sunken costs in R&D. There may indeed even be instances in innovative environment for a competitor to turn around what might appear as a bottleneck using different principles through its own R&D.

Equally, many integration decisions and exclusivity agreements are typically driven by efficiency considerations, which might be entirely justified by the investment costs in innovation at least for a reasonable period of time in order to preserve a justified competitive edge.

429 Innovation necessarily potentially implies some form of temporary dominance through the development of entirely new products and technologies sensitive to potential new or enhanced products not sensitive to price increases given their unique characteristics at each step of innovation.

430 *"It is important not to loose sight of the fact that the primary purpose of Article [82] is to prevent distortion of competition – and in particular to safeguard the interest of consumers – rather than to protect the position of particular competitors"*, Advocate General Jacob, Case C-7/79 Oscar Bronner v. Mediaprint.

431 See the Telia/Telenor merger where the Commission accepted a number of divestiture commitments and requested additional access commitments regarding local loops in Sweden and Norway.

R&D licensing should also be considered with care as it could potentially reduce incentive to invest and innovate. Free ride or easy access to available innovation diminishes the incentive to innovate of other market participants; it may distort the nature of the investments since the more unique innovation is the more likely the third parties would want to share it.

The justification in terms of competition policy for interfering with a dominant undertaking's freedom to contract often requires a careful balancing of conflicting considerations. In order for refusal of access to amount to an abuse, it must be extremely difficult not merely for the undertaking demanding access but for any other undertaking to compete. 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 the purpose of its business. Particular care is required where the goods or services or facilities to which access is demanded represent the fruit of substantial investment. That may be true in particular in relation to the refusal to license intellectual property rights.[432]

List of possible behavioural remedies

Types of behavioral remedies, which could be considered. The following list provides some indications as to the potential areas where behavioral remedies could be applied and indeed reassessed or even revised over a certain period of time and following a full competition analysis to account for specific circumstances of each case (products, marketplaces, level of investment, sunk costs, network effects, etc…)

Infra-structure

Infrastructure: To prevent (i) Refusal of access; (ii) Raise of rivals' costs; (iii) Degradation to offering and/or the quality offered by competitors; (iv) Selective pricing to attract customers away from competitors; (v) Control of market entry by denying new peering requests, foreclosing or threatening to foreclose peering agreements, replacing them with paid interconnection; (vi) "Exclusive bundling" of products.[433]

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432 Advocate General Jacob, Case C-7/79 Oscar Bronner v. Mediaprint.

433 See WorldCom/MCI and MCI-WorldCom/Sprint decisions.

Portals: To prevent consumers (i) To choose their content provider independently of their access provider; (ii) To use the portal as an exclusive or preferable outlet for the delivery of music or films; (iii) To deprive competitors of the access to music and films library.

To ensure that (i) The default portal be changed, if the consumer so wishes; (ii) The consumers can access third party portals; (iii) The consumers can change the default portal themselves; (iv) The consumers can authorize a third party portal operator to change the default portal for them.

Portals

By way of illustration, in the Vodafone/Vivendi/Canal+ merger, the Commission's investigation has showed that the joint venture "Vizzavi", which develops and provides a branded multi-access Internet portal throughout Europe would have led to competitive concerns in the developing national markets for TV-based Internet portals and developing national and pan-European markets for mobile phone based Internet portals. The Commission's objective was to ensure that consumers could choose their content provider independently of their access provider. To address these concerns, the parties provided undertakings ensuring that:

- The default portal can be changed, if the consumer so wishes;
- The consumers can access third party portals;
- The consumers can change the default portal themselves;
- The consumers can authorize a third party portal operator to change the default portal for them.

