STUDYING OF SPECIAL PRACTICAL ISSUES OF ABUSE OF DOMINANCE

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Abstract

Abuse of a dominant position, or monopolization, is one of the most challenging areas of competition law in both developed and emerging markets. Situations involving abuse of dominance may range from predatory behavior by firms in isolated local markets for low-technology products (for example, industrial waste collection) to high-tech industries in which access to a network is restricted for anticompetitive purposes. The research work applies methods such as a scientific abstraction, system analysis and logic synthesis. The result of the study emphasizes that in transitional and developing economies assessing the existence of a dominant position, defining markets in abuse cases, evaluating the existence of a dominant position, the assessment of market shares, excessive prices, price discrimination, tie-ins, refusal to deal, predatory pricing. raising rivals' costs, vertical restraints, abuse and intellectual property, assessing abuse resulting from government intervention, determining appropriate remedies are of outstanding significance. The practical significance of the study is its potential to enrich the academic and practical knowledge of specialists working in this field. Moreover, experts conducting research into the creation and development of sound and effective environmental policies will be supported by the effective implementation of competition policy. The originality and scientific novelty lies in the fact that the research work analyzes and systematizes experience of developed and developing countries; moreover it gives recommendations to look into these countries regarding their practices for the abuse of a dominant position.

Key words: abuse of a dominant position, dominance or monopolization, competition law, market power.

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Introduction

Abuse of a dominant position, or monopolization, is one of the most challenging areas of competition law in both developed and emerging markets. Situations involving abuse of dominance may range from predatory behavior by firms in isolated local markets for low-technology products (for example, industrial waste collection) to high-tech industries in which access to a network is restricted for anticompetitive purposes.

Abuse of dominance cases may have special importance in transition economies. For example, competition law provisions relating to abuse of dominance may have an important role to play in addressing anticompetitive practices that entrench former state-owned monopoly enterprises. Abuse of dominance provisions may also be useful for easing restrictions on access to distribution systems in local markets.

In cases involving abuse of dominance or monopolization it is essential to ensure that application of the law does not inadvertently curb efficient business practices. It is important to recognize that firms may achieve legitimately a dominant position in a market (for example, through innovation, superior production or distribution methods, or greater entrepreneurial efforts). Moreover, many practices that appear anticompetitive (such vertical market restraints as tying or exclusive dealing requirements) can serve legitimate procompetitive purposes in some circumstances.

Competition law provisions regarding abuse of a dominant position typically include several common elements. First, before the law can be applied it is necessary to define the relevant market in which the possible abuse is realized. Second, it is necessary to establish the existence of a dominant position by a firm or group of firms. Third, it is important to identify specific practices that may be harmful to competition and assess their overall effects in the relevant market (s).

The specific content and application of these elements can vary significantly among countries. For example, some countries' laws specify that a dominant position can be inferred largely or entirely on the basis of a large market share. In contrast, some countries' statutes require consideration of entry conditions and other factors that influence the ability of firms with large market shares to exercise market power. An additional key distinction is that in some countries the mere charging of high prices or the carrying out of other exploitative acts maybe treated as abuses, while in others the law focuses on exclusionary conduct by firms that harms

the competitive process (that is, conduct preventing competing firms from entering or expanding).

In many - perhaps most - abuse cases fines and imprisonment are not appropriate remedies, because there is no criminal nor anticompetitive intent. In fact, the firm that committed the abuse might well have thought its behavior to be completely legitimate. Rather, the appropriate remedies will be either "behavioral" orders to cease conduct that thwarts the competitive process or structural measures - when permitted under the law - to eliminate the ability of the dominant firm to commit the abuse. Certainly if companies do not comply with the decision of the antitrust authority a large fine or other penalty will be appropriate.

In extreme cases efforts by incumbent firms to deter entry by potential rivals may extend to outright criminal conduct (for example, threats to the safety of individuals or corporate facilities, extortion, and so on). Then, competition agencies should seriously consider requesting the assistance of the police or other authorities to bring criminal charges.

