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DIPLOMA THESIS

EU's Competition Policy v. USA's Antitrust

Key Differences to Know

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Academic Year: 2009/2010

Declaration

Hereby I declare that I compiled this diploma thesis independently, using only the listed literature and resources.

Prague May 20th, 2010

Petra Lu á ková

Acknowledgments

I would like to express thanks to my supervisor Ing. Zdeněk Hrubý, CSc. for his valuable advice, useful comments, important insights and all the help.

I am grateful for being a Charles University student. The perspectives I got and people I met throughout my studies have influenced my life in many good ways.

Last but not least my thanks belong to my family for their immense support.

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Abstract

This thesis is a comparative study of European competition policy and American antitrust. It introduces both policies and focuses mostly on key differences between them, especially on the non-price vertical restraints and monopoly pricing. The economic theory is indecisive about the effects of vertical agreements on competition. The EU finds them often anticompetitive compared to the U.S. that believes in their procompetitive or neutral impact. The case studies illustrate how antitrust measures are applied and what consequences they might have in terms of market structure, innovation, motivation or deterrence. The findings are backed by law systems, historical development and in particular by economic discussion of antitrust efficiency. The analysis suggests that without a suitable economic theory that would explain the outcome of market interventions as well as corresponding welfare effects the differences are hard to overcome.

Key words: antitrust, competition policy, vertical mergers, monopoly pricing, Article 81(101) and 82(102) of the EC Treaty, Sherman Act

Bibliographic notation

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Ochrana hospodářské soutěže – politika Evropské unie v. politika Spojených států amerických

Zásadní rozdíly

Abstrakt

Práce porovnává politiku na ochranu hospodářské soutěže v Evropské unii s politikou Spojených států amerických. Jednak představuje přístupy obou států k této problematice, ale zaměřuje se především na zásadní rozdíly mezi nimi. Soustředí se především na různý postoj k vertikálním dohodám mezi firmami a monopolní cenu. Ekonomická teorie nedává jasné závěry o vlivu vertikálních dohod na hospodářskou soutěž. Evropská unie je často považuje za protizákonné a zastává názor, že poškozují hospodářskou soutěž. Naopak z pohledu Spojených států mají vertikální dohody většinou kladný nebo neutrální dopad. Součástí práce jsou případové studie, které ukazují realitu zákonů na ochranu hospodářské soutěže a ilustrují jejich následky například změněné podmínky na trhu, vliv na inovace, investice apod. Celková analýza je podpořena právním rámcem, historickým vývojem a hlavně pak ekonomickým rozbořením efektivnosti soutěžní politiky. Ze závěru plyne, že rozdíly evropské a americké soutěžní politiky jsou jen velmi těžko popísekonat bez všeobecně přijímané teorie, která by uspokojivě vysvětlila dopad pravidel hospodářské soutěže a vliv jejich intervencí na trhy a společnost.

Klíčová slova: antitrust, hospodářská soutěž, vertikální fúze, monopolní cena, články 81(101) a 82(102) smlouvy ES, Shermanův zákon

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List of Abbreviations

A	authority
AAI	American Antitrust Institute
ABA	American Bar Association
BER	Block Exemption Regulation
CA	Clayton Act
CCE	Chief Competition Economist
CET	Chief Economist Team
CFI	Court of the First Instance
CH	challenged
DG COMP	Directorate General for Competition
DOJ	Department of Justice
EC	European Commission or European Community
ECJ	European Court of Justice
ECR	European Court Ruling
ECSC	European Coal and Steel Community
EU	European Union
FTC	Federal Trade Commission
IE	Internet Explorer
IPRs	Intellectual Property Rights
LII	Legal Information Institute
LR	long run
MC	marginal costs
NCH	non-challenged
NRF	New Regulatory Framework
OECD	Organization for Economic Cooperation and Development
OEM	original equipment manufacturer
ONP	Open Network Provision
OS	operating system
PC	personal computer
RPM	Resale Price Maintenance
SA	Sherman Act
SME	Small and Medium-sized Enterprise
SR	short run
TEC	Treaty Establishing the European Community

TEU	Treaty on the European Union
TFEU	Treaty on the Functioning of the European Union
TPA	Third Party Access
U.S.	United States
USA	United States of America
WMP	Windows Media Player
WTO	World Trade Organization
WWII	Second World War

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Diploma Thesis Proposal

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Proposed Topic:

EU's Competition Policy v. USA's Antitrust

Topic Characteristics:

The aim of diploma thesis is to analyze in detail the difference between the competition policy of the European Union and the antitrust of the United States of America. Even though they use the same economic reasoning to protect and promote competition, the applied policies and actions taken sometimes differ. The inquiry into this important regulation policy will search for factors determining their difference and discuss resulting outcomes. Case studies will illustrate the actual impact of different approach to the regulation of market.

Hypotheses:

1. How has the different history of integration influenced the current policies of both areas?
2. Do they face the same problems?
3. Do they share same preferences when trying to "make markets work better"?
4. How robust are the competition policies in general? Face to face to financial crisis, are the competition policy rules obeyed? Or preferential treatment in the name of state aid takes place?

Methodology:

The comparative analysis of the development and current state of competition policy and antitrust, backed by economic theory on the one hand and reality (competition laws) on the other. Findings will be supported by case studies to demonstrate the real-life impact.

Outline:

1. Introduction
2. The EU's Competition Policy
3. The USA's Antitrust
4. Comparative analysis
5. Model
6. Conclusion

Core Bibliography:

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Gateway to the EU – United in diversity:

http://europa.eu/pol/comp/index_en.htm

Official site of the EU's Competition Policy:

http://ec.europa.eu/competition/index_en.html

U.S. Department of Justice: Antitrust Division:

<http://www.usdoj.gov/atr/>

U.S. Federal Trade Commission – Antitrust/Competition:

<http://www.ftc.gov/bc/index.shtml>

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“Competition is not only the basis of protection to the consumer, but is the incentive to progress.”

Herbert Clark Hoover, 31st President of the United States of America

Introduction

Economics is about differences, it is the difference between product A and B that defines their chances on market. Differences in price, quality, accessibility and all kind of characteristics are crucial factors that make consumers decide. Difference is determining and that is why my diploma thesis is devoted to key differences between the rules of competition in the United States of America (U.S.) and in the European Union (EU). Our society is based on cooperation and competition. We are a member state of the EU that was established to fully exploit the advantages of free market competition.

Therefore, the difference between American and European competition policy deserves more detailed comparative analysis. The goal is to learn a lesson and possibly answer the question why. Why the universal principles of competition are sometimes treated and perceived differently on the different sides of the Atlantic Ocean. Do they stand on different grounds? According to the official website, EU's competition policy is “making markets work better”¹. Are the European markets indeed better? The following chapters will try to shed some light on the questions above.

¹ http://ec.europa.eu/competition/index_en.html

The paper is structured as follows: First chapter introduces law systems in the U.S. and in the EU, second chapter focuses on American practice of antitrust based primarily on the Sherman Antitrust Act. Third chapter presents the European practice of competition policy, Article 81(101) and Article 82(102), and it discusses the main differences and related implications. Fourth chapter concerns models of behavior of firms engaged in vertical agreement and fifth chapter is devoted to a case study – two versions of the famous Microsoft Case which took place on both side of the Atlantic. Finally, the last section concludes.

So far, what is known about the unlike approach to competition? It might start with a different name. What Americans call antitrust is competition policy for Europeans (by Europeans it is referred to the population of the EU). For the purpose of this thesis, both terms will be used as synonyms. Academic journals usually divide competition policy into three different areas — antitrust, monopolies, and mergers. Consecutively, they focus on specific issues – all of them are too broad to be captured in a paper or even in a book.

What follows are some highlights among research papers that grounded my comparative analysis. Stephen Martin (2008) contrasts goals of antitrust and comes to a conclusion that the historical evolution of “the rules of the game” is too different to be overlooked. U.S. moved from pursuing multiple economic and political goals to consumer welfare evaluation. For the EU, in the first place, competition is a way to reach and preserve single market. Both include a large portion of political economy, however U.S. is missing abuse control elements and prevention of the state aid that can distorts even chances.

Shapiro and Kovacic (2000) discuss the generality of Sherman Act. Congress passed this law and “gave federal judges extraordinary power to draw lines between acceptable cooperation and illegal collusion, between vigorous competition and unlawful monopolization” (Shapiro and Kovacic 2000, 43). Judges employed economists but as the economic mainstream theories were

changing so were the rulings. This ongoing change created somewhat unstable and hardly predictable business environment.

Cooper, et al. (2005) focused on the comparison of vertical policies and tried to employ more analytical tools because in this case the difference is surprisingly huge. Vertical non-price restraints are generally permitted under American law but are often declared to be illegal under European law. Their paper explains different vertical practices by different loss functions. In Bayesian framework they characterize pro-competitive and anticompetitive actions by their probabilities. From the likelihood and the Bayesian rule follow two types of errors. The derived model suggests to challenge a vertical agreements (apart from other conditions) only if the costs of type-II error (the loss from failing to prosecute an anticompetitive practice) are greater than the costs of type-I error (the loss from prosecuting a pro-competitive practice) (J. C. Cooper, L. Froeb, et al. 2005, 14-17).

The effect of placing a vertical restrain can be also judged differently. Cooper, et al. (2005) claim not to have an adequate "natural experiment" that would enable them to compare the state of world with and without a restrain. It is the impossibility to know what would have happened if the policy had not been in place. Experimental economics allow us to test some hypothesis however not policies that are applied on a large scale and have a lot of consequences. What would have been without the policy, restrain or generally speaking any kind of change can be more guessed than estimated. Such a comparison is not a very reliable one. However, this time there might be a way round.

The paper by Cooper, et al. (2005) inspired me to look for the missing "natural experiment" on the other side of the Atlantic. Taking into account that vertical non-price agreements are often legal in the U.S., some American case could be a counterpart for a certain European case. Ideally, the same company and the same practice would be involved in both cases. In my opinion the famous Microsoft case fulfils these conditions therefore Chapter 5 includes a case study

based on the American and on the European treatment of Microsoft's non-price restraints. It would be helpful to be able to judge a policy on the grounds of an effects-based analysis than on the grounds of a questionable political decision.

There is a general agreement on the increasing significance of the economic analysis in competition policy. Greater role for economics in antitrust is a development tendency of the last decade or two.

There is one more thing that should be kept in mind when talking about policies. The success of each policy depends on the policy itself and then on institutions which implement the new rules. At this point historical time concept (shared by Post-Keynesian and neo-Austrian school) deserves to be emphasized. Because every policy that comes into force carries the legacy of its predecessors, in terms of expectations, institutions and also debts, both real and imaginary ones. For this reason before we come to the actual differences and models we will devote some time to the development and description of current stages of the American antitrust and the European competition policy.

Chapter 1

1.1 Common Law v. Civil Law²

The law perspective is a good starting point for the comparison. Alden F. Abbott (2005a), former director of the antitrust policy office at the U.S. Federal Trade Commission (FTC) introduces the American antitrust through law, mainly Sherman Act (SA) and Clayton Act (CA), and describes the European and American competition policies as converging.

At the beginning we should be aware that by referring to American law and European law we are comparing hardly comparable. The United States of America

² The brief overview of common and civil law is based on broad definitions of the Free Legal Dictionary. Available at: <http://legal-dictionary.thefreedictionary.com> (retrieved in January 2010).

are operating (with the exception of Louisiana) in the common law framework and the European Union stands on civil law (except for the Great Britain and Ireland). This fact might be well-known, however the true differences between these two systems remain unfamiliar.

Europeans are used to written laws, generally speaking, one can read what is considered to be illegal and what sanctions one will face if he or she breaks the law. Americans live in a different law framework, the source of the law for them are the past rulings by judges, as opposed to statutes that are fundamental for civil law. Also the role of judges differs significantly; common law has more adversarial system instead of inquisitorial system typical for civil law. Moreover, there is a major role of juries in common law and these courts can also review constitutionality of certain rulings.

The main difference can be most easily described as follows – common law draws abstract rules from specific cases, whereas civil law starts with abstract rules, which judges must then apply to the various cases before them.³

1.1.1 Common Law

“The Anglo-American common law tradition is built on the doctrine of Stare Decisis (‘stand by decided matters’) which directs any court to look to past decisions for guidance on how to decide a case before it.”⁴ The core idea is that on the principle it is unfair to treat similar facts differently on different occasions and it also supports the belief that one person is the legal equal of any other.⁵

Among the pros of common law the efficiency is usually named at the first place because similar cases are not decided twice, thus work is not duplicated. As a matter of fact, past rulings are binding for any future case. Common law judges

³ [http://encyclopedia.thefreedictionary.com/Civil+law+\(legal+system\)](http://encyclopedia.thefreedictionary.com/Civil+law+(legal+system))

⁴ <http://legal-dictionary.thefreedictionary.com/stare+decisis>

⁵ Dr. Eric Craft, Law & Economics class, University of Richmond, VA, 2009.

have the authority and duty to make law by creating precedents.⁶ The body of precedents has been established over years and nowadays lawyers draw connections or distinctions depending on what helps their client. Might seem mechanical but the application of precedent relies on reasoning by analogy.⁷

“When there is no precedent to rely on the case is called the case of first impression. A court may have to draw analogies to other areas of the law to justify its decision. Once decided, this decision becomes precedential. However, it is possible not to obey a precedent, if the historical conditions have change or the philosophy of the court underwent a major shift.”⁸ Due to the characteristics mentioned above common law is said to be more predictable, more stable and even more fair than civil law. The system itself is relatively coherent and legal advice is more reliable compared to the European expectations.

Common law have roots in England in the 12th century when the decisions of judges started to be recorded and became binding. Judges were travelling all over the country and discussing their cases afterwards. Over the time a consistent system of law that was common throughout the whole country developed, hence the name common law (Dainow 1967).