Marketplace

Marketplace: To ensure that: (i) The marketplace is opened to all firms in the industry on a non-discriminatory basis; (ii) It is based on open standards; (iii) It allows both shareholders and other users to participate in other B2B exchanges; (iv) It provides for adequate data protection, including firewalls and security rules.[434]

Necessity to grant temporary relief

Considerations for temporary relief. Market power in the New Economy is well recognised as being temporary and fragile with the need for market leaders to continue to innovate, to compete for their installed base and to maintain their competitive edge. Rapid technological changes lead to markets in which firms compete for innovation for temporary market dominance from which they may be displaced by the next wave of products advancement. In such dynamic markets and competition where high fixed costs and network effects are essential to preserve their technological lead against the risk of being overtaken by new entrants, considerations should be given to allow temporary relief from undertakings which could be considered appropriate to effective competition in a more traditional static environment. Temporary relief from providing access rights or temporary exclusivity should not be excluded and reviewed after a reasonable time period. Equally, undertakings could also be either limited in time to allow market forces to develop but not unduly. Specific review and assessment should be considered after a pre-determined period of time as by way of illustration in the Vodafone merger. This kind of approach would be similar to the customary practice developed under Article 81 §3.

[434] See the press release on the Covisint decision.

The above, although primarily focused on merger cases, could equally be considered under Regulation n°17 with guidance provided to national competition authorities and courts when dealing with exemptions under Article 81 §3. This highlights to the extent necessary some of the problems inherent to the White Paper on Modernization of the rules implementing Articles 81 and 82 of the Treaty.

Section III.

Recommendations

Recommendations

1. **Amendments to the current EU regulatory instruments are not necessarily required to make a dynamic analysis operable in the E.U.**

The existing instruments can be relied on but should be read with more consideration given to efficiencies

Despite a few cases that might suggest otherwise, antitrust operates more as a system of deterrence than as a system of regulation. It shapes economic behaviour by attaching legal risk to certain forms of conduct under certain conditions. A classic problem in the design of antitrust policy is how to deter conduct that is anticompetitive and welfare reducing, while not discouraging the very pro-competitive, welfare-enhancing competition that antitrust is designed to protect. This classic problem persists in New Economy industries. It is necessary for competition authorities to focus today on the vigour of dynamic 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 entry powered by drastic innovation. There are many things, such as price fixing, merger to monopoly, or foreclosure of essential distribution channels, that the New Economy companies with substantial market power could in principle do to reduce competition. Of course such conduct is and should be illegal.

In order to achieve this objective, it has been argued that the existing instruments are not designed to address this kind of dynamic analysis and more specifically the merger control Regulation[435] which is arguably driven essentially by asserting dominance or strengthening dominance, as opposed to the approach taken in assessing agreements according to Article 81 §3 and Regulation n°17.

[435] Council Regulation (EEC) n° 4064/89.

The Commission relies heavily on the classical test of dominance provided for in Article 2 paragraph 2 ECMR: '*a concentration which does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded in the common market or in a substantial part of it shall be declared compatible with the common market".* This test translates a classical static approach in terms of market shares and market power and suggests that the Commission is not prepared to balance efficiencies with dominance once the level of dominance has been reached. Maintenance or preservation of competitive market prevails over any other consideration. This view is enshrined in Commission decision-making process since as early as De Havilland[436] decision. The Commission made it surprisingly clear in a competition policy roundtable of the OECD that *"there is no real legal possibility of justifying an efficiency defense under the merger Regulation. Efficiencies are assumed for all mergers up to the limit of dominance-the "concentration privilege". Any efficiency issue are considered in the overall assessment to determine whether dominance has been created or strengthened and not to justify or mitigate that dominance in order to clear a concentration which would otherwise be prohibited".*[437]

Concentrations: Dominance test applied under ECMR constitutes a too narrow criteria

We would contend that there is nothing in the ECMR, which prevents applying a dynamic approach to justify temporary dominance in a fast moving competitive environment ("fragile monopolist, winner takes most"…). We would argue that the dynamic approach in relation to mergers in the New Economy is specifically provided for in the ECMR. Indeed, Article 2 §2 should not be read in isolation. Article 2 paragraph 1 (thus coming before the dominance test) specifically provides that '*In making his appraisal of mergers, the Commission shall take into account the need to maintain and develop effective competition within the common market (…), the market position of the undertakings concerned and their economic and financial power, the alternatives available to suppliers and users, their access to supplies or market, any legal or other barriers to entry, supply and demand trends, the interest of consumers, and the developments of technical and economic progress provided that it is to consumer's advantage and does not form an obstacle to competition*".