Allegations of abuse of a dominant position may sometimes relate to industries that are natural monopolies - those in which a single firm can supply the market at lower costs than two or more independent firms can, usually because of large economies of scale. Such industries may include electricity transmission, natural gas distribution, and, possibly, parts of telecommunications and transportation. In such industries there may be a need to regulate prices. Such regulation might be undertaken either by a specialized agency set up to oversee conduct in the particular industry or by the competition agency itself. But even where there are effective regulatory controls, there may still be a role for competition policy in maximizing the scope for market forces to work and ensuring that regulated firms do not engage in anticompetitive practices in unregulated markets.

Assessing the existence of a dominant position. Determining whether a firm occupies a dominant position in a market involves two principal steps: defining the relevant product and geographic markets and assessing the degree of dominance exercised by the firm(s) within the market.

Defining markets in abuse cases. Specifying relevant product and geographic markets is essential in the development of most competition law cases (see Anderson, Khosla, and Monteiro 1996.) As well as providing the basis for analysis, defining markets contributes directly in

assessing competitive effects. It often has an important bearing on the application of specific statutes and on the disposition of a case. A narrow definition of a market will tend to result in higher market shares for incumbent firms, often important in establishing market power and, therefore, anticompetitive effects of some business practices.

In most abuse cases definition of the relevant market is likely to be based on functional characteristics of the product and on consumer behavior. These may include physical characteristics of the product, uses to which the product is suited, and evidence about buyers' willingness to switch from one product to another as relative prices change. Other factors, such as switching costs and parallel price movements that indicate substitutability, also may be relevant. Similarly, defining the relevant geographic market is likely to be based on factors, such as transportation costs and perishability, that limit the ease with which products can be moved over long distances.

Markets in antitrust (especially merger) cases are sometimes defined using the "prospective price increase" or the "hypothetical monopolist" approach. This asks whether consumers, faced with a price increase, could easily switch to an alternative product or another supplier. If the answer is yes, then the alternative product and source of supply is included in the relevant market for the case.

The underlying principle - the focus on consumer responses to price increases-can also be useful in defining markets in abuse of dominance cases. The application of these principles, however, is different. That is, abuse or monopoly cases typically relate to a lessening of competition that has already occurred rather than what may occur as a result of a proposed merger. In abuse cases it is likely that prices will already have been raised above competitive levels. And any further increase will probably result in massive substitution by consumers. Such evidence of substitutability is, however, entirely consistent with the exercise of market power in a properly defined market in an abuse of dominance case. Of course, at the investigation stage it is not certain that an abuse has occurred and that prices are currently above competitive levels, but the investigator should be aware of this possibility.

This point is illustrated by the U.S. cellophane case, which involved allegations that the du Pont de Nemours & Company had monopolized the supply of cellophane in the United States in violation of the Sherman Antitrust Act. The U.S. Supreme Court defined the relevant market as consisting of a broad range of flexible wrappings, including waxed paper and other materials, as

well as cellophane. The Court found that these products were perceived as reasonably interchangeable by consumers. Some commentators, however, say that the Court was wrong in defining the market so broadly. In particular, it failed to recognize that consumer willingness to switch to alternative products at a monopoly price is fully consistent with the exercise of market power by a monopolistic firm. As a result it failed to appreciate the extent of market power exercised by the du Pont Company.

More generally in abuse cases, defining the relevant product and geographic markets should take into account the impact of alleged exclusionary practices, which typically sit at the heart of the case. An example: contrast the relevant market useful for assessing a merger of banks offering Visa and MasterCard services with the relevant market necessary for analyzing alleged exclusionary conduct by Visa and MasterCard toward a new low-priced card entrant. The first case would include new card issuers who would enter the industry if the price of credit card services rose significantly. But such potential entrants would be excluded in the second case because firms that would enter only at a higher price are not relevant to assessing the feasibility of entry by a low-price firm [see Salop 1993].

In some cases it may be preferable to look for direct evidence of exploitation of market power (for example, abnormally high prices or profits) rather than focus on market definition. Alternatively, one may look for historical evidence of a decline in output or excessive price increases following implementation of alleged exclusionary practices. The use of such evidence can carry significant problems of interpretation and reliability, however [Fisher and McGowan 1983: 81-97], but it could be relevant in some cases.

Evaluating the existence of a dominant position. Once the relevant markets have been defined, it is generally a straightforward analysis to determine whether a firm occupies a dominant position. This depends on two main factors: the market share of the dominant firm and the extent of entry barriers.