In a common law jurisdiction several stages of research and analysis are required to determine what the law is in a given situation. Step by step the facts must be ascertained and relevant statutes and cases must be searched for. Next step is to present the principles, analogies and statements by various courts and understand what they consider important in order to determine how the next court is likely to rule on the facts of the current case. The importance of the decisions stems from the hierarchy of the courts; higher courts’ decisions are preferred to those of lower courts. Last step is to link all the lines and reasons and

⁶ <http://encyclopedia.thefreedictionary.com/common+law>

⁷ <http://legal-dictionary.thefreedictionary.com/precedent>

⁸ Ibid.

determine what the law is . After detailed description of the legal situation the law is then applied to the facts.⁹

The law extracted from the relevant past rulings is the strength of the common law countries and it is said to be the source of the successful commercial systems in the United Kingdom and United States. Reliable prediction of the proposed course of action – whether it is likely to be lawful or unlawful – attracts business and increases productivity because no large margins have to be kept. The clause that any possible lawsuit will be held in a pre-specified law jurisdiction is not unusual. Especially the State of New York and English common law have a depth and predictability not (yet) available in any other jurisdiction.¹⁰

1.1.2 Civil law

By contrast, civil law is a legal system based on written codes that has originated in the ancient Roman Empire. The term civil law may have two other meanings, first, it can mean law between citizens, which regulates affairs between persons themselves (private law) and it can be also distinguished from criminal law which is state's list of prohibited actions and the process that follows afterwards.¹¹

However, the most common use of this term refers to the civil law system. It is characterized by laws written into collection (codified – not determined by judges). Citizens are provided this collection to let them know what applies to them; here the legislation of the civil law is the primary source of law. “However, codification is by no means a defining characteristic of a civil law system, as e.g. the civil law systems of Scandinavian countries remain largely uncoded, whereas common law jurisdictions have frequently codified parts of their laws,

⁹ Dr. Eric Craft, Law & Economics class, University of Richmond, VA, 2009.

¹⁰ <http://encyclopedia.thefreedictionary.com/common+law>

¹¹ <http://duhaime.org/LegalDictionary/C/CivilLaw.aspx>

e.g. in the U.S. Uniform Commercial Code.”¹² The two legal systems also differ in methodology, legal opinions under civil law are shorter and more formal, also the type of education required for a judge or attorney differs from state to state. Moreover, “the rules of evidence are less complicated because legal professionals are considered capable of identifying reliable evidence (there is no jury composed of laymen).”¹³

There are more than just two legal systems that were briefly characterized. All law systems are or were influencing each other, it worth noting that several important features of civil law, as we know it today, originated surprisingly in the Islamic law. The Middle East introduced to western countries e.g. the notion of equity, good faith, presumption of innocence, and also the concept of agency.¹⁴

Chapter 2

2.1 Antitrust Practice in the United States of America

Carl Shapiro (2009), Deputy Attorney General for Economics, Antitrust Division, Department of Justice (DOJ) U.S. in his speech before the American Bar Association (ABA), on the Antitrust Symposium remarked that there are three basic reasons why markets fail to achieve efficiency. Those are externalities and public goods (such as pollution and climate change), imperfect information (which underlines the necessity for health, safety, and financial regulations), and market power — which brings us to antitrust — broadly described as a policy focused on private arrangements that reduce competition.

“Any agreement is likely to be anticompetitive if it enables the firm to gain or preserve market power that it otherwise would not have.” (Melamed 1998)
Antitrust or competition policy are not just another type of government

¹² [http://encyclopedia.thefreedictionary.com/Civil+law+\(legal+system\)](http://encyclopedia.thefreedictionary.com/Civil+law+(legal+system))

¹³ Ibid.

¹⁴ Ibid.

regulation, their objective is not to steer markets. Their goal is to ensure that firms compete for the benefit of the consumers.

To understand better the origins of antitrust a quick look into a recent history will be helpful. Those days (the end of the 19th century) of the second industrial revolution were characterized by expansion of almost every industry – especially transportation (railroads), technology (chemistry), communication (telegraph), and mining. The United States had a continuous influx of cheap immigrant labor, vast land, and natural resources. All together the country was booming. Thus, how do you finance a boom?

A new form of business organization emerged – stockholder/shareholder company – and it soon changed the shape of the American economy. A form of company that was built on agency principle, built on trust, hence the name trusts. Companies were expanding, merging, and forming trusts which eventually became a synonym for monopolies. Among the most known ones were Standard Oil, U.S. Steel, and American Tobacco Company. The existence and power of these trusts resulted in “antitrust laws”. That is the explanation where the name comes from. The most important antitrust laws will be introduced in the following paragraphs.

American antitrust policy relies primarily on two acts — Sherman Antitrust Act, 15 U.S.C. §§ 1-7 (1890) and Clayton Act 15 U.S.C. §§ 12-27 (1914) supported by the Federal Trade Commission Act, 15 U.S.C. §§ 41-58 (1914, as amended) — and it is enforced primarily by two institutions — Department of Justice and Federal Trade Commission (FTC). Section 1 and 2 of the Sherman Act are absolutely crucial for the legal understanding of competition in the U.S. (both of them follow).

2.1.1 Sherman Antitrust Act, Section 1: Trusts, etc., in restraint of trade illegal; penalty

“Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding \$100,000,000 if a corporation, or, if any other person, \$1,000,000, or by imprisonment not exceeding 10 years, or by both said punishments, in the discretion of the court.” (As amended by the Antitrust Criminal Penalty Enhancement and Reform Act of 2004.)

During the *Standard Oil Co. v. United States*¹⁵ the Supreme Court has interpreted this section as prohibiting restraints that unreasonably restrict competition. Therefore, it became more about the reasonableness of the conduct. Courts usually define two types of violation — conduct that is illegal per se and conduct that violates the rule of reason. “Per se violation requires no further inquiry into the practice’s actual effect on the market or the intentions of those individuals who engaged in the practice.”¹⁶ Traditionally, per se illegal is price fixing, division of markets, group boycotts, and tying arrangements. (Abbott 2005a) The Supreme Court defined the rule of reason during *Board of Trade of Chicago v. United States*¹⁷ as follows: „The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition.”

In late seventies this definition turned out to be slightly outdated. Thus courts refined its methodology. Before, the rule of reason approach required full market

¹⁵ *Standard Oil Co. of New Jersey v. United States*, 221 U.S. 1 (1911)

¹⁶ <http://topics.law.cornell.edu/wex/antitrust>

¹⁷ *Board of Trade of Chicago v. United States*, 246 U.S. 231 (1918)

analysis to be done, both anticompetitive effects and possible benefits had to be examined. Nowadays a “quick look” version of the rule of reason can be applied. FTC elaborated four step structured framework for evaluating each case. Full market analysis can be skipped if anticompetitive effects are obvious after any steps. Thus, over time rule of reason gained a continuity feature (the level of detail necessary to evaluate the effects on competition depends on the case).

2.1.2 Sherman Antitrust Act, Section 2

“If an economist finds something—a business practice of one sort or another—that he does not understand, he looks for a monopoly explanation.”

Ronald Harry Coase¹⁸

Sherman Antitrust Act, Section 2: Monopolizing trade a felony; penalty: “Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding \$100,000,000 if a corporation, or, if any other person, \$1,000,000, or by imprisonment not exceeding 10 years, or by both said punishments, in the discretion of the court.”

Also for this Section an important clarification was given during the Standard Oil case; the Supreme Court stated that Section 2 does not prohibit monopoly status in and of itself. Moreover, it does not make unlawful the charging of monopoly prices. It is the anticompetitive conduct that is forbidden. However, the vague phrasing together with the principles of the common law make it very

¹⁸ (Coase 1972, 67)

difficult for courts to define a coherent legal standard. The understanding of Section 2 was further improved by the Alcoa¹⁹ case. This influential decision explained that size does not determine guilt.

Until 1985 there was an ongoing debate about where is the line between competitive and exclusionary conduct. In the Aspen Skiing²⁰ case the court stated that “if a firm attempts to exclude rival on some other basis than efficiency, then it is fair to consider its behavior as predatory”. By this definition market power gained through “growth or development as a consequence of a superior product, business acumen, or historic accident”²¹ is allowed.

The Sherman Antitrust Act consists of another five sections (seven in total) however, they are not so crucial and firms are sued less often for violating these provisions. Still, American antitrust policy stands and falls with Sherman Act, therefore, it deserves more attention. What were the origins and what was the intent of the Sherman Act 120 years ago? The unusual history of Sherman Act gives us an interesting insight into a statute that has influenced American economy significantly. In the year of the 100th anniversary of the Sherman Act Robert Bradley Jr. wrote “A ‘Cynical’ Interpretation of the Sherman Act” opposing the general believe that the Sherman Act was motivated by widespread hostility towards monopoly and governmental bias towards small businesses.

No conclusions shall be drawn, just several facts will be mentioned. The “cynical” interpretation begins with Senator John Sherman, a pro-tariff Republican from Ohio; a man who lost his battle for the Republican presidential nomination against Russel Alger (head of the Diamond Match Company – a trust of the exact kind that Sherman Act was supposed to regulate).

¹⁹ United States v. Aluminum Company of America (“Alcoa”), 148 U.S. 416 (1945)

²⁰ Aspen Skiing v. Aspen Highlands Skiing, 472 U.S. 585 (1985)

²¹ United States v. Grinnell Corp., 384 U.S. 563 (1966)

Overall, there is a general agreement that Senator “Sherman was a driving force behind that very broad and ambiguous law” (Bradley 1990). Congress was slightly supportive and public opinion was partially against the increasing market power of the trusts and partially benefited from their economies of scale (production was increasing, prices were decreasing). Trusts were powerful and protected by high tariffs from foreign competition. It was the era of American protectionism policies.

This situation evokes some questions e.g. “How the Congress could support high tariffs on the one hand and antitrust law on the other?” (Bradley 1990) If Sherman wanted to increase the competitiveness in the U.S. why did he propose his legislation so late? (e.g. Standard Oil trust was established in 1882) There was only little discussion about decreasing the tariffs. Rumor also has it that Sherman wanted to do something memorable before leaving politics. Or it might have been good tactics how to turn an attention away from the tariffs.

These provoking questions are too far from serious economic analysis and will be abandoned right now. Nevertheless, it is important to keep in mind that there might have been something more behind the veil of promotion of competition.

2.1.3 Clayton Antitrust Act, Section 7: Acquisition by one corporation of stock of another

“No person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another person engaged also in commerce or in any activity affecting commerce, where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.

No person shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of one or more persons engaged in commerce or in any activity affecting commerce, where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition, of such stocks or assets, or of the use of such stock by the voting or granting of proxies or otherwise, may be substantially to lessen competition, or to tend to create a monopoly. This section shall not apply to persons purchasing such stock solely for investment and not using the same by voting or otherwise...”

The above cited section 7 of Clayton Act is the third crucial pillar of the U.S. antitrust. It regulates mergers, an important part of American economy. Mergers change the competitive structure of any market; they change the market itself for better (e.g. economies of scale etc.) or worse (toward monopolistic behavior). Until mid-seventies most of the cases against mergers, brought up as a violation of the Clayton Act, were won by the United States. Government was given a tool to challenge mergers however it lacked a necessary experience, expertise, and knowledge (Abbott 2005a). The state’s criteria were based on the then idea of concentration usually measured by indices, however, market power/share has a lot of dimensions and indices are only approximate. Besides what should they measure – actual power or potential power?

The turning point in this situation was the General Dynamics²² case from 1974. The relevant merger was upheld even though it increased the market share up to 50% in some areas. Therefore, market concentration stopped being the major reason and further examination of the market situation was introduced. Terms as market dynamics, the degree of competitiveness, entry conditions, effects on efficiency, market structure, and probable future began to be taken seriously.

²² United States v. General Dynamics Corp., 415 U.S. 486 (1974)

Finally, in 1982 DOJ (joined by FTC) issued new Horizontal Merger Guidelines that “laid out a multi-step approach to evaluating mergers grounded in detailed economic analysis.” (Abbott 2005a) Considerable economic content gave economist the say they were waiting for and economic analysis became essential. The guidelines were designed to be revised over the years (last revision was carried out in April 1997).

2.1.4 Federal Trade Commission Act

The Federal Trade Commission Act (15 U.S.C. §§ 41-58, as amended)²³ “was designed to supplement and bolster the Sherman Act and the Clayton Act ... to stop in their incipency acts and practices which, when full blown, would violate those Acts ... as well as to condemn as ‘unfair methods of competition’ existing violations” of those acts and practices.²⁴ The Act gives the Federal Trade Commission a unique role in determining what constitutes unfair methods of competition.²⁵

Under this Act, the Commission is empowered, among other things, to

- (a) prevent unfair methods of competition, and unfair or deceptive acts or practices in or affecting commerce;
- (b) seek monetary redress and other relief for conduct injurious to consumers;
- (c) prescribe trade regulation rules defining with specificity acts or practices that are unfair or deceptive, and establishing requirements designed to prevent such acts or practices;
- (d) conduct investigations relating to the organization, business, practices, and management of entities engaged in commerce; and
- (e) make reports and legislative recommendations to Congress.

²³ <http://www.ftc.gov/ogc/stat1.shtm>

²⁴ F.T.C. v. Brown Shoe Co., 384 U.S. 316, 322 (1966) (quoting F.T.C. v. Motion Picture Adv. Serv. Co., 344 U.S. 392, 394-95 (1953)).