ECMR Article 2 §1 referring to the development of technical and economic progress should be given more consideration in such an innovative environment

Whereas n°13 goes on saying '*Whereas it is necessary to establish whether concentrations with a community dimension are compatible or not with the common market from the point of view of the need to preserve and develop effective competition in the common market; whereas, in so doing, the Commission must place its appraisal within the general framework of the achievement of the fundamental objectives referred to in article 2 of the Treaty*".

Article 2(1) and 2(2) are complementary. They should not be read in isolation. They allow for the specific treatment of efficiencies to justify the creation of a temporary dominant position, whilst preserving and developing effective competition in the common market. The adoption of

436 Case N° IV/M.53, OJ L 334/42 (1991).

437 OCED/GD (96) 65 *"Efficiency claims in Merger and other Horizontal Agreements"*.

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

Dynamic approach entrenched in Art.81(3)

In the field of agreements, a dynamic approach is entrenched in art 81 §3 in relation to the granting of exemptions. In its assessment, the Commission systematically balances anticompetitive harms with pro-competitive efficiencies.[438]

Need for innovation. The new issues involved by the New Economy call for innovative and evolving case law. It is does not appear to be sufficient to rely on existing principles howsoever entrenched they might be in the Commission practice and case law.

Well-established principles can always be reversed to deal with specific issues raised by the New Economy

In this regard, the recent decision of the U.S. Court of Appeal of June 28, 2001[439] in the Microsoft case is good food for thought for those who fear deriving from well-established principles or case law. In the particular instance, the Court of Appeal did not fear to revert a well-established case-law which dates back to the late forties that bundling was “per se” illegal[440] and apply a rule of reason test by saying *"the separate product test is a poor proxy for net efficiency from newly integrated products;[…] because of the pervasively innovative character of platform software markets, tying in such markets may produce efficiencies that courts have not encountered previously."*[441]

This shows that even well established case law can and does evolve in order to adapt to the new challenges induced by the New Economy. Accordingly European competition authorities should approach mergers on a dynamic rule of reason test, thus adapting existing case law. As suggested above, nothing in ECMR, nor in Article 81 §3 test, prevents them from doing so.

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438 Article 81 §3 states: *"The provisions of paragraph 1 may be declared inapplicable in the case of any agreement or category of agreements between undertakings (…) which contributes to improving the production or distribution of goods or promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not (a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives; (b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question".*

439 United States Court of Appeals for the District of Columbia Circuit, United States of America v. Microsoft Corporation, Appeals from the U.S District Court for the District of Columbia.

440 The first case to give content to the separate products approach was *Jefferson Parish*, Docket 466 U.S. 2.

441 US Court of Appeals June 28, 2001 N°00-5212 USA v. Microsoft.

2. Considerations to be given to clarify the existing instruments or consider notices or guidelines in targeted areas

With respect to concentrations

Efficiencies should be balanced with anti-competitive effects on an equal footing

In order to cope with a more dynamic analysis, Article 2 §1 and Article 2 §2 of the Merger Control Regulation should be treated on an equal footing. This would allow a better balance between the efficiencies and the anticompetitive concerns resulting from the merger. Accordingly, the well-established principle by which *"efficiencies are assumed for all mergers up to the limit of dominance"*[442] should no longer be applied as such.

Dominance seems inherent to the New Economy. However it is fragile and temporary

minance for most New Economy industries does not have the same meaning as in traditional economy. Dominance can be considered as inherent to the New Economy, as it often involves emerging markets where limited or no competition yet exists. Moreover, dominance is usually fragile and temporary as any new technology may be rapidly superseded by another one. Therefore, even though the proposed merger creates or strengthens a dominant position, this does not automatically mean as a result that *"effective competition would be significantly impeded in the common market"*.

The emergence of new markets requires a dynamic appraisal of concentra-tions

As to the market definition and the appraisal of market power, the current Commission notice can be considered as sufficient provided that the criteria are applied with a prospective approach. The traditional hypothetical monopolist test should be used carefully given the lack of available information on historical price fluctuations and price movements. The emergence of new markets requires criteria based on the analysis of the functionality of the products.