The assessment of market shares. In general, the greater the market share of an alleged dominant firm, the more likely it is to exercise market power. It is nearly impossible to set out market share thresholds at which a firm can be judged to have or not have significant market power. It is unlikely, however, that a firm with a market share of less than 35 percent would have the ability to reduce output or impose a significant price increase above the competitive level.

Conversely, where a firm has a market share of 65 percent or more, it is much more likely to exercise market power, if significant entry barriers exist.

In addition to its own market share, a firm's ability to exercise market power may also depend on the size of other firms in the market. For example, even if a firm has a market share of 50 percent, its ability to exercise market power maybe limited if the rest of the market consists of a small number of competing firms that compete vigorously with the leader as opposed to a cluster of weaker firms that simply adopt prices established by the leader. Finally, even where a single firm has an overwhelming share of a market, it may be unable to exercise market power if entry by new firms or expansion by existing competitors is easy.

Assessment of entry condition. Identifying entry barriers in abuse cases is not so different from other antitrust cases, for example, merger cases. There are, however, two special considerations in abuse of dominance cases. First, as in defining relevant markets, assessment of barriers to entry should take into account the theory of the case. Barriers that would be ineffective if prices were raised higher than prevailing levels may still be relevant in assessing exclusionary practices that prevent prices from falling below current levels.

Second, the conduct being investigated can in some cases be the most significant barrier to entry. The ability of firms to deter entry through behavioral as opposed to structural barriers is increasingly recognized [Ordover and Saloner,1989]. Such entry-deterring conduct includes predatory pricing, exclusionary contractual provisions, tying requirements, and use of fighting brands. Thus valid cases of abuse may sometimes involve markets in which there are few barriers in the more traditional, structural sense of specialized physical assets. Of course, traditional structural barriers in a market would reinforce concerns about the potential anticompetitive effects of restrictive business practices.

Identifying and investigating abuses. Two broad types of business conduct have traditionally been recognized as abusive by competition laws and enforcement agencies:

- Exploitative abuses, in which a firm takes advantage of its market power by charging excessively high prices to its customers, discriminating among customers, paying low prices to suppliers, or through related practices.

- Exclusionary abuses, in which a firm attempts to suppress competition - for example, by refusing to deal with a competitor, raising competitors' costs of entering a market, or charging predatory prices.

These practices are abusive when put in place by a dominant firm because the market does not offer alternatives for consumers. However, when there is sufficient competition in the market, such behavior (especially potentially exclusionary acts) may enhance market efficiency and benefit consumers because it is motivated by the need to compete efficiently, not to make anticompetitive profits. Thus because potentially abusive acts and practices can help promote competition, determining whether such practices constitute abuse is among the most difficult tasks facing a competition agency. A thorough economic analysis of the anticompetitive effects of alleged abusive behavior is needed, even when a firm clearly enjoys a dominant position.

It is worth noting that in some legal systems there is a presumption that certain practices by dominant firms are inherently unfair. This approach has the merit of facilitating the design and enforcement of new competition laws.

With exploitative abuses it is often difficult to clearly say what is an acceptable exercise of market power. For an enforcement agency it is almost impossible to define the "right" price a dominant firm should charge for the sale of products or services, since accurate and timely information on costs and demand is generally unavailable or expensive to acquire. Therefore, competition agencies should seek to minimize the extent to which they regulate prices of individual firms and focus more on seeking to prevent dominant firms from engaging in exclusionary acts that threaten competition. Some countries specify that setting "excessive prices" can constitute an abuse, but competition agencies are more likely to promote a healthy market economy if they limit their involvement in direct price regulation. Moreover, if firms expect that their prices will be regulated if they grow and capture a sizable share of a market, their incentives for innovation and entry into new markets will be diminished, damaging consumer welfare in the long run.

Exclusionary abuses also require careful analysis. This should take account of the competitive environment in which the firm operates, because a potentially abusive practice (such as exclusive dealing) may also help firms compete more efficiently (by, for instance, improving the quality of service to consumers). A dominant firm may compete aggressively, say, as a reaction to a threat from its competitors not simply to exclude others from a market. Such behavior should not necessarily be considered abusive since it may provide substantial advantages for consumers.