²⁵ Intel v. FTC (2009), Administrative Complaint
Available at: <http://www.ftc.gov/os/adjpro/d9341/index.shtm>

Thus FTC introduced the notion of fairness into law and moved antitrust closer to the European way of thinking (see the next chapter). Before we conclude the general introduction into American antitrust policy there are two doctrines left. Most rules are closely followed by exceptions and so are the U.S. antitrust laws. "Antitrust immunities" are exemptions from prosecution under antitrust laws. The most important one is called state action doctrine. It was first articulated in *Parker v. Brown*²⁶, which held that, in light of the States' status as sovereign entities, Congress did not intend the Sherman Act to apply to the activities of the states themselves. The doctrine states that activities of private entities conducted under state authority may be shielded from federal antitrust scrutiny. However, states may not simply authorize private parties to violate the antitrust laws.²⁷

The Supreme Court has held that the state action doctrine shields private conduct from the antitrust laws only when a two-pronged test is satisfied. First, "the challenged restraint must be one clearly articulated and affirmatively expressed as state policy and second the policy must be 'actively supervised' by the state itself (the active state supervision provision is to ensure that details such as rate or price are set by deliberate state intervention, not simply by agreement among private parties)."²⁸ Moreover, because of the federalism principle, the doctrine shields not only the state itself but also actions of governor, state legislature, or the state Supreme Court (providing they are acting in their sovereign capacities). (Abbott 2005a) All together, state action doctrine creates a great opportunity for rent seeking and it may harm the American antitrust system.

State action doctrine is not the only one impairing the coherency of antitrust rules. There is also the Noerr-Pennington doctrine that "immunizes from antitrust

²⁶ *Parker v. Brown*, 317 U.S. 341 (1943)

²⁷ <http://www.ftc.gov/opa/2005/06/kentuckymovers.shtm>

²⁸ *Ibid.*

liability individuals who urge the federal or state government to take actions that may impose restraints on trade. It provides antitrust immunity for individuals petitioning government and may shield a particularly effective way of monopolizing market – through the misuse of governmental process.”²⁹ Last but not least there are some sector specific immunities concerning the business of insurance, collective bargaining, broadcasting rights, baseball etc.

Chapter 3

3.1 Competition Policy Practice in the European Union

“In 1963, EC Competition Commissioner Hans von der Groeben³⁰ highlighted three purposes of EC competition policy: to prevent firms or Member States from erecting barriers to trade to replace those dismantled by the EC, to promote integration, and ‘to safeguard an economic and social order based on freedom’ for businessmen, consumers, and workers. He saw these three goals – competition, integration, and freedom – as mutually consistent.” (Martin 2008, 49)

This background suggests that the structure of the European competition policy is very different compared to the American one. The EU divides the competition issues into five areas – antitrust, mergers, cartels, liberalization, state aid, and international. All of them will be introduced in the following subchapters. A significant reform of the Community competition law took place prior to the 2004 enlargement.

As of February 2010 the new European Commissioner for Competition is Joaquín Almunia (born in 1948, Bilbao, Spain). At the same time Alexander

²⁹http://www.antitrustinstitute.org/Antitrust_Resources/Antitrust_EXEMPTIONS/The_Noerr_Pennington_Doctrine/index.ashx

³⁰ Hans von der Groeben. The role of competition in the Common Market in American Bar Association Proceedings Conference on Antitrust and the European Communities 14, 1963, p. 18.

Italianer (1956, the Netherlands) was appointed the new Director-General of the Directorate General (DG) for Competition.

The story of European Union and its competition policy is inseparable from the European common market (or sometimes called single market). The primary purpose of competition policy in the EU is to protect the common market. In Europe it had to be created and that is probably why we treasure it more and protect it more. European rules promote something the U.S. has always had – single market. This historical difference is most likely the underlying reason explaining why the EU competition rules are so strict. According to the former European Commissioner for the Internal Market and Services Charlie McCreevy “the single market has been a big success for Europe; one might even say the EU’s greatest achievement so far.”³¹

The competition policy of the European Union is grounded in the times when European Coal and Steel Community (ECSC) was established. The member states created the common market for coal and steel by dismantling the barriers to trade. The competition policy provisions that were included in the ECSC Treaty are fundamental predecessors of those of the EU’s current competition law. Although ECSC does not exist anymore its heritage is still present. “In 1951 Treaty of Paris that founded the ECSC brought ‘a prohibition approach’ which was a brand new way of dealing with competition. Article 60 of the ECSC Treaty prohibited unfair competitive practices and Article 65 prohibited agreements that would distort competition within the common market.” (Martin 2008, 44) As we will see these two Articles have a lot in common with Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU) which both govern competition rules nowadays. They are the “European version” of the Section 1 and 2 of the Sherman Act, sometimes similar and sometimes very different.

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<http://www.delaware.ec.europa.eu/newzealand/press/speeches/McCreevyAucklandCoC2009.htm>

3.2 Antitrust — Article 101 (ex Article 81 TEC)³²

Antitrust is ruled by the Article 81 of the EC Treaty (to avoid confusion we will keep the “old” well known name of this Article):

1. The following shall be prohibited as incompatible with the internal market: 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 internal market, and in particular those which:

(a) directly or indirectly fix purchase or selling prices or any other trading conditions;

(b) limit or control production, markets, technical development, or investment;

(c) share markets or sources of supply;

(d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

(e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

2. Any agreements or decisions prohibited pursuant to this Article shall be automatically void.

3. The provisions of paragraph 1 may, however, be declared inapplicable in the case of:

- any agreement or category of agreements between undertakings,
- any decision or category of decisions by associations of undertakings,
- any concerted practice or category of concerted practices,

³² All references to Article 81 TEC should be understood as references to the current Article 101 of the Treaty on the Functioning of the European Union (TFEU) (as renamed by the Treaty of Lisbon which entered into force on 1 December 2009).

which contributes to improving the production or distribution of goods or to 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.³³

3.2.1 Implications of the Article 81(101)

When it comes to the Article 81 it is crucial to note that it says “all agreements between undertakings.” There is no difference between vertical and horizontal agreements, both of them fall within the same category even though their impact on markets differs significantly. There is more or less consensus on the impact of horizontal agreements in the sense that they increase market concentration, and most probably decrease competition. Therefore, the Commission’s official approach to horizontal mergers is quite unified and set in the Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings.

However, when it comes to the vertical agreements the situation is different. There is no mainstream economic concordance on how vertical structures influence markets. The Commission (EC) is rather strict compared to the American authorities and it applies rules that are similar to horizontal agreements, in some degree disregarding the different basis of both types of structures. The Guidelines on vertical restraints describe vertical agreements that generally do not fall within Article 81(1)³⁴ (those are the ones of minor importance between small and medium sized firms (SME) and agency agreements).

³³ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12008E101:EN:HTML>

³⁴ http://europa.eu/legislation_summaries/competition/firms/l26061_en.htm

The consensus about the basic framework for evaluating horizontal mergers is much greater compared to the one for vertical cooperation. Typically vertical mergers raise fewer competitive concerns but any other general conclusions are hard to draw. “U.S. challenges vertical restraint less often than the EU” (Greenfield and Aye) and it has been lax towards vertical restraints as supported by the fact that no restraints were challenged during the 12-year period between January 1981 and January 1993 (Comanor and Rey 1997). The U.S. enforcement officials focus on vertical restraints in “waves” and this decade the number of cases is increasing again.

To make the situation clearer we shall begin with the definition of vertical agreements as defined in Article 2(1) of the Block Exemption Regulation (will be introduced later):

“Agreements or concerted practices entered into between two or more undertakings each of which operates, for the purposes of the agreement, at a different level of the production or distribution chain, and relating to the conditions under which the parties may purchase, sell or resell certain goods or services” (European Commission 2000, 23). By the definition the undertakings are non-competitors and the final consumer is excluded from the chain.

“The concerted practice from the definition is deemed to exist where contact between competitors occurs with a meeting of minds to cooperate rather than to compete and where there is a causal link between the contacts and the subsequent course of conduct. Thus, there is only a difference in intensity compared to tacit acquiescence, which constitutes an agreement.” (Ablasser-Neuhuber and Plank 2010)

In the first place, there is no simple solution as to whereby any particular type of restraint — territorial restrictions, tie-ins, vertical price restraint, etc. — always improves economic efficiency or reduces it. (Comanor and Rey 1997)

Vertical mergers frequently bring important efficiencies because they achieve better products through increased integration, lowering transaction costs, or reducing production or distribution costs. (Greenfield and Aye) On the other hand, vertical mergers threaten to harm consumers if they limit markets. The problem is to weigh the procompetitive effects against the anticompetitive consequences.

Pamela Jones Harbour, the former FTC Commissioner, stresses another type of competition — interbrand and intrabrand. Each of them matters at different stage of the decision. “Indeed, when a consumer already has made a decision to buy a particular brand, the only competition that really matters is intrabrand.” (Harbour 2004)

Vertical restraints can help intrabrand coordination in various ways (restructure incentives) and might also affect interbrand competition in negative way when reducing competition by collusive behavior or in the long run (LR) by driving out the rivals or erect entry barriers.

The question remains how to distinguish whether the vertical agreements is efficiency enhancing or anticompetitive?

Given this uncertainty, how does the EU apply the Article 81? What should the American companies get ready for when entering the European single market? Whereas horizontal agreements generally decrease competition, vertical agreements are not so straightforward. Such agreements to be enforceable must not fall within the Article 81(1) because this type of agreements is automatically void and cannot be brought to court.

The European law does realize the possible positive effects of some vertical agreements, therefore the third paragraph of the Article 81 states that to those arrangements “which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit” the first paragraph of the Article 81 is

inapplicable. More detailed description of this provision is given in the Commission's Guidelines on Vertical Restraints issued exactly 10 years ago.

The key factor of economic growth is stability and predictability at least as far as institutions goes. That is why the European Commission has enacted by Commission Regulation (EC) No 2790/1999 so called "Block Exemption Regulations" (BER) which sets out the principles when an agreement fulfils the criteria of Article 81(3) and as such it is enforceable before national courts and protected from antitrust prosecution. BER is a common name for the exemptions that covers Vertical Block Exemption Regulation, then BER for the Motor Vehicle Sector, and BER on Technology Transfer Agreements.

The current Block Exemption Regulation on vertical restraints expires in May 2010. The scope of the ongoing discussion and review is to update the BER and Guidelines to reflect the most recent market development. Among others the increase of sales on the Internet and an increase in large distributors' market power.³⁵

The Block Exemption Regulation creates a presumption of legality for vertical agreements depending on the market share of the supplier or the buyer. It creates "safe harbor". The threshold for market share is 30 % in order for the block exemption to be applicable (European Commission 2000, 21) and may not contain hard-core restrictions (according to the article 4 of the BER).

"The assessment of vertical restraint involves in general the following four steps: 1) First, the undertaking involved need to define the relevant market in order to establish the market share of the supplier or the buyer, depending on the vertical restraint involved.

2) If the relevant market share does not exceed the 30% threshold, the vertical agreement is covered by the BER, subject to hardcore restrictions and conditions set out in the regulation.

³⁵ http://ec.europa.eu/competition/consultations/2009_vertical_agreements/index.html

3) If the relevant market share is above the 30 % threshold, it is necessary to assess whether the vertical agreement falls within the Article 81(1).

4) If the vertical agreement falls within Article 81(1), it is necessary to examine whether it fulfills the conditions for exemption under Article 81(3).

In assessing cases above the market share threshold of 30 % the Commission will conduct a full competition analysis. The following factors are the most important to establish whether a vertical agreement brings about an appreciable restriction of competition under the Article 81(1): market position of the supplier, market position of the competitors, market position of the buyer, entry barriers, maturity of the markets, level of trade, nature of the product and other factors." (European Commission 2000, 120-121)

The exemptions and conditions under which they are granted are rather complicated and elaborated in detail (see the regulation) however, the BER does not cover any restrictions and obligations that do not relate to the conditions of purchase, sale and resale. (European Commission 2000, 25)

Because the market share criterion is a crucial one for the BER to apply the question about market definition arises. The relevant product and geographic markets are defined as follows: "The relevant product market comprises any goods or services which are regarded by the buyer as interchangeable, by reason of their characteristics, prices and intended use."

"The relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of relevant goods or services, in which the conditions of competition are sufficiently homogeneous, and which can be distinguished from neighboring geographic areas because, in particular, conditions of competition are appreciably different in those areas." (both Guidelines on Vertical Restraints, 90)

For the purpose of the BER the previous definitions apply (for more details on relevant market see "Commission notice on the definition of the Relevant Market for the purposes of Community competition law," Official Journal C 372, 1997).

Among the most common vertical restraints that the regulation is trying to address are especially single branding, exclusive distribution, exclusive customer allocation, selective distribution, franchising, exclusive supply, tying and recommended and maximum resale prices. (European Commission 2000)

The way our economy functions is extremely dependent on smoothly working distribution channels. Manufacturer and distributor together form a vertical structure whether they cooperate or not. If each of them maximizes own profits and ignores the spillover effects then the aggregate profits are most likely not maximized and society suffers a certain loss of efficiency. The vertical coordination could eliminate this loss.

The case specific market structure, relevant product, and geographic market affect the way a vertical restraint influences the market. However, vertical structure that is facing strong competition both from other brands and other distributor has considerably reduced ability to decrease the economic efficiency. The competition from other brands and other retail distribution systems come before the focus on intrabrand competition. (Comanor and Rey 1997)

It is interesting to note that American antitrust focuses primarily on the advantages of vertical agreements (efficiencies that arise when a buyer buys its supplies exclusively from one supplier) such as – from the buyer's point of view – guaranteed supplies, protection against rise in prices, LR planning because some costs can be considered fixed for a certain period, optimal storage – no extra costs, less demand fluctuation. From the seller's point of view – more predictable demand, protection against the prices fluctuation, and reduction of selling expenses.

Greater price certainty, decreased costs and a possibility to prevent free-riding (e.g. through Resale Price Maintenance (RPM)) make vertical agreements alluring. Even though RPM is prohibited the recommended minimum and maximum prices are acceptable. Resale price maintenance can be both beneficial and harmful. It could prevent some dealers from free-riding on the point-of-sale services offered by others, on the other hand RPM facilitate cartel like behavior at both levels. (Tom 1994)

Generally, vertical structures can solve the double markup problem too. Manufacture may wish to constraint directly the retailer so he or she would not exploit its local market power and thus harm both manufacturer and consumers. Empirical literature (see Cooper, et al. 2005b) on vertical restraints suggests double markups savings and other forms of savings (e.g. transaction costs). Cooper, et al. also quote a study which points out that in 1991 30% of litigated resale price maintenance cases involved maximum RPM, apparently the manufactures were trying to limit the downstream market power in favor of their products.