Sophisticated packages of commitments should not be rejected on the basis of their complexity

ncerning remedies, the Commission should be better prepared to deal with sophisticated packages of commitments as vertical mergers between firms of the New Economy often involves integration of intertwined activities comprising the provision of both access and content. The complexity is, in a way, generally inherent to the sectors of the New Economy. Therefore, the "complexity" that the Commission invoked to reject remedies should no longer be as a decisive argument as it is today.

cordingly, the current notice on remedies acceptable should be reviewed in order to consider sophisticated commitments as measures to be dealt with rather than as measures unlikely to solve the competitive concerns.

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442 See the Competition Policy Roundtable of the OCDE, OCDE/GD(96)65 *"Efficiency claims in Mergers and other Horizontal Agreements"*.

2.2 *Specific instruments are needed to deal with vertical agreements, portals, marketplaces and infrastructure issues*

2.2.1 With respect to vertical agreements, apparently, the new Block Exemptions Regulation and the guidelines on vertical restraints, far from dealing with all New Economy issues, seem to have been designed to provide guidance for traditional sectors, with some limited consideration to the Internet when included in their distribution network.[443]

Specific notices or guidelines are required to deal with portals, marketplaces and infrastructure issues

refore, it might be necessary to provide notices or guidelines addressing these issues and those raised by portals, B2B and B2C marketplaces and infrastructure. A more dynamic approach should also be considered for the definition of the markets and the appraisal of market power and dominance. This is all the more required that with the coming reform of Regulation n° 17, the businesses will need to form their own views on compatibility.

2 With respect to portals, the new sets of rules would aim at providing practical tools to the businesses allowing them to check on a legal certainty that their alliance comply with the competition standards. These rules would have to ensure that the consumers can choose their content provider independently of their access provider. Particularly, they would have to indicate that:

- The default portal can be changed, if the consumer so wishes;
- The consumers can access third party portals;
- The consumers can change the default portal themselves;
- The consumers can authorize a third party portal operator to change the default portal for them.

3 With respect to B2B and B2C Marketplaces, new instruments would have to ensure that:

- The marketplace is opened to all firms in the industry on a non-discriminatory basis;
- It is based on open standards;
- It allows both shareholders and other users to participate in other B2B exchanges;
- It provides for adequate data protection, including firewalls and security rules.

[443] Guidelines on vertical restraints focus on the restrictions imposed on distributors by suppliers for the use of the Internet to sell their products.

The proposed regulatory framework is not sufficient

2.2.4 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 the potential issues, as they are entirely based on traditional criteria. The objective of a new set of rules would be to prevent the following practices:

- Refusal of access;
- Raise of rivals' costs;
- Degradation to offering and/or the quality offered by competitors;
- Selective pricing to attract customers away from competitors;
- Control of market entry by denying new peering requests, foreclosing or threatening to foreclose peering agreements, replacing them with paid interconnection;
- "Exclusive bundling" of products.

3. Need for an international consistency of approach

Necessity to develop common principles on a multilateral basis

Mergers which need approval from the EU Commission as well as from the US antitrust authorities (and may be from other jurisdictions) should be dealt with by the authorities simultaneously and be decided upon within the same timeframe. One of the reasons for this lack of coordination is the difference in procedural rules. Whereas under the ECMR there are fixed deadlines within which the Commission may investigate and must decide on a notified merger, such fixed deadlines do not exist under US merger control law once the authority has issued a second request.

Given the strong network externalities of the New Economy, access to global connectivity is bound to become a major and permanent issue in international antitrust.

Many layers of the Internet are potential bottleneck candidates. A well-known example is access to the Internet address space, the logical core of the Internet and the root servers. Other effects of high concentration of market power at the "top-level" may be seen at the level of the so-called certification and trust services, the billing and payment systems being built up to underpin worldwide transactions for e-commerce both by existing credit card companies and others, and, of course, in the well-known case of browser access software. Even in the e-commerce field which is generally seen as an area of low entry costs and, therefore, highly competitive, strong externality effects may start to work and global access issues may arise. On-line auction markets may become an example[444], while business-to-business (B2B) exchanges grouping major companies at a global level for negotiating supply and demand may become another.

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 in international antitrust in dealing with the New Economy effects will become a first-priority issue.