In industrial economies it is important to assess possible efficiency rationales for potentially abusive behavior because competition authorities should not discourage firms to compete aggressively nor punish those that are successful through legitimate means. This concern may not be as great in transition economies, in which dominant positions may be the result of recent privatizations and restructurings, not superior performance over an extended period. Nevertheless, competition agencies should always be aware that potentially abusive acts can in some circumstances yield efficiencies, even for firms with large market shares. Thus efficiency considerations should always be taken into account in analyzing the competitive effects of business practices.

Excessive prices. Prices may be high for many reasons, including surges in demand, high unit costs, and exercise of market power. To prevent a dominant firm from abusing its position and charging excessive prices, antitrust enforcers should be more concerned with the reasons that lead to high prices and profits than with the prices themselves. This is partly because it can be difficult and time consuming for a government agency to determine a firm's costs, which must be known to judge whether prices charged are excessive and to set the “right” price. It can be difficult to determine costs when a firm makes only one or a few products; it can be impossible for a firm that produces lots of products. Moreover, price differences among firms can often be explained, at least in part, by quality differences among products. Thus it is not easy to conclude confidently that prices charged for particular products are excessive and should be reduced.

There is another, serious risk with regulating prices. In a market economy profits serve a critical function: when firms earn high profits, they create an incentive for others to enter the industry. When firms earn relatively low profits, they have an incentive to exit. By responding in this way, firms are more likely to produce goods and services that are highly valued by consumers - efficient and good for consumers and firms. This process requires that prices for the most part be unregulated. When government agencies regulate prices, the crucial role played by profits in providing incentives to enter and exit does not work well.

Of course, some firms cannot or do not enter markets even when profits are high. This is often the case in industries in which firms have been granted a legal monopoly by the government, as in most public utilities. However, many other sectors of the economy may be heavily regulated, making it difficult for a new and more efficient firm to enter the market. Thus an important role for a competition agency can be to advocate removal of legal barriers to entry.

Competition agencies can provide recommendations to legislative bodies and other government agencies on how laws and regulations can be modified to strengthen competition and improve efficiency.

There are, however, some industries in which the market can support only one firm even when there are no legal barriers to entry. These natural monopolies can arise when economies of scale or economies of scope (or both) are so strong that the costs of production are lowest when a single firm supplies the market. Examples may include electricity transmission and local water supply. In Western economies the prices and practices of natural monopolies are often not under the jurisdiction of the competition agency but reviewed by regulators. Transition economies may wish to consider a similar approach.

When a regulatory agency does not exist, the competition authority would likely be responsible for ensuring that the industry performs as competitively as possible. If the industry is truly a natural monopoly (that is, cost considerations dictate that only one firm should supply the market), then the competition agency may need to consider regulating prices and practices of the firm. But given the difficulty of regulating prices, such action should be taken only when it is clear that the market is indeed a natural monopoly and that entry cannot be expected to help restore competitive pricing.

Finally, excessive prices may not result from superior efficiency of the dominant firm but from exclusionary practices aimed at abusively extending or maintaining dominance. For example, a vertically integrated dominant firm may refuse to sell some of its products to other firms. Such practices can promote higher prices. For instance, a telephone company may refuse to sell information on subscribers, so that it can be the sole provider in the markets in which such information is most valuable (for example, mailing list services, direct marketing, and marketing research). Competition might then be reduced in these markets. The best course of action is to put a stop to the practices that restrain competition, eliminating the firm's ability to charge excessive prices.

Price discrimination. Price discrimination is the practice of a seller charging different prices according to the profile of the customer and in the absence of appreciable cost differences that might justify different prices. A discriminatory strategy can also involve charging the same price to customers even though there are different costs of supplying them. With price discrimination, a firm may earn higher profits than when it charges a single price (net of costs) to all consumers. Some extra profits may come from increased sales; thus price discrimination can increase a firm’s total production.

Price discrimination requires that a firm identify different consumers who are willing to pay different prices. The firm must also be able to prevent arbitrage, that is, prevent the disadvantaged consumers from purchasing the product from the consumers who buy it at a favorable price. In theory, there are few markets where arbitrage is not possible, but in practice arbitrage may require complex contracts or that consumers overcome inertia, uncertainty, and instability - or both. Thus competition agencies should not use theoretical arguments to conclude too quickly that discriminatory practices cannot occur. Nor should they assume too easily that the conditions for successful price discrimination are easy for a firm to meet.