On the other side, European Union focuses much more on the possible negative impacts of vertical restraints, especially exclusive dealing contracts because this type of arrangements may also compromise competition by either collusion or exclusion. The EU stresses that vertical agreements are likely to foreclose markets (thus increase the market power) or create substantial barriers to entry. The EC primarily cares whether a merger will strengthen a dominant firm and to what extent it could foreclose the market. Moreover, common exclusive buying arrangements are perceived as tacit grandfathers of cartels.

In the United States the emphasis is less on remaining competitors and the merged firm's anticompetitive leverage and more on the effect of a merger on future prices and output levels in a given market.³⁶ However, nowadays the U.S. courts prefer the use of the rule of reason when judging the vertical agreements

³⁶ <http://www.ftc.gov/speeches/pitofsky/fordham7.shtm>

(subject to the Section 1 of the SA as an unreasonable restraint of trade). Nevertheless, to block an agreement it must have substantial negative effects because in the opinion of the U.S. authorities vertical restraints limit the contracting parties' freedom of action. (Comanor and Rey 1997)

The best way to explain the American attitude towards vertical agreements are the words of Douglas Melamed, Principal Deputy Assistant Attorney General, DOJ Antitrust Division: "Vertical agreements are generally procompetitive because they usually involve a combining of complements – e.g. the manufactured product and distribution services – for greater good." (Melamed 1998) Compared to the European approach the difference is striking.

Explanation for Melamed's theory follows. It is a market based interpretation of the positive effect of the exclusionary vertical agreements. Under these agreements the distributors are pushed to some kind of commitment or promise which actually imposes a cost on them (they cannot contract with manufacturer's rivals). Taking into account the deliberate behavior of both parties; if they have chosen the exclusionary promise it is either profitable for both of them (due increased efficiency) or it is a way to change the market conditions in someone's favor. Thus the efficiency is brought by economies of scales or similar ones or by extra profits obtained due to the altered market power.

Exclusionary agreement might be an efficient option. If there were be any other more efficient legal alternative, the distributor is expected to choose it. Distributor's loyalty prevents free-riding and decreases the cost of preventing it. To choose the distributor on the basis of objective criteria without discrimination is in manufacture's best interest.

3.2.2 Parallel trade

The different approach to vertical restraints can be best seen on the case of parallel trade. The EU is characterized by four fundamental freedoms — free movement of people, labor, capital, and goods and services. To ensure the free

movement of goods and services any provisions that “restrict territory into which, or the customers to whom, the buyer may sell the contract goods or services are, is in principle prohibited.” Because the restrictions of territorial sales result in the prevention of parallel trade (especially in pharmaceutical sector) European courts continue to address this issue. (European Commission 2000)

Article 28(30)³⁷ of the EC Treaty prohibits all measures having an equivalent effect of a qualitative restrictions. The objective to integrate national markets into a single market is crucial, therefore partitioning of national markets is in principle prohibited. That is why the EU law tolerates parallel trade. The argument is that the original dealer by selling its product at the first market is sufficiently compensated and has exhausted its patent rights for the entire EU. The goal of market harmonization is more important than the Intellectual Property Rights (IPRs) of the patent holder. (Moore 2006)

As oppose to the U.S. where parallel trade is illegal and the IPRs are preferred. Different national laws and regulations have created an opportunity for arbitrage and the infamous shipping of prescription drugs from Canada to the United States.

“However, illegal drug importation into the U.S. is in decline because pharmaceutical companies have successfully restricted the supply of drugs to the main culprits in Canada who have been selling drugs to Americans.”³⁸

Under the United States patent law, patent owners have the right to exclude others from making, using, offering for sale, selling or importing a patented invention.³⁹ Apparently, the priority is to ensure that the firms have an incentive to invest in R&D. The discussion about the economic efficiency or inefficiency of the parallel trade is not the scope of this thesis, however it is an important

³⁷ http://www.europarl.europa.eu/factsheets/3_2_1_en.htm

³⁸ http://www.researchandmarkets.com/reports/336022/parallel_trade_in_europe_and_the_us_the.htm

³⁹ Infringement of Patent, 35 U.S.C. 271 (1995)

difference in approaches that fall within the Article 81(101). Overall, the situation creates a small paradox because the EU which is more strict about the vertical arrangements allows parallel trade and the U.S. that is generally more tolerant towards vertical agreements considers it to be illegal.

Different treatment of vertical restraints may primarily reflect the lack of consensus as to their LR economic consequences. Moreover, the idea of national protectionism does not go together with the values of the European Union as such. The authorities have used the non existence of mainstream economic analysis of the vertical arrangements as a good reason to decide according to their preferences. However, consistent policy standards across jurisdictions are not likely to arise until there is a general consensus about the economic implications of the vertical restraints.

3.3 Antitrust — Article 102 (ex Article 82 TEC) ⁴⁰

The abuse of dominant position and exclusionary abuses are covered by the Article 82 of the EC Treaty (again the old name will be used throughout the text):

Any abuse by one or more undertakings of a dominant position within the internal market or in a substantial part of it shall be prohibited as incompatible with the internal market in so far as it may affect trade between Member States.

Such abuse may, in particular, consist in:

(a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;

(b) limiting production, markets or technical development to the prejudice of consumers;

⁴⁰ All references to Article 82 TEC should be understood as references to the current Article 102 of the Treaty on the Functioning of the European Union (TFEU) (as renamed by the Treaty of Lisbon which entered into force on 1 December 2009).

(c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

(d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.⁴¹

The most famous enforcement of this article is less than one year old, on May 13, 2009, the Commission imposed a record fine of € 1.06 billion on Intel for abusing its dominant position.⁴² It is the highest fine in the history of the EC. Intel was found guilty because it sought to exclude its primary competitor from the relevant market for computer chips called x86 by offering rebates to its customers under condition that they buy most or all of their computer chips from Intel and by paying directly to computer manufacturers to make them delay the launch of products containing chips of Intel's rivals. The Commission objected mainly to the conditions of the rebates as constituting highly anti-competitive behavior. However, rebates are a common practice therefore the Commission usually distinguishes between quantitative discounts and rebates and loyalty/fidelity rebates – the latter being prosecuted under the Article 82 (if dominant player engages in this practice). On the other hand, loyalty as such has been always awarded since it may bring desirable efficiencies for both parties. Conditional rebates may be considered exploitative, exclusionary or both.

Therefore, according to the EC, Intel like other companies for instance Microsoft or British Airways abused its dominant position. To determine, whether an undertaking is abusing its power or not in the relevant market and therefore can be prosecuted under the Article 82, we must first find out whether it possess a dominant position. Since the AKZO case the dominance is presumed when the

⁴¹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12008E102:EN:HTML>

⁴² The EC, Intel Antitrust Case: <http://ec.europa.eu/competition/sectors/ICT/intel.html>

undertaking's market share exceeds 50 per cent. "Meanwhile, as a general rule, an undertaking which does not enjoy a dominant position in a relevant market may engage in conduct which would otherwise be considered abusive, without risk of enforcement action under the Article 82." (Carney and O'Loughlin 2009)

In general, this opinion constitutes an unfair treatment because in the case of a dominant firm the Commission applies dissimilar conditions to equivalent transactions. Dominant firm is considered special and as such according to the ECJ it requires also a special treatment. The current European approach can be best understood from the Michelin I⁴³ decision: "a finding that an undertaking has a dominant position is not itself a recrimination but simply means that, irrespective of the reasons for which it has such a dominant position, the undertaking concerned has a special responsibility not to allow its conduct to impair genuine undistorted competition on the common market" (Michelin, par. 57).

The reason why discounts, rebates and bonuses are considered to be a serious issue is because of their ability to produce an exclusionary effect. The ECJ at the first place tries to determine whether the behavior of the dominant firm can change the market entry conditions and thus make the market entry either very difficult or almost impossible for its competitors. Second, the behavior is examined from the consumer point of view. Will it decrease the variety of goods available or make impossible to choose between various sources of goods – inputs? Last but not least the dominant firm can justify and give objective reasons for its discounts, rebates or bonuses. If the justification exists the dominant undertaking will be given an opportunity to demonstrate that its system for discounts, rebates and/or bonuses makes economic sense. (Carney and O'Loughlin 2009) This approach resembles to a certain degree the American "rule of reason".

⁴³ NV Nederlandsche Banden Industrie Michelin v Commission, Case 322/81 [1983] ECR 3461 (known as Michelin I).

As stated above the Commission is concerned most about exclusionary actions (they reduce or impede competition) which are often confused with exploitative actions (an unfair or unreasonable practice aimed at consumers or suppliers). To avoid the any misunderstanding both definitions follow:

“Exclusionary abuse – conduct by a business holding a dominant position which has the object or effect of excluding a competitor from a market e.g. refusal to supply, predatory abuse, margin squeeze, and fidelity-inducing discounts are the most common ones.”⁴⁴

“An exploitative abuse can be characterized as a use of a dominant position which is illegitimate because of a direct adverse effect on the interests of customers.”⁴⁵

What distinguishes the European competition from the American one most is the perception of dominant position. However, to abuse the dominant position, the firm has to have it first. Article 82 affects dominant firms only; therefore the perception and definition of dominance are absolutely crucial. On February 9 2009 the European Commission adopted “Guidance on its enforcement priorities in applying Article 82 (EC) to abusive exclusionary conduct by dominant undertakings”. The Guidance Paper introduces more “effects-based approach” in order to ensure that the law “protects competition and consumer welfare, not individual competitors who do not deliver to consumers”⁴⁶. Even though the Commission declares changes in its approach towards dominant firms it does not admit that some of the previous decisions might have been flawed. It accredits the change to innovation and technical development.⁴⁷

⁴⁴ <http://www.reckon.co.uk/solutions/competition-law/exclusionary-abuse/>

⁴⁵ <http://www.reckon.co.uk/solutions/competition-law/exploitative-abuse/>

⁴⁶ EU press releases: MEMO/08/761 (3/12/2008)

⁴⁷ Ibid.

Regarding dominant firm behavior, in its *United Brands*⁴⁸ decision, the ECJ wrote that Article 82 serves the Community goal of instituting “a system ensuring that competition in the Common Market is not distorted.” (Martin 2008, 50)

Paragraphs 65 and 66 of the *United Brands* judgment are often quoted as a characterization of a dominant position:

Par. 65.: The dominant position referred to in Article 82 relates to a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition in being maintained on the relevant market by giving it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of its consumers.

Par. 66.: In general a dominant position derives from a combination of several factors which, taken separately, are not necessarily determinative.

The above quoted definition is the one used by the EU however when we look closer at the member states case law and judicial codes there are 27 more or less different definitions of the dominant position, approximately the same holds for the thresholds market share that indicates a dominant firm.⁴⁹ Ambiguity of this kind does not need any further comments because the inexact legal criteria can be very discouraging.

However, assessing the dominant firm’s position is a very complex task and all market aspects have to be taken into account and for this reason one more comprehensive definition of dominance follows: “A firm is in a dominant position if it has the ability to behave independently of its competitors, customers, suppliers and, ultimately, the final consumer. A dominant firm holding such market power would have the ability to set prices above the competitive level to sell products of an inferior quality or to reduce its rate of innovation below the

⁴⁸ *United Brands Co. v. EC Commission*, Case 27/76 [1978] ECR 207 (known as “*Chiquita Bananas*”).

⁴⁹ http://www.concurrences.com/rubrique.php3?id_rubrique=578

level that would exist in a competitive market. Under the EU competition law, it is not illegal to hold a dominant position, since a dominant position can be obtained by legitimate means of competition, for example by inventing and selling a better product. Instead, competition rules do not allow companies to abuse their dominant position."⁵⁰

Now, the notion of dominance is set and we will move forward with its consequences. First of all the dominance under the EU law might be discouraging legitimate and desirable competition of dominant undertaking because it imposes restrictions and additional responsibility on the firm. In this sense the firm is punished and not rewarded for its successful market conduct. Even though this incentive may not be significant, still it is distorting. "The successful competitor, having been urged to compete, must not be turned upon when he wins."⁵¹

The Guidance Paper suggests three steps to assess particular type of conduct. First comes the question of dominance. Especially the market share threshold for dominance has been discussed a lot before the Guidelines were published. Nevertheless, the Commission claims that experience suggest that dominance is not likely if the undertaking's market share is below 40 % in the relevant market. (European Commission 2009) The 40 % threshold is more a type of golden rule than a strict law. Moreover, as discussed above, the dominance assessment depends also on the entry conditions in the particular market and credible outlook of the industry e.g. future expansion by competitors, even the buyer's power is to be considered. The opinions on the effect of the potential competition vary and are slightly biased towards e.g. Prof. Stephen Martin thinking: "The fact that competitors may come any day has essentially the same effect as if it had come, because to keep it out requires the same kind of influence that would be necessary to drive it out." (Martin 2008, 6)

⁵⁰ http://www.concurrences.com/article.php3?id_article=12326&lang=en

⁵¹ United States v. Aluminum Company of America (known as "Alcoa"), 148 U.S. 416 (1945)

When the undertaking is found to be subject to the scrutiny under the Article 82 afterwards the Commission turns its attention to the market foreclosure. The EC is extremely worried about foreclosing markets (second step of the conduct analysis). The most relevant factors for anticompetitive foreclosure assessment are considered the following – market position of the dominant undertaking, entry and expansion conditions of the relevant market, positions of the competitors, position of the customers and suppliers, the extent of the allegedly abusive conduct, evidence of actual foreclosure and evidence of the exclusionary strategy. (European Commission 2009)

The progress in judging the dominant firm can be seen in the Guidance Paper which takes into account even the effect of a hypothetical competitor (when the possible market foreclosure is assessed). “In order to determine whether a hypothetical competitor as efficient as the dominant undertaking would be likely to be foreclosed by the conduct in question, the Commission will examine economic data relating to costs and sales prices, and in particular whether the dominant undertaking is engaging in below-cost pricing.” (European Commission 2009, 25) Unfortunately, any proof of market power or market power effects imposes some costs and introduces uncertainty into the antitrust enforcement process. (Melamed 1998)

Moreover, market power and market share should not be sufficient to condemn exclusionary agreements because they sometimes happen to be the most efficient form of distribution. For this reason the company can defend its conduct as “objectively necessary” or on the grounds of efficiencies that result from the conduct and that clearly outweigh any long run anticompetitive effects. The burden of proof lies with the dominant firm.