This issue is complicated because in a number of cases the development of innovative markets passes through a temporary strong market position or monopoly by lead actors. In many cases, antitrust regulators will search for an optimal mix of structural and behavioural remedies, in order to guarantee the development of competitive market structures on the one hand and the fair remuneration of the innovator's high-risk investment (the motor of the New Economy) on the other. Antitrust decisions of the future will have more and more global implications and will raise increasingly complex global enforcement issues. Securing access to all levels of the new-networked economy for market actors will be in the focus of international antitrust developments.[445]

What is needed today to deal with international cooperation in the field of antitrust policy is a forum focused especially on the substantive issues surrounding international antitrust enforcement. Some international organizations have already addressed this kind of issues on a multilateral basis. Among them, the OECD Competition Law and Policy Committee, the UNCTAD's Intergovernmental group of experts on Competition law and the WTO Working group on Trade and competition policy have played a great role in reaching consensus on many antitrust issues. In that regard, the Fourth WTO Ministerial Conference to be held at Doha in November 2001 should launch negotiations to come to a "*realistic competition agreement establishing a solid basis for international cooperation against anti-competitive practices with an impact on international trade*". However, the broad mandates of those International Organizations make them unsuitable to

444 Alan Murray in Wall Street Journal 9 June 2000: *"Ebay Inc dominates the online auction market because it is the biggest. Sellers go there to reach the most buyers; buyers go there to reach the most sellers".*

445 "*Access issues under EU regulation and antitrust law- the case of telecommunications and internet markets"* Conference June 23-24 Washington DC- The University of Oklahoma College of law and the centre for global partnership- the Japan foundation.

deal practically with complex enforcement issues such as those involved by the New Economy.

The GCI seems adapted to provide some guidance

In that regard, the **Global Competition Initiative (GCI**), as a new and different forum focusing only on competition issues, seems more adapted to the recent developments to be faced with in the field of New Economy. Joel Klein, ex-U.S. antitrust chief, proposed the creation of this GCI in September 2000: "*The rate of economic internationalization will increase in the years ahead and increase dramatically -- beyond what most people are predicting and beyond what many people will be comfortable with," […] "the burdens on international cooperation and coordination among various national antitrust authorities will likewise increase; as markets become more global, the number of countries having a legitimate enforcement interest in a particular merger will increase as well. This creates a whole host of problems -- substantively and procedurally -- about simultaneous review and the implications of one competition authority's actions for the actions of other authorities".*[446]

European DG for Competition has fully supported this idea from the beginning. Mario Monti, on the 4th July 2001 declared: "*The time is ripe to profit from our experience with bilateral instruments and use their tools to put in place a more open and inclusive cooperation framework […] there is a broad consensus on the need and the timeliness of a Global Competition Initiative in view of the rapid transformation in the world economy"*[447].

This GCI would be a forum for antitrust agencies from developed and developing countries to formulate and develop consensus on proposals for procedural and substantive convergence in antitrust enforcement.

According to Mario Monti[448], the GCI should be expected to discuss the following issues:

- It would address enforcement issues;

- It would tackle systemic issues related to the application of the principles of good governance in the area of competition law and policy;

- The forum would formulate substantive competition rules and economic analysis in cases having a prominent international component;

- Finally, the forum would consider topics, which are important for developing countries.

446 Joel Klein *"Time for a global competition initiative?"* EC Merger control 10th anniversary Conference, September 14, 2000.

447 Speech by Mario Monti *"International co-operation and technical assistance: a view from the EU"*. UNCTAD 3rd IGE Session Geneva, 4 July 2001.

448 Speech by Mario Monti "*International co-operation and technical assistance: a view from the EU*". UNCTAD 3rd IGE Session Geneva, 4 July 2001.

The GCI can provide recommenda-tions

Practically, the CGI would work as follows: it would focus on a small number of issues called "projects" and selected sufficiently far in advance in order to permit constructive dialogs and large participation. Those projects would be aimed at leading to non-binding general guidelines or "best practice" recommendations. Where the GCI would reach consensus, it would belong to governments to implement them on a voluntary basis through unilateral or multilateral arrangements. Consideration should be given to entertain participation of the private sector in this new forum.

Practitioners and business people should have a major role to play in identifying projects and developing work plans. International organizations could also participate and be called upon to contribute.

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