Showing that price discrimination is harmful to consumers can be difficult. In many cases the difference in price may not be discriminatory because it can be explained by differences in the cost of serving different consumers. For example, consumers who pay higher insurance premiums or higher interest rates may be more risky-and thus more costly to supply-than consumers who pay lower rates. In other cases price differences for what appears to be the same product can be explained by quality differences. To rule out such cost-based or demand-based explanations, competition agencies would have to estimate a firm's costs. But it is well known that such analysis can be time-consuming and uncertain. Therefore, price discrimination investigations should not be made a high priority.

In theory, discrimination can be exclusionary when a dominant firm charges lower prices to buyers more likely to switch to other suppliers. It is difficult, however, to distinguish this practice from that of a firm selling to customers willing to pay only a lower price and not the nondiscriminating price. This practice (referred to in the economic literature as third-degree price discrimination) can result in more customers being supplied than would be the case with a single price for everyone. In general, if a discriminatory strategy leads to an increase in the quantity sold, then it should be considered procompetitive.

Another way of discriminating among customers is to set up discount schemes. Discounts usually refer to large single orders in which some economies of scale (for example, in transport) lead to a reduction in the total unit cost of supply. Other types of discounts are granted in relation to the total orders placed by a customer in a certain period, for example, a year. Such an effect is greatly increased when a dominant firm sells many products and the discount scheme operates for all sales, irrespective of the quantities of each product bought.

Although they might increase the cost of entry especially when imposed with long-term contracts, discount schemes are a powerful instrument of competition and normally benefit consumers. Moreover, they can be justified on efficiency grounds, since they allow a firm to pass on to customers substantial cost reductions - for example, because they bring about a significant reduction of sales efforts.

Discounts can be restrictive if they become similar to exclusive contracts-that is, if they are granted only to customers that agree not to buy from other competitors, thereby raising barriers to entry. In this case, however, what matters is the exclusive aspect of such contracts (how binding and how lengthy is the exclusivity clause). In fact, the restrictiveness of discount schemes must be analyzed case by case and should be assessed according to the costs they inflict on new entrants and by the disadvantages suffered by consumers.

Tie-ins. A tie-in is the sale of one product (the tying good) on condition that the buyer purchase another product (the tied good). In general, such behavior should not be considered abusive if the firm does not have market power in the tying good. Even when the firm does, establishing that a tie-in is abusive requires detailed analysis of the purpose of the tie-in and the market context.

Sometimes two products are vertically related, with one good an input in the production of the other. If so, the competition agency must try to understand the reasons for the tie-in. In general, a tie-in cannot be motivated by abuse if the two products are used in fixed proportions (as might be the case in an industrial process): the dominant firm could maximize profits by charging a sufficiently high price in the tying market, and the tie-in practices would not increase profits.

Tying is often motivated by the firm's desire to maintain or increase its reputation for quality or product reliability. This should not be considered abusive since it increases efficiency and market demand. For example, poor servicing of a dominant firm's product by an independent company may negatively influence the reputation of the dominant firm and result in lower sales. To avoid this the dominant firm might sell its products and services together through a tie-in contract. Nevertheless, it is worth considering whether the legitimate aim of the dominant firm to maintain or increase its reputation could be reached by less restrictive means, such as an improvement of its quality control processes.

Tying raises concerns for competition policy when it allows supranormal profits to be made in a properly defined market. This might be the case when tie-in practices raise entry barriers to competitors and enable the exercise of market power in the tied market. Tying can also be an abuse if used to evade price regulation on the tying good. Suppose a dominant firm has market power in its primary product. Suppose further that the dominant firm's price is regulated, which effectively prevents it from earning all of the monopoly profits that it could if there were no regulation. The dominant firm would have an incentive to sell its regulated product on condition that another product is purchased (whose price is not regulated) and then set the price of the bundle to capture all monopoly profits in the regulated good.

Some tie-ins could be used in moderately competitive markets to exploit consumers. In particular, consumers who have bought a relatively expensive durable good may have no reasonable choice but to go to the manufacturer when replacement parts or service is needed - the so-called lock-in effect. Even when the primary product market is competitive, the seller might be able to take advantage of consumers who have already purchased the good and do not have many alternatives for replacement parts. If future consumers of the good are informed of this practice, however, they will consider parts prices when they make their original purchase. In this situation, if the manufacturer also faces competition for the original product, its ability to exploit locked-in consumers will be reduced if not eliminated.