The Guidance Paper addresses more closely some specific forms of abuses such as exclusive dealing and rebates (with the focus on long-term exclusive dealing arrangements, in particular the EC looks at the retroactive and individualized

rebates), tying and bundling (especially when the two products are distinct – which includes technical tying – and foreclosure is likely), predatory pricing (deliberate incursion of losses or foregone profits in the short run), and finally refusal to supply and margin squeeze (any company should have the right to choose its trading partners); the refusal to supply covers not only goods but also Intellectual Property Rights. (European Commission 2009, art. 4) It worth mentioning that the refusal to grant access to the IPRs is per se legal! (Abusive only in exceptional circumstances, the Guidance Paper includes the non-exhaustive list of these circumstances which were fulfilled e.g. by the Microsoft Corporation.) (Mayer and Brown 2008, 8)

The Commission is trying to make the assessment process further transparent because it realizes the costs of this procedure. It is important to minimize the sum of enforcement costs and also the costs of enforcement errors (these are the costs incurred when efficient pro-competitive transactions are prevented or when anticompetitive transactions are permitted). (Melamed 1998) Both types of costs are related, however, their relation can be hardly described by a “simple” correlation. In theory, if the enforcement costs are increasing the enforcement errors should be decreasing but the law of decreasing marginal utility (of increased enforcement) is very likely to apply. On the other hand, the increase in enforcement costs might as well increase enforcement errors when the investigation focuses on less significant or too difficult issues. “Moreover, legal rules that require substantial enforcement costs for their application will lead to an increase in enforcement errors to the extent that the prospect of such costs deters efficient transactions or legal challenges to anticompetitive transactions.” (Melamed 1998)

At the end of the day, regardless the size of the company, the outcome is a decisive factor. Final impact on markets matters the most.

3.3.1 Monopoly pricing

Special case that falls within the Article 82(102) in which American and European jurisdictions differ is monopoly pricing. Over the course of time the importance of monopoly pricing for the dynamics of the market mechanism was recognized. (Gal 2004, 13) The legal possibility of monopoly pricing practice is an important incentive to invest and innovate. For the effort to obtain a competitive advantage the company should be rewarded.

“It is critical that competition policy has a clear view of whether price discrimination should be permitted or not. Unfortunately, this is not always the case, as price discrimination, while generally permitted in the U.S., is often viewed with suspicion elsewhere (especially in the EU). In addition, while price discrimination on its own is not a violation of U.S. antitrust law, practices whose sole purpose is to enable price discrimination – such as tying products together to meter usage – can be antitrust violations. In other jurisdictions (including Europe) price discrimination on its own can be an antitrust violation.” (Carlton and Israel 2009)

The acceptance of monopoly pricing has several important advantages. First, there is no need to apply price regulation which brings a lot of practical problems such as price setting facing the asymmetric information, questionable efficacy of governmental interventions and others. On the other hand, monopoly pricing particularly in Europe is not considered to be fair.

If we accept the notion of fairness, the question is: what constitutes an unfair price? How high it has to be to become abusive according to the Article 82? The ECJ in General Motors⁵² case defined a price as abusive when it has no reasonable relation to economic value. And if markets do not set the price how does it? Who is to say who sets the price and how? The judges or regulators or any

⁵² General Motors Continental NV v. EC Commission, Case 26/75 [1975] ECR 1367

other appointed person is given an extremely difficult task to calculate the “just” price and affect markets.

If anybody determines the regulated price, it changes the market conditions, incentives and it is also reflected in expectation. We must ask whether the limited ability of government to set the price and costs of regulation outweigh its benefits. Does the regulation cause more good than bad?

The European Article 82(102) prohibits conduct that directly or indirectly imposes “unfair purchase or selling prices or other unfair trading conditions”. Therefore, the excessive pricing prohibition is to be analyzed in the light of fairness. The EU approach forbids both exclusionary as well as exploitative conduct. Furthermore, the Commission confirmed that cost-price test is a first step towards a finding of abuse. A comprehensive cost analysis is fundamental to determine whether the price is excessive; (if needed followed by market comparison test). (Gal 2004, 37)

Moreover, what profit of a dominant firm is a reasonable one? The test for excessiveness of the price adopted by the EC in the Naloo⁵³ case showed a turn towards more economic based approach. This test focuses more on the competition and competitiveness downstream rather than on the profits of the dominant firm.

There is another reason why the excessive pricing is considered to be an abuse of market power. If we will track the roots of this idea we would get back to the Ordoliberal ideology developed by the Freiburg School in Germany right after the Second World War (WWII) which wanted an economic constitution that would limit the convergence of private economic power in the interest of a free and fair political and social order. Thus excessive pricing is an abuse of the market power because it creates an unequal distribution of the benefits of the market. (Gal 2004, 27) The Ordoliberal ideology is already outdated but the notion of fairness in

⁵³ Naloo v. EC Commission [2001] ECR II 515

our society remained. Economics in most cases maximizes total welfare or total social welfare and the distribution of the total “pie” is left for the next step. Competition policy can increase the size of the “pie” however it is not a suitable tool for redistribution.

Monopoly as such does not violate the U.S. competition law, nor does the monopoly pricing. Obtaining or maintaining monopoly is compatible with American free market as long as the monopolist does not engage in “exclusionary conduct” defined by the U.S. Supreme Court (e.g. in the *Trinko*⁵⁴ case) as “a conduct that makes no economic sense but for its tendency to eliminate or lessen competition.” “Thus conduct by a dominant firm that makes economic sense in that it promotes firm’s efficiency does not violate Section 2 of the Sherman Act even if such conduct harms existing or potential competition.” (Abbott 2005b)

Section 2 of the Sherman Act reaches inefficient behavior that may allow a non-dominant firm to obtain a monopoly. By contrast, Article 82 does not sanction conduct, whether efficient or inefficient, until a dominant position has been obtained.

Under current law, American enforcers and courts, unlike the European enforcers, will almost invariably leave undisturbed efficient business conduct, even if its effects are to allow a firm to maintain its monopoly. (Abbott 2005b, 12-13)

Compared to the Article 82 of the EC Treaty which sanctions any “abuse of the dominant position” and does not include an efficiency clause the distinction is striking. It is true that Article 82 does not prohibit dominant positions as such, merely the abuse of such a position in a specific market when it is likely to affect

⁵⁴ *Verizon Communications v. Law Offices of Curtis V. Trinko LLP*, 540 U.S. 398 (2004) (known as “*Trinko*”).

trade between Member States.⁵⁵ This confirms the different perception of monopoly of which the distinct approach is just a natural consequence.

As was stated at the beginning the purpose of this thesis, among other reasons, is to emphasize the significance of difference. There are factual differences and then there is the different attitude. It is what Michael Gal calls “two systems of believe.” The question is about our belief in how markets operate. The U.S. considers economy as essentially competitive, if the creation of the artificial barriers is forbidden, and finds monopolies created in other way than artificial to be natural and relatively unimportant. (Gal 2004, 4) The U.S. state of antitrust also reflects the role of government and its tendency to interfere with free markets which is very limited. On the other hand, the law of the EU shows a different attitude, it reflects a lesser belief in the ability of market forces to erode monopoly and stronger belief in the ability of a regulator to intervene efficiently and set and change the rules of the game in the market. (Gal 2004, 4) The EU also rests more on the principle of distributional justice than the U.S.

This creates at the first sight invisible background of American and European antitrust approach – different beliefs about the ability of market forces. Michal Gal even claims that monopoly pricing regulation in many ways mimics the competition policy itself.

3.4 Mergers

However, the European competition policy does not supervise only antitrust. It further covers mergers which are reviewed and assessed in accordance with the Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (The “Merger Regulation”) and Commission Regulation (EC) No 802/2004 known as the “Implementing Regulation” (amended 2008).

⁵⁵ http://www.europarl.europa.eu/factsheets/3_3_2_en.htm

According to the Merger Regulation, the EC has a right to block a merger based on the following provision: "A concentration with a Community dimension which creates or strengthens a dominant position as a result of which effective competition in the common market or in a substantial part of it would be significantly impeded should be declared incompatible with the common market."⁵⁶

Mergers (the regulation generally covers the horizontal ones) are very difficult to judge as discussed previously. The company's point of view is straightforward – joining forces and increasing the market share is a sign of success. However, for the European Commission the significant market share is a reason to worry. "If the annual turnover of the combined businesses exceeds specified thresholds in terms of global and European sales, the proposed merger must be notified to the European Commission, which must examine it (on the grounds that some mergers may reduce competition in a market; usually by creating or strengthening a dominant player). This is likely to harm consumers through higher prices, reduced choice or less innovation."⁵⁷

One example for all, the Commission was examining the acquisition of Wella by Procter&Gamble and concluded that it would reduce competition in the market for hair-care products, especially in Ireland, Norway and Sweden. Hence Procter&Gamble offered to license some of its product lines to its competitors to be able to carry out the acquisition. (European Commission 2004) There was a similar case in the Czech Republic, where the Office for Protection of Competition did not allow an acquisition of Delta Pekárny by Bakeries International, because these firms are the two biggest market players and together would become a dominant on the market with bread, rolls etc.⁵⁸

⁵⁶ Council Regulation (EC) No 139/2004, January 2004, paragraph 24, (known as "The EC Merger Regulation").

⁵⁷ http://ec.europa.eu/competition/mergers/overview_en.html

⁵⁸ <http://www.mobchod.cz/index.php?itemid=2597>

Predominantly the EC asks whether a merger will strengthen a dominant firm and to what extent it would or could foreclose the relevant market.

3.5 Cartels

The next section covers cartels which represent a very specific problem. It is a secret way to avoid competition. This illegal cooperation may take a lot of forms e.g. dividing up the market, limit production, exchange sensitive information, fixing prices or coordinate them. Under economic reasoning, it is profitable for a company to collaborate secretly with its competitors and together set a new market strategy. The cartels can be both vertical and horizontal. All of them are prohibited under the EU Competition law with no exceptions. Fines up to 10% of the worldwide turnover may be imposed on the guilty parties.⁵⁹ Hundreds of millions of Euros are not an exceptional penalty, to demonstrate the determination of the EU to punish such a behavior five largest fines imposed by the Commission in cartel cases follow:

Table 1: Five highest cartel fines per undertaking (since 1969)

Year	Undertaking	Case	Amount in €
2008	Saint Gobain	Car glass	896.000.000
2009	E.ON	Gas	553.000.000
2009	GDF Suez	Gas	553.000.000
2007	ThyssenKrupp	Elevators and Escalators	479.669.850
2001	F. Hoffmann-La Roche AG	Vitamins	462.000.000

Source: Cartel Statistics, European Commission Report, as of January 31st, 2010. Available at: http://ec.europa.eu/competition/cartels/overview/index_en.html

Even though the possible fine is a considerable amount of money, companies still tend to avoid the competition and get involved in cartels. This gives us a clear idea about how profitable a cartel may be. Notwithstanding, the profitability of such a behavior, cartels are very fragile, inherently instable. Breaking the secret

⁵⁹ http://ec.europa.eu/competition/cartels/overview/faqs_en.html

agreement is attractive for each of the participants as long as the others stay with the then plan. And because these pacts are unenforceable, hardly ever written or coordinated on a weekly basis; it is not easy to discover that somebody has been cheating on the secret deal.

The Commission has recently decided to use this characteristic feature to fight the cartels and has introduced a Leniency program. "In essence, the leniency policy offers companies involved in a cartel – which self-report and hand over evidence – either total immunity from fines or a reduction of fines which the Commission would have otherwise imposed on them."⁶⁰

Leniency program has theoretical background in a special kind of information asymmetry – moral hazard. In the case of cartels it is the internal moral hazard of the players. Suppose a situation when a cartel is already working and all members have been enjoying extra anticompetitive profits. At certain point one of the members may give up on cartel at the costs of other members and thus get cartel profits (from previous period) as well as protection from legal prosecution (for breaching antitrust laws) offered by Leniency program. Severe penalties and costs of damages enforcement by private parties further increase the risk and the entire structure becomes very unstable. Every player might have an incentive to deviate from common strategy which would not be the case if actions of each player were observable (at least within the cartel). The member who first reports the cartel becomes a winner and in business everyone wants to win.

The EU has a model Leniency program but countries differ in their leniency arrangements. Generally, the further convergence of leniency programs on the EU level is expected soon. The Commission intends to introduce a broader cooperation of the Member States competition authorities and hopes in support by the private enforcement of the competition law. A directive that would

⁶⁰ <http://ec.europa.eu/competition/cartels/leniency/leniency.html>

formalize the uniform procedure is being discussed (see the White Paper adopted in 2008).

3.6 Liberalization

In order to further support the common market the Commission has adopted directives under the Article 86 of the EC Treaty to make public companies more transparent and open up the markets. The most visible success is probably the liberalization of air transport that changed the entire industry and enabled the existence of low costs carriers. "Services such as transport, energy, postal services and telecommunications have not always been as open to competition as they are today. The European Commission has been instrumental in opening up these markets to competition. In the EU Member States, services like these have previously been provided by national organizations with exclusive rights to provide a given service."⁶¹

A lot has been done to liberalize the markets, however, some deliberate decisions to break up the former structures were controversial e.g. the New Regulatory Framework (NRF), which is the set of rules dealing with electronic communications markets. According to this framework the European Commission created a set of so called relevant markets that are analyzed by national regulatory offices in order to investigate whether there is an effective competition on those markets or not. If any company is claimed to have a significant market power, then it is required to impose remedies on such a market. (Zají ek and Zeman 2008)

Another very interesting principle is the Open Network Provision (ONP, sometimes called Third Party Access) which is trying to overcome the high sunk costs of building a network. The authority can simply order an incumbent to allow others (competitors) to use its network for a regulated price. Adopting such a policy has had a significant impact. National monopolies used to over-invest

⁶¹ http://ec.europa.eu/competition/liberalisation/overview_en.html

into networks (often as a consequence of the rate-of-return regulation that applied to many natural monopolies). Suddenly, after ONP there was no incentive to invest at all for anybody. (Zají ek and Zeman 2008)

Sometimes the competition policy resembles a list of state interventions. It might create the impression that if we come across a market or incentive failure it is sufficient to impose some kind of regulation. However, this is not the only right way to deal with markets. The NRF and ONP are intended to be a warning that reminds us that there is a critical number of state interventions after which the Invisible hand stops functioning properly. The paragraphs above were to show that the regulatory measures are sometimes questionable and their influence is hard to anticipate. Regulation is not an answer for every market problem but still if it is used reasonably it is an effective tool (as long as the economic theory is kept in mind). There might be a stamp on each directive "To Be Applied with Caution."

3.7 State Aid

State aid represents one of the EU v. U.S. differences because it is not a part of the American antitrust. For the U.S. authorities the state aid does not constitute a market distortion (at least no official provisions cover it). The fear of impairing the single market made it part of the European competition policy. There is nothing unclear about why state aid is monitored and in general forms forbidden by the EU law. It gives the companies (often previously partially state-owned) an unfair advantage over their competitors. It distorts equal chances. The cost curve with e.g. subsidy (governmental help) changes, thus basic optimization problem changes as well. Marginal costs are different, consequently the price is different and there is an oversupply of given product. Throughout the process of production the wrong information multiplies and spreads through the economy like a virus. It is the misleading signal that does the damage in the way described by F. A. Hayek in his famous article "The Use of Knowledge in Society".

“The objective of State aid control is, as laid down in the founding Treaties of the European Communities, to ensure that government interventions do not distort competition and intra-community trade. In this respect, State aid is defined as an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities.”⁶²

Under standard terms the State Aid is prohibited by the Articles 87, 88 and 89 of the EC Treaty (107, 108, and 109 of the TFEU) because it is incompatible with the common market. However, there are a number of exemptions, to be more specific – transportation, coal, fisheries and agriculture operate under different regimes and also R&D, training, employment and environmental protection can be supported through the exemption clause.

Nowadays, the importance of state aid is even increasing due to the fading financial crisis. State often provides the first aid treatment as well as becomes the lender of last resort afterwards. It is really questionable what kind of help the state should give to banks and other institutions to stay in compliance with the competition policy rules and at the same time help where it is necessary.

Notwithstanding, the current state aid cases cannot be investigated for months because only the immediate help might possibly change the course of ongoing situation. “The European Commission has published guidance on how Member States can best support financial institutions in crisis while respecting EU state aid rules and so avoiding excessive distortions of the competition. The guidance is based in particular on EC Treaty rules allowing for aid to remedy a serious disturbance in the economy of a Member State (Article 87.3.b of the EC Treaty).”⁶³

3.8 International Issues

Last section of the European competition policy tackles the international issues. With the proceeding globalization more of the above mentioned matters are

⁶² http://ec.europa.eu/competition/state_aid/overview/index_en.html

⁶³ http://ec.europa.eu/competition/state_aid/reform/reform.html

becoming international; in order to face companies that join forces worldwide also the European Commission got involved in international cooperation with various international organizations such as OECD and WTO. The same applies for the financial crisis aid that is tried to be coordinated at least EU-wide in order to gain the best response.

Chapter 4

4.1 Modeling Strategies or else Model-it-yourself

Vertical mergers should be challenged based on something robust and empirically testable – ideally a model that would be grounded in solid industry specific evidence. However, the literature suggests that there are just few not very persuasive models (often based on our prior beliefs about the practice in question). Moreover, it also seems that purely structural criteria are very problematic. In addition, a suitable model has to take into account both LR and SR effects and should overlook neither interbrand nor intrabrand competition. The impact of vertical restraint can be analyzed in static or dynamic framework. The dynamic one takes into account entry conditions, incentives for investment and other important factors and is more suitable for the analysis. On the top of it, even the purpose of the distribution system matters because e.g. franchising contracts are distinguished from other distributional arrangements in order to protect the franchisor's know-how and reputation. To incorporate all these features into a model is an extremely difficult task that no one has done successfully so far.

Still economic models are an approximation of reality that is their weakness and their strength at the same time. The power of modeling comes from simplifying reality. Therefore, any results given by a model must be examined in the light of that model. It is crucial to understand the distortions the model has done to the reality to be able to process it.

However, most economic models have in common the way they are constructed. We can call it “per partes” or “step by step” anyway it always starts from a simple model which abstracts from many real features and as the theory develops further the model becomes more complicated incorporating previously omitted variables.

At the beginning of any modeling we should state our hypothesis. In the antitrust-merger case we are looking for presumptions of a vertical merger to be procompetitive (or anticompetitive). The starting point should be a description of the real state of the world. “However, in evaluating vertical mergers we must never forget that economics of vertical relationship is fundamentally different from the economics of horizontal relationship. A company and either its supplier or distributor generally have a mutual incentive to lower their prices.” (Salinger 2005) If they have an opposite goal we should be able to identify it (based on some sort of conditions).

Mergers are often (especially the horizontal ones) described by game theory models. But in this case the setting is vertical not horizontal therefore the general model equilibrium has different characteristics and the usual Nash equilibrium solution is not adequate. (Salinger 2005) To understand why, we will look closer at the Nash equilibrium, its formal definition follows⁶⁴:

A pure strategy Nash equilibrium of a strategic game $(I, (S_i), (u_i)_{i \in I})$ is an outcome $s \in S$ subject to $i \in I$ the following condition holds

$$u_i(s_i^*, s_{-i}^*) \geq u_i(s_i, s_{-i}^*) \quad \forall s_i \in S_i.$$

⁶⁴ (Mas-Colell, Whinston and Green 1995, 246)

Where I is finite set of players, $I = \{1, \dots, I\}$, $(S_i)_{i \in I}$ is a set of available actions where S_i is a non-empty set of actions for player i , $(u_i)_{i \in I}$ is a set of payoff functions where $u_i : S \rightarrow \mathbb{R}$ is a function from the set of all outcomes to the real numbers.

In words, the Nash equilibrium is a set of strategies, one for each player such that no player has an incentive to unilaterally change its action.⁶⁵ Every player takes the strategy of others as given and according to them chooses own best response. From the definition follows that the model holds decisions of other players/agents constant. But this is not the case if the relation is vertical. If a vertically integrated firm changes output or price then it directly affects the downstream market to which it supplies. It makes no economic sense to suppose that the supplier from the downstream market will not react accordingly. Vertical structure simply requires vertically interconnected players. For this reason Nash equilibrium is not optimal and the same holds for e.g. classical Cournot model that does not include buyers/consumers among players either (see the definition)⁶⁶:

A Cournot oligopoly is a game between n firms, where the strategy space S_i of firm i is its production level, which lies in the interval $[0, \infty)$, and its utility function is $u_i(d_1, \dots, d_n) = P_i(d_1, \dots, d_n)d_i - c_i(d_i)$, where P_i is the market inverse demand function, for the good of firm i , which maps the vector of production levels to a market clearing price in \mathbb{R}^+ .

Thus, are there any other suitable methods? In a small regional scale “Difference in Differences” approach could be actually helpful. Local comparable markets with different degree of integration might point out the effects either positive or negative of vertical structure. However, we are considering the EU

⁶⁵ <http://www.gametheory.net/dictionary/NashEquilibrium.html>

⁶⁶ (Nadav and Piliouras 2010)

perspective not the national one and from the point of the EU these local markets most probably would fall below so called “Community dimension” threshold (defined by turnover criteria in Merger Regulation).

However, I would like to propose a slightly different approach. If the vertical relationship is too complicated for game theory and functional forms of behavior lack empiric evidence to be based on we could begin on the micro level by describing the firms’ conduct. The micro foundations are always useful. My suggestion is to characterize the options that a firm has by the following payoff matrix:

Table 2: Payoff Matrix (neutral) for a firm that has engaged in a vertical agreement and enforcement officials – authority (A)

		Firm				
		Anticompetitive		Procompetitive		
A u t h o r i t y	CH	A Wins	$c - la + p$	$- b - p - lf$	$- d - la + p$	$- a - p - lf$
		A Loses	$- c - la$	$b - lf$	$d - la$	$a - lf$
	NCH		$- c$	b	d	a

Source: own model

In the case of the above payoff matrix, firm equals to the vertically integrated manufacturer and distributor, they are considered to be one entity due to the common goal. Authority (A) stands for enforcement officials but in the payoff sense it is perceived as an impact on/payoff for the whole society which includes consumers and authority as well as competition itself. (CH) is an abbreviation for challenged practice – a case when the authority files a suit against the firm whereas (NCH) stands for an unchallenged practice.

All variables are positive and each (horizontal) doublecell of the table constitutes a payoff for authority and firm in a given situation when the “game” (not necessarily the deal) is over. The variables are defined as follows:

- a gain of the firm when it engages in procompetitive practice
- b gain of the firm when it engages in anticompetitive practice
- c costs of the anticompetitive action if it is unchallenged for the authority/society/competition
- d gain of the authority/society/competition in case of a procompetitive action
- la litigation costs of the authority
- lf litigation costs of the firm
- p penalty paid by the firm if it engages in a anticompetitive practice and gets caught (the practice is challenged and the authority wins the lawsuit)

The first row of the payoff matrix includes opportunity cost i.e. what firm and/or authority would have got in terms of a and d or b and c, had the authority lost the trial. We put some more restrictions on our variables to make the setting more reasonable. In addition, we suppose:

$$a, b, c, d, p, la, lf > 0$$

$$la, lf < a, b, c, d, p$$

$la < lf$ it makes sense to assume that the litigation costs are higher for the firm (based on empirical observations)

$b \gg a$ the anticompetitive conduct brings greater profit

$p < b$ penalty is lower than the possible anticompetitive profit

Further, it makes sense to assume (even though it is not necessary) that b and c are likely to be higher than d . The especially interesting relation between b and c and also a and d depends on particular conduct in question and does not influence the firm's decision because the firm optimizes only own behavior not total social benefits. The costs of deciding whether to challenge the vertical merger are neglected.

The story behind the payoff matrix (Table 2) offers a decision framework that rests on neither prior beliefs about the practice nor industry structure. Suppose an upstream market firm decides to settle a contract with a downstream market firm. They agree on an ordinary deal between manufacturer (upstream market firm) and distributor (downstream market firm). At this point it does not really matter whether the vertical arrangement is a procompetitive or an anticompetitive one.

Further, we suppose that the deal is actually settled if and only if it is beneficial for both parties. Taking into account the freedom of contracting and the previously mentioned market interpretation by Melamed (1998) (see p. 27). It is a reasonable assumption that holds in majority of cases. Thus from now on, these two firms form a vertical structure to which it is referred as a "Firm" in the payoff matrix.

Table 2 shows the payoff matrix for each player, it does not take side, it is objective – what a third party would observe, it could be as well expressed in terms of money. However, the firm takes into account a different version of Table 2 because it does not care about the authority's payoff at all. The firm maximizes its own profits therefore it perceives the situation as described in Table 3.

Table 3: Payoff Matrix – Firm’s Perspective

		Firm	
		Anticompetitive	Procompetitive
CH	A Wins	- b - p - lf	- a - p - lf
	A Loses	b - lf	a - lf
NCH		b	a

Source: own model

The firm decides facing the above given options. Depending on the law system experience, and institutional framework it can more or less anticipate whether the practice in question will or will not be challenged. The Table 3 includes also “mistake scenarios” and corresponding costs. We suppose that the firm itself knows what practices it got engaged into which reduces further the number of options to three (probability of these options will be discussed later on). The firm chooses optimal conduct because profit is its only interest.

Nevertheless, it is important to realize that the firm and the authority are uneven players. The firm chooses its conduct and we suppose that it knows very well whether it is likely to harm competition (anticompetitive) or improve it (procompetitive). Compared to authority that faces the same conduct but does not know into which category it would fall. Based on the empirical evidence, rules, guidelines, and expert judgment etc. authority decides whether to challenge the practice or not. At this moment the enforcement officials face the possible costs of type-I error (loss from prosecuting a procompetitive practice) and of type-II error (loss from failing to prosecute an anticompetitive practice). When it comes to prosecution authority either loses (it misjudged the conduct or failed to prove that it actually is anticompetitive) or wins (restores the market situation and thus

benefits consumers if it was right or if it was wrong it does a significant damage in terms of costs of type-I error).

As was stated above authority and firm are not in the same position. Not even authority compares and balances options in Table 2. Rather it focuses on Table 4 and decides accordingly.

Table 4: Payoff Matrix – Authority’s Perspective

A u t h o r i t y			Anticompetitive	Procompetitive
	CH	A Wins	$c - la + p$	$- d - la + p - x(a)$
		A Loses	$- c - la$	$d - la + x(a)$
	NCH		$- c$	$d + x(a)$

Source: own model

How the authority perceives the problem can be seen in Table 4. The significant difference is captured in new variable – term $x(a)$. Even though real payoffs have not changed, the table is slightly different because the authority is not selfish and its goal is not only to protect competition against distortions but also to promote competition and support competitive environment (growth, welfare etc), therefore it cares about the procompetitive vertical structure. This “care” is expressed by the new term $x(a)$ where x is the function of a and it constitutes a spillover effect unintentionally produced by the firm when it engages into a procompetitive vertical arrangement. Unfortunately it is not a part of firm optimization process. It represents benefits of setting right precedent, increased welfare of society, new innovation motives etc.; all of them authority pursues as its objectives. Note that $x(a)$ is different form d which equals to real positive effects of the actual procompetitive practice in place such as lower price due to decreased transaction costs, output expansion etc.