The competition agency must determine whether the conditions necessary for anticompetitive lock-in - imperfectly informed consumers, weak efficiency explanations for the tie-in - exist in sufficient measure to raise competitive concerns. If, for example, the cost of replacement parts is substantial in relation to the price of the durable good, as, say, with a motor car, the replacement parts market would not constitute a properly defined relevant market. Consumers would switch to a different car should they be charged monopoly prices in the replacement parts market. In other words, if consumers were informed about all costs they would incur by purchasing a given product, then the tie should not be worrisome for antitrust authorities since competition in the primary market could provide enough discipline to the firm.

Of course, consumers may be unable to anticipate all costs related to the use of a product and might be subjected to abusive behavior by a dominant firm trying to exploit a possible asymmetry of information. Such a situation may not be common. It refers in general to products bought infrequently, and where exploitation would not appreciably affect future demand for the firm's

product. In general, consumers learn from experience. If they are exploited with a tie-in contract and there is competition in the primary market, then their ability to easily switch suppliers may deter the abuse.

Refusal to deal. Competition law does not generally impose on firms a duty to cooperate with competitors. When a firm (even a dominant one) refuses to deal with another firm with which it has a vertical relationship, the result may not be anticompetitive. For example, a dominant pipeline company's refusal to deal with an oil producer could reflect various procompetitive rationales: poor reputation of the oil producer, efficient management issues, or peak load concerns. In this example, there are circumstances, however, in which a refusal to deal with an additional customer would be anticompetitive. This would be the case if a powerful group of existing customers were to threaten the pipeline owner that they would build another pipeline, should it grant access to some other firms.

Refusal by a dominant firm to grant access to a firm producing a scarce input necessary to operate in a downstream market in which the dominant firm also operates may be an abuse. This may occur when the price of the scarce input is regulated and the firm tries to extend its dominant position in a vertically related (but unregulated) market. The monopolist finds it profitable not to deal with a downstream competitor because it can overcome regulatory constraints on profits by keeping the competitor out and supplying the service itself. Profits would be earned not on the regulated market but on the competitive (unregulated) one. This behavior is particularly common in recently deregulated industries in which some markets are open to competition but others are still legal monopolies.

In De Montis Catering Roma v. Aeroporti di Roma, a state-owned company controlling the Rome airport and having an exclusive license to provide maintenance and ground services denied access to the airport premises to a company wishing to compete for airline catering, a service in which the licensee had a de facto monopoly but which was not covered by its exclusive rights. The Italian Antitrust Authority found no justification for the refusal and Aeroporti di Roma was charged with trying to extend its monopoly power in a related market and with hindering competition and damaging users of catering services because of higher prices and lower quality of services supplied by the airport to airlines.

In general, to assess abuse in cases of refusal to deal it is necessary to look at: the market power of the firm, the rationale for the refusal, and the resulting competitive harm. As always, it

is critical to properly define the relevant markets. If the relevant downstream market is such that the shut-out firm can sidestep the refusal and still be a competitor, the refusal to deal cannot be anticompetitive. Even when this is not possible, it may be that the facility could be duplicated at reasonable cost in a reasonable time.

Especially in refusal to deal cases, competition agencies should be careful not to mistake injury to competition with injury to individual competitors. Orders requiring firms to provide mandatory access to "essential" facilities should be sought only when the benefits of providing such access clearly outweigh the costs. Thus competition authorities should avoid embracing an excessively broad "essential facilities doctrine," that is, routinely compel firms to deal with rivals, which often benefits competitors but not competition. Indeed, competition agencies that regularly impose on large firms a duty to deal with competitors run a serious risk of discouraging firms from investing in new goods and services for fear that they could not earn an adequate return.

Predatory pricing. Predatory pricing is the practice of a dominant firm selling its products at prices so low as to drive competitors out of a market, prevent new entry, and successfully monopolize the market. The cost can be high, but a predator expects future discounted profits to outweigh present losses and forgone profits. If the firm operates in more than one market, selling its product in some markets at prices below costs may help sustain high cartel prices in others, although supply might be diverted to the market with higher prices.