The term $x(a)$ could be called a “side effect” of d which the authority takes into consideration. Third party would not include $x(a)$ (as in Table 2) however authority counts it in. It is a parallel to the theory of consumer from microeconomics. Table 2 contains pure gains whereas Table 4 comprehends also the utility which the authority gets from the firm’s behavior. However, for the firm the profits and utility are the same (it is neutral). That is the reason why in this situation the important parameters i.e. number of decisions, information, forcing power etc. are unequally distributed. That is why this situation is difficult to capture and even more difficult to solve.

If we omit the litigation costs then according to the Table 4 the costs of type-I error (loss from prosecuting a procompetitive practice) are approximately equal to $d+x(a)$ and the costs of type-II error (loss from failing to prosecute an anticompetitive practice) would be around the value of c .

The framework itself is rather descriptive but it gives intuition about the options both firm and authority have. My idea was to put together an orientation for the problem and keep it clear without an excessive amount assumptions and “if clauses”. It is said that formulating the problem out loud solves one half of it and it gives shape to its actual answer. One of the points was also to underline the influence of the institutional framework which is preset; authority does not perform 100% deliberate decision as opposed to the firm but takes all the responsibility.

Conclusions for unequally “powerful” players are hard to give, however the authority’s disadvantage (of not knowing what kind of practice it is facing) is partially offset by the correcting feature it was given i.e. authority has the possibility of legal remedy on its side thus if it decides to challenge a procompetitive practice it may be corrected by the court. It is always a two step procedure with the (built-in) self-correcting mechanism. Antitrust final judgments

are always case dependent but the general framework sheds some light on the rulings in cases with economic heart.

Especially, Table 4 emphasizes the implications of non-private player – authority – involvement. The essence of private and social goals is different thus the incorporation of the notion of social welfare makes conclusions about vertical restraints even harder.

Adding probabilities of being challenged or not and of losing or winning the trial could extend the setting, however the probability matters in case of optimization but because in this case it comes from more or less external sources it could obscure the point I wanted to make about the options both players have in this framework. Nevertheless, it could be included as a possible improvement in the next step of analysis.

The probabilities were ruled out on the grounds of following assumptions. Neither probability of being prosecuted nor probability of winning/losing the trial are randomly assigned numbers. In majority of cases the authority bases its decision on the guidelines, case law, and internal rules. It is a process that may sometimes fail but it is more or less independent of any specific case, it is not a person-based decision. For this reason on average the process comes to a right conclusion.

The decision framework that was introduced on previous pages was to facilitate understanding, to enlighten the structure and give some basics for optimization. For each case the variables take different values but still they allow us to compare the options both firm and authority are facing. The first step in such a situation analysis is certainly orientation and that is what I wanted to provide because it is the only fully general part, common for all vertical restraints monitored by authorities. It also gives some ideas about how and “where” mistakes are produced and what costs they have which will turn out to be useful background for the following subchapter.

As demonstrated by the intuition behind the payoff matrixes the authorities that work in a certain preset framework are monitoring settings, applying directives etc. so if a practice should be challenged and it is not, it accounts primarily for a mistake in the process, the same is true for losing the trial.

The notion of mistakes brings us closer to a different model that was developed by Cooper, et al. (2005) and stands exactly of these mistakes. This model is introduced in the next subchapter and it focuses on the influence and consequences of the above mentioned decisions' errors. Moreover, it offers an explanation why competition policy of the European Union and antitrust of the United States are different.

4.2 Learning by Mistakes – The Case of Model Based on Errors

Let's start from the beginning the influence of the Chicago school was stronger in the U.S. which might be another reason why their attitude to vertical restraints is different.

"Chicago school economist believe that majority of vertical restraints are actually efficient. They claim that errors of over-enforcement and deterrence (so called type-I errors i.e. loss from preventing desirable merger) are more harmful than errors of under-enforcement (type-II errors i.e. loss from permitting undesirable acquisition). Merger laws are far more concerned with avoiding type-II errors – that is with allowing anticompetitive mergers – than with avoiding type-I errors by preventing desirable one." (Harbour 2005)

Based on the error types Cooper, et al. (2005) offer reasonable explanation why the U.S. and the EU even though they share the same economic theory may come to a different conclusion about vertical arrangements.

Cooper, et al. (2005) have used a model set in Bayesian framework to interpret both approaches to vertical restraints. They have introduced a model which draws inferences from available evidence and makes enforcement based on these inferences. Their model supposes that a vertical practice can be either

procompetitive “C” or anticompetitive “A”. Moreover, let x be evidence observed by a decision maker and correlated with competitive effects of the practice. The idea of the model stands on the Bayes rule and loss function. Given the evidence x , assume that the decision maker can either stop the practice or allow it to continue. The model focuses mainly on two things – the problem of interference and prior beliefs.

“Given the evidence what is the probability that a given practice is anticompetitive? The policy maker’s belief about the relative odds that a given practice is anticompetitive $\frac{P(A|x)}{P(C|x)}$ can be written as a function of prior beliefs about the practice $\frac{P(A)}{P(C)}$ and the relative likelihood that the evidence observed is produced by anticompetitive conduct $\frac{P(x|A)}{P(x|C)}$.” (J. C. Cooper, L. Froeb, et al. 2005)

Thus

$$\frac{P(A|x)}{P(C|x)} = \frac{P(x|A)}{P(x|C)} \frac{P(A)}{P(C)}$$

The expected loss from type-I error (prosecuting a procompetitive practice)

$$E[Loss_I | x] = L_I P(C|x) = \frac{L_I P(x|C) P(C)}{P(x)}$$

The expected loss from type-II error (failing to prosecute an anticompetitive practice):

$$E[Loss_{II} | x] = L_{II} P(A|x) = \frac{L_{II} P(x|A) P(A)}{P(x)}$$

The Bayesian rule suggests that vertical merger should be challenged if and only if the expected type-II loss is greater than the expected type-I loss. The question is whether it is possible to measure the parameters x , A , and C

accurately enough to make this rule really applicable. On the other hand, it clearly shows that if we suppose similar prior beliefs (the U.S. and the EU) then different likelihood and loss functions can explain divergent antitrust policies.

The expected loss equations together with the equation expressing $\frac{P(A|x)}{P(C|x)}$ form the optimal enforcement rule that depends on the likelihoods, loss functions, and prior beliefs:

$$\frac{P(x|C)}{P(x|A)} < \left(\frac{L_{II}}{L_I} \right) \left(\frac{P(A)}{P(C)} \right)$$

The following assumption is based on empirical evidence:

$$0 < \frac{P(x|A)}{P(x|C)} < 1$$

According to Cooper, et al. (2005) last inequality together with the expression above justifies the difference in competition policies, discussion follows.

4.2.1 Where Does the Difference Come from?

European competition law condemns many more vertical agreements than does the U.S. antitrust law. The commentators like to say that the EU pursues vertical non-price restraints with “remarkable hostility”. In the U.S. vertical agreements are presumed to be legal unless the plaintiff can show otherwise. Moreover, since the *Sylvania case*⁶⁷ vertical non-price restraints are to be judged under the rule of reason. (J. C. Cooper, L. Froeb, et al. 2005)

Now let’s start with the EU, the Cooper’s model suggests (in order to be in compliance with empirical facts i.e. harsh treatment of vertical agreements in the EU) that the costs of type-II error are more important and perceived as more dangerous and damaging in the EU. To get to know why we have to go back and

⁶⁷ *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977)

take a look into European history (mentioned at the beginning). Europe has spent the last decades by creating the common market and the primary objective of competition policy is to protect the European single market.

Any vertical arrangement that would discriminate, create barriers to entry or foreclose the market would harm the single market significantly. For example exclusive territories based on national borders would impair it severely. This reasoning is in line with empiric evidence because the EU indeed prosecutes vertical arrangements with great determination. In a nutshell, the costs of type-II errors are too high for the Europeans and they would not let anything to damage their integration. On the other hand, the model implies that the EU competition policy decisions are skewed – biased against type-II errors. Only further research could enlighten the consequences of such a bias, moreover it would be interesting to know to what extent it is actually skewed.

Now it is time to return to the legal introduction which stands behind the explanation why the U.S. are biased against type-I errors. The U.S. law system is based on the doctrine of Stare Decisis ('stand by decided matters') which transmits a one-shot mistake into a significant long run loss that increases over time. If the U.S. officials condemn a beneficial practice the benefits may be lost for good due to the Stare Decisis doctrine. Moreover, if the courts permit an anticompetitive practice the welfare loss decreases over time because in the American perception monopoly is self-destructive, because its profits attract new competition. (J. C. Cooper, L. Froeb, et al. 2005)

When a vertical practice is wrongfully condemned for harming competition it generates a great loss for society because one bad decision prevents other efficient mergers to happen. Therefore, the American enforcement officials are biased against type-I errors. This attitude further reflects the reluctance to change precedents which are overruled only in exceptional circumstances.

Cooper, et al. (2005) developed a model that is able to explain the differences, the costs of type-II errors are really high in Europe due to the integration goal, therefore the European officials are naturally biased against them. On the other hand, the American legal system causes a considerable bias against type-I errors in the U.S. Even though the model solves the problem of differences in a surprisingly clear way it overlooks many other features such as institutions. It also does not facilitate any predictions and most importantly all three crucial parameters are very hard to measure or estimate. Meanwhile, relying on economic analysis can reduce the differences between competition policies over time.

Nevertheless, it reflects reality to a certain degree and also makes an important point – there is no such a thing as different competition policies or different treatment of competition, there are merely different preferences which are easier to overcome when confronted with evolution. In fact we all share the same belief about competition and that is what counts.

Regardless the conclusions of Cooper's model it is obvious that decision mistakes matter a lot. Moreover, we have already discussed the increasing role of economics and economists in antitrust. "However, increased use of economic reasoning and analysis should not erode effective enforcement by introducing errors." (Röller 2005) The decision process is not fully exogenous, it is partially influenced by human decision and humans incline to making mistakes. Simple logic suggests that there would be some correlation between the increasing power of economic analysis and number of mistakes made.

Have you ever wondered how many economists actually work for the DG COMP? In the times of Lars-Hendrik Röller as Chief Competition Economist there were over 700 officials working for the DG COMP, approximately 200 out of them were economists (as of March 2005). However, the number of officials holding the Ph.D. degree by that time was only about twenty; ten of them working in a specialized team (the Chief Economist Team) for the Chief Competition

Economist (CCE). The main responsibility of the CCE is to get involved in cases and guidelines. It has basically two functions – to provide independent opinion on cases and guidelines – “check and balances” function and “support function”. (Röller 2005) Nowadays, the Chief Competition Economist is Damien Neven (born in 1959, Belgium) who was reappointed for the next three years in September 2009.

Cooper, et al. (2005b) have also done a very extensive literature search on the welfare effects of vertical restraints. They searched all kinds of cases across many industries ranging from cable TV companies to gasoline, fast food, or aluminum producer. However, only one conclusion can be drawn from their findings – the evidence supports the presumption that the vertical practices are likely to be efficient. In most of the empirical studies reviewed vertical practices are found to have significant procompetitive effects. (J. C. Cooper, L. M. Froeb, et al. 2005b)

“It is difficult to distinguish welfare enhancing from welfare reducing vertical practices based on evidence because the theory of vertical control tells us only that anticompetitive effects are possible.” (Cooper et al. 2005) The need is to distinguish between exclusionary acts which reduce social welfare and competitive acts which increase it.⁶⁸ The outcome, more than anything else, depends on prior beliefs of authority because in theory (up-to-date) the effect of vertical restraints is ambiguous.

The review of empirical evidence suggests that vertical restraints are likely to be benign or welfare enhancing which is in major contrast with European aggressive policy biased against type-II errors. “It is said that antitrust advocates have confused the theoretical possibility of harm with an empirical demonstration of such a harm.” (Carlton and Waldman 1998, 37)

⁶⁸ Verizon Communications v. Law Offices of Curtis V. Trinko LLP, 540 U.S. 398 (2004) (known as “Trinko”)

“Vertical enforcement will remain uncertain unless and until profound studies of vertical effects and antitrust economist develop formal, testable models that would incorporate such findings in a tractable way.” (Harbour 2005) Even at the time when we will understand the economic implications of vertical structures the worries will remain because mergers themselves facilitate exchange of information and thus coordination which further increases incentives and ability to engage in conduct that could harm competition as well as consumers.

Chapter 5

“Computers are incredibly fast, accurate and stupid. Human beings are incredibly slow, inaccurate and brilliant. Together they are powerful beyond imagination.”

Albert Einstein

5.1 The European Union, the United States and the Microsoft Corporation

In economics natural experiments are often missing. Despite, the famous Microsoft Case could be a quasi natural experiment in the field of vertical arrangements. In both jurisdictions Microsoft was sued for tying and bundling. Theory distinguishes between “physical tying” and “contractual tying” Microsoft was accused of both but for the purpose of comparison we will focus on the competitive effects of “physical tying”. Even though Microsoft markets its (tied) products worldwide it was not charged for the same bundle.

In Europe⁶⁹ it all started in December 1998 with a complaint from Sun Microsystems alleging that Microsoft was refusing to supply it with interoperability information necessary to interoperate with Microsoft's dominant PC operating system (OS).⁷⁰ In February 2000 when the Commission got acquainted with the case and the market situation, it broadened the scope of the investigation to examine Microsoft's conduct with regard to Window Media Player (WMP).⁷¹ Later Microsoft was accused of anticompetitive tying of WMP with Windows operating system (OS). On March 24, 2004 the final decision was published, it ruled that Microsoft had abused its dominant position in the PC operating system market by harming competition through tying of its separate WMP product with its Windows PC operating system.⁷² It also confirmed the interoperability claim but this part is out the scope of vertical measures. Further, Microsoft was fined € 497 million⁷³ for abusing its market power in the EU under the Article 82. In order to restore the conditions of fair competition the remedies were ordered. As regards tying, Microsoft had to offer a version of Windows without WMP (the version with WMP could be offered too but with no additional conditions imposed on the distributors). As regards interoperability, Microsoft was required to disclose complete and accurate interface documentation which would allow non-Microsoft work group servers to achieve full interoperability with Windows PCs and servers.⁷⁴

For several reasons Microsoft did not comply with the March decision and based its defense largely on patent law. According to the former Commissioner Neelie Kroes Microsoft was the first company in fifty years of EU competition

⁶⁹ The following overview of the European Microsoft Case is based on research I did for the purpose of my seminar paper "The EU Competition Policy and the Microsoft Case", January 2008.

⁷⁰ <http://ec.europa.eu/comm/competition/antitrust/cases/microsoft/investigation.html>

⁷¹ Ibid.

⁷² <http://ec.europa.eu/comm/competition/antitrust/cases/microsoft/investigation.html>

⁷³ EU press releases: IP/04/382 "Commission concludes on Microsoft investigation" (24/03/2004)

⁷⁴ Ibid.

policy that the Commission had had to fine for failure to comply with an antitrust decision.⁷⁵ The Commission acceded to extraordinary measures – a periodic penalty payment of € 2 million per day starting on December 15, 2005. On August 1, 2006 the periodic penalty payment increased up to € 3 million per day. As of February 2008 Microsoft had to make non-patented interoperability information available for a reasonable remuneration (the previous one was found unreasonable). Finally the amount of periodic penalty payment was fixed to € 899 million.⁷⁶

The above paragraphs were to show what “special responsibility of dominant companies” (see p. 31) really means. The question is, what a company may face when it enjoys the benefits of network effects (value of a product increases as the number of its users grows) and system effects (value of a product depends on components available and their quality). How a product, such as WMP that has dozens of freely downloadable substitutes on Internet, can cause incredible problems. It proves the determination of the EU to ensure even chances on markets and makes us think about its consequences and about motivation to invest in innovations.

Philosophizing about Article 81 and 82 might seem rather dry however their impact is very live and really affects most of us, e.g. since March 2010 Windows users will be offered a “Browser Choice Screen”⁷⁷ via automatic updates which lets them download any of 12 browsers (IE is only one among them and is not even the first one). Microsoft has done this by itself to prevent any other “tying products” prosecution just because the Commission was concerned about consumer’s choice and innovation and considers IE to be a barrier to competition.

⁷⁵ EU press releases: IP/04/382 “Commission concludes on Microsoft investigation” (24/03/2004)

⁷⁶ Commission Decision of 27 February 2008 fixing the definitive amount of the periodic penalty payment imposed on Microsoft Corporation (Case COMP/C-3/37.792 — Microsoft).

⁷⁷ <http://www.browserchoice.eu>

The U.S. story is different⁷⁸. From early 1990s the U.S. Department of Justice focused on Microsoft's marketing practices. In July 1994 Microsoft signed a consent decree and obliged not to use its dominance in OS market to distort competition. In August 1995 the U.S. District Court finally approved the decree which imposed two very important restrictions – a horizontal one and a vertical one. According to the horizontal one Microsoft was not allowed to use zero marginal costs pricing but on the other hand it could use quantity discount and $MC = P = 0$ is a special case of quantity discount thus the lowest possible price remained unclear.

The vertical restriction forbade contractual tying but allowed the expansion of functionality of Microsoft's products (i.e. technological tying). (Economides 2001, 8) In August 1997 Microsoft was accused of anticompetitive action due to the agreement with Apple concerning Internet Explorer (IE) becoming Apple's default browser for the next five years. Shortly after that in October 1997 DOJ charged Microsoft with alleged violation of the 1995 consent decree. The complaint claimed that IE, bundled to Windows 95, broke the consent decree.

The court case began on May 18, 1998 with a detail investigation regarding why and how was the IE tied with Windows and Microsoft was alleged that it violated both Section 1 and Section 2 of the Sherman Antitrust Act. The lawsuit was rather turbulent, over the years the U.S. administration changed, the judge changed, Microsoft survived the risk of splitting into two companies, the case was highly publically discussed, and Microsoft's reputation was threatened.

Eventually the case was settled and final judgment was issued on November 12, 2002. "The proposed settlement required Microsoft to share its application programming interface with third-party companies for five years on in order to restore to health computer market. Microsoft had to disclose parts of its source

⁷⁸ The following overview of the American Microsoft Case is based on research I did for the purpose of my bachelor thesis "The Microsoft Case", IES FSV UK, May 2007.

code necessary for interoperation and communication with Windows.”⁷⁹ It is important to note that the agreement did not comprehend any mandatory change of Microsoft’s code nor prevented future software tying with Windows. Moreover, Microsoft could no longer punish OEMs for doing business with its competitors; royalties and volumes discounts had to be based on objective criteria, exclusive agreements were forbidden.

Finally, the Final Judgment does not constitute any admission by any party regarding any issue of fact or law.⁸⁰ Compared to the EU case no fine was imposed. Microsoft just paid \$28.6 million (\$25 million to cover the costs of the litigation and attorney fees and \$3.6 million is to finance the compliance with Final Judgment).⁸¹

Even a brief look into both Microsoft cases shows clearly the difference we were trying to identify throughout the whole thesis. Two products tied to Windows demonstrated how legal provisions are transformed in reality and how they interfere with markets in both jurisdictions. It is crucial to understand what these or generally any other compulsory changes have done (in terms of deterrence, innovation, motivation, changed market shares etc.). In fact we never know what the situation would have been like without governmental intervention.

It is clear why the authorities focus on present (and future) market situation but previous development also matters, e.g. in the case of IE neither the market share nor the functionality of IE fell down from heaven, early Internet users would remember a so called “browser war” (especially intense struggle between IE and Netscape Navigator at the end of 1990s primarily in the U.S.) during which

⁷⁹ Final Judgment: <http://www.justice.gov/atr/cases/f200400/200457.htm>

⁸⁰ Ibid.

⁸¹ http://www.state.ia.us/government/ag/latest_news/releases/nov_2002/Appeal.html

Microsoft proved to have a superior product and became the winner in business where “winner takes most.”

The EU case resembles the U.S. to a certain degree. Both jurisdictions decided not to apply the per se rule because they feared discouraging innovations. (Gifford 2009) However, regardless whether it is about WMP or IE, at the end it is a matter of product design and the perception of “essential facility doctrine” and at this point comes the difference: “As regards interoperability, the Commission required, among others, the disclosure of certain server-to-server protocols not covered by the US case. As regards tying, the US remedy did not contain provisions on code removal as it was designed for a monopoly maintenance and not a tying liability.”⁸²

It seems that while the U.S. was narrowing the scope of essential facility doctrine, the EU was expanding it (especially the corresponding duties of the incumbent). (Gifford 2009) Whereas the U.S. focused on Microsoft’s agreements to be uniform and non-discriminatory, the EU found Microsoft to satisfy exceptional circumstances (and it was not because of the nature of computer or software industry) under which refusal to license IPRs is abusive even though according to current case law refusal to grant access to IPRs is per se legal. (Mayer and Brown 2008) It is the attitude to Microsoft that shows different approach to antitrust the best.

Last but not least, we should ask what the regulators really wanted to achieve. The underlying philosophy of regulation is to correct markets and at the same time not to harm the firms. Did the regulators manage to keep up this basic philosophy?

There are only several aspects that can be compared directly e.g. European fines and American settlement. The other more important features are hard to detect and even harder to compare. Thus, who influenced the markets more,

⁸² EC MEMO/04/70 from March 24, 2004

the EU officials or the U.S. authorities? The impact of their decisions on society, computer industry or Microsoft's goodwill is almost impossible to identify and it is undistinguishable from the influence of other factors. However, e.g. Microsoft's revenues were not affected by the trials, not even by the breakup order which was threatening Microsoft for almost a year.

European Union tends to be more straightforward, its actions are always very visible and it also cares about the impression of the EU inhabitants a lot. United States probably still are, to a certain degree, influenced by the Chicago school that emphasized the minimalist approach, pointing out that the money invested in antitrust enforcement would do more good somewhere else e.g. in R&D.

Overall, the aftermath of Microsoft's rulings seems to be ongoing in the EU (e.g. in the form of Browser Choice Screen) where Microsoft is always under the supervision; which is not the case in the U.S. where Microsoft does not enjoy any special attention from the antitrust officials.

Conclusion

"First, do no harm."

Hippocrates

The aim of this thesis was to address the differences in competition policy of the European Union and antitrust of the United States. Step by step we introduced both American and European frameworks and rules under which they operate. Consequently, we focused on the practice of protection of competition. Throughout the paper similarities in competition policy were slightly omitted and the differences were stressed. The search for explanation was partially successful in some aspects of antitrust we managed to show why there are differences and that in the case of economic policies past development matters a lot. The paper

focuses mainly on the most significant difference – treatment of non-price vertical restraints.

Since the *Sylvania case*⁸³ vertical restraints are to be judged under the rule of reason in American jurisdiction and subject to either Section 1 (unreasonable restraint of trade) or Section 2 (monopolization by exclusionary means) of the Sherman Antitrust Act. In the U.S. vertical agreement is presumed to be legal unless the plaintiff can show it is likely to harm market wide competition which means reduced economic welfare. (J. C. Cooper, L. Froeb, et al. 2005)

On the other hand, the European Commission can challenge vertical merger of firms under the Article 81(101) (both dominant and non-dominant firms for vertical restraints) or Article 82(102) (for abuse of dominant position). The European primary objective is to avoid distortions of the common market, as it is explicitly written in the Treaty on the Functioning of the EU. Different anticompetitive practices are claimed to be illegal because they are “incompatible with the common market”.

The EU focuses on the distortions caused by vertical agreements, however it realizes that not all vertical arrangements are harmful and therefore those which fulfill the conditions (see pp. 22-23) are automatically exempted by Block Exemption Regulation. Since the end of the 90’s when the BER was published, the European approach towards competition policy enforcement started to be based more on economic reasoning and employed more often economic analysis. However, even with this gradual change the number of vertical restraints challenged in the EU is still significantly higher compared to the U.S. (Cooper, et al. 2005)

Vertical restraints are inevitably connected with a basic question – are vertical arrangements efficiency enhancing or anticompetitive?

⁸³ *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977)

It is interesting that the American antitrust focuses mainly on the advantages of vertical integration such as decreased price volatility, easier long run planning, guaranteed supplies, reduction of selling expenses, and more predictable demand. Moreover, it solves the double markup problem. On the other side, the EU is more concerned about anticompetitive effects of vertical restraints. European authorities stress possible market foreclosure, creation of barriers to entry, facilitated collusion, and exclusive contracts that may limit competition. Nonetheless, of all things the EU is worried most about vertical agreements that would increase dominant firm's power.

The Guidance Paper on the Article 82(102) introduced more "effects-based approach". Economic analysis is employed in the increasing number of cases and it relies heavily on economists. However, more decisions imply also more mistakes. (Röller 2005)

This fact became essential for Cooper, et al. (2005) who developed a model that offers possible explanation for differences between American and European jurisdictions. Their model is based on wrong antitrust decisions and prior beliefs about the practice in question. Authorities are facing either the loss from prosecuting a procompetitive practice (type-I error) or the loss from failing to prosecute an anticompetitive practice (type-II error). The model suggest that the U.S. is biased against type-I errors due to its legal system that stands on precedents and the EU is biased against type-II errors because they would distort Europe's great achievement – the common market.

Cooper, et al. (2005) proposed plausible explanation. However, the problem might be hidden elsewhere, there is no general consensus on the economic theory underlying the efficiency or inefficiency of vertical mergers. The mainstream approach is missing and the fact that vertical restraints are treated quite differently in these two jurisdictions may simply reflect the indecisive economic debate about their consequences. (Comanor and Rey 1997)

As was shown earlier it is not easy to model effects of vertical restraints, economists are trying hard to overcome this obstacle, however no two vertical mergers are alike which makes the situation very difficult. In my thesis I tried to give an outline of options that both authority and integrated firm are facing in form of payoff matrix. Orientation in the market situation could be the first step towards better understanding because "market conduct should not be regulated unless it can be shown that regulation improves economic performance sufficiently to offset its costs." (Gal 2004, 16)

The review of empirical evidence suggests that vertical restraints are likely to be benign or welfare enhancing which is in major contrast with European aggressive policy biased against type-II errors as proved by Cooper, et al. (2005). The Microsoft Case that took place on both sides of the Atlantic illustrates this point. The harsher treatment of Microsoft's bundling practices supports the findings of Cooper's et al. (2005) model.

The aim of the thesis was to address differences that turned out to be underlined by different history and different preferences. In the EU almost everything is connected with Common Market and competition policy is not an exception. The idea of integration is always in background and predetermines the European approach towards everything. On the other hand, the American sense for freedom and equality justifies and somehow excuses their different attitude.

Antitrust is not a tool for redistribution, it is intended to protect consumers not competitors. There are always winners and losers. Interventions in competition law require careful consideration in order to preserve the incentives to compete and innovate. Recent cases suggest that the EU is moving from "fair" competition to free competition but the notion of fairness is purely normative. Who is to say what is fair when adequate economic theory is missing?

Another goal was to learn a lesson about competition, one out of many to come thus "first, do no harm". Perhaps, the antitrust enforcement officials could take an oath like medicine doctors promising that they will not harm market forces which brought our civilization to where it is now.

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