Predation is condemned not because it results in lower prices now, but because it is likely to lead to reduced output and higher prices in the future. For this to occur other firms must be weak, there must be barriers to reentry into the market so restoration of competition is not possible after existing competitors have exited, and profits to be gained in the postpredation period must outweigh all losses. These conditions are not normally present, however, in a healthy market economy, and genuine instances of predatory pricing are rare.

Some countries have ruled that prices may only be predatory if they are set below marginal cost. Prices below average variable cost (and below marginal cost), however, can be rationalized in times of distress. Since marginal cost is difficult to calculate, the rule of thumb in antitrust proceedings has been to approximate marginal cost by average variable cost, which is easier (but by no means simple) to measure or estimate. One danger in doing this arises with industries with excess capacity. For these, the average variable cost may be much higher than the marginal cost, and a firm may be accused of predatory pricing even if prices are roughly equal to marginal

costs. In any case, charging prices just below competitors' marginal cost (limit pricing) may be exclusionary, but such pricing would not be considered predatory if the firm's price exceeds its marginal cost. Prices above average total cost should never be considered predatory. Prices between average total cost and average variable cost can represent an investment in promotion (they are not sustainable in the long run).

If entry into the market is easy, it is virtually impossible to claim that predatory pricing is occurring, because the firm would be unable to raise prices in the future [Joskow and Klevorick 1979: 1-26]. Although some competitors may suffer losses, these are due to low prices in the market (which benefit consumers), and any losses the dominant firm suffered in an attempt to monopolize the market will not be recovered. Many countries find it useful when assessing predatory pricing allegations to first consider whether there are sufficient barriers to entry or reentry to make predation a viable strategy.

Raising rivals' costs. Raising rivals' costs may be less costly than predatory pricing as a means of excluding competitors from the market, because it may not require a direct reduction in profits for the dominant firm. The 1961 Pennington case is often referred to as a classic example. This case involved the strategic use of collective bargaining arrangements by a dominant firm. It was alleged that higher wages industry wide were actively encouraged by large producers to increase the costs of smaller, marginal firms in the U.S. coal-mining industry. Supposedly, a high wage level for the industry benefited capital-intensive firms, since it had a proportionally smaller impact on their costs than on smaller, labor-intensive competitors [Williamson 1968: 85-116]. But it is difficult to actually prove that a dominant firm accepted high wages for its employees just for the sake of raising the costs of its competitors.

Other examples of raising the cost of a small rival is by engaging it in litigation (fixed costs weigh more on a small budget), or strategically advertising to such a degree that it raises sunk-cost investments for small rivals and potential entrants. With advertising, however, such expenses should be more properly considered an investment in the reputation of the firm. Moreover, a firm's reputation may not be limited to the market to which the advertisement is directed. Thus many firms that have gained a reputation in one market use it to enter a different market. For instance, firms with high standing in the fashion industry have used their reputation to move into other markets, such as perfumes or shoes.

Vertical restraints. Vertical restraints are restrictions that an upstream firm (for example, a manufacturer or a wholesaler) places on its downstream firm (for instance, a retailer). Vertical restraints include exclusive territories (downstream retailer agrees to limit where it sells the product); exclusive dealing (retailer agrees not to sell rival products); and resale price maintenance (retailer agrees not to sell below prices established by the manufacturer). Sometimes they are used together; for example, exclusive territories may be used along with resale price maintenance. When such restraints harm competition, it is usually in a standard horizontal context.

There are two ways in which vertical restraints might harm competition. First, they might be used to support collusion. Second, they may raise rivals' costs, thus creating or strengthening barriers to market entry. Although the second is more relevant to abuse investigations, the first might also apply. For instance, an upstream firm with a dominant position might collude with its competitors and use the vertical restraints as instruments of policing a cartel. At the same time the competitive environment would have also weakened for retailers.

Vertical restraints can also hurt competition when they raise rivals' costs. Because vertical restraints can promote procompetitive outcomes as well as anticompetitive ones, however, it is crucial that competition authorities make this distinction. For instance, antitrust laws would not be violated if a manufacturer used vertical restraints - establishing, say, a network of exclusive dealers - to better control costs and, as a result, expand sales relative to smaller rivals. Higher-cost rivals would be disadvantaged by the dealership network, but the (more efficient) exclusive network should not be considered a violation of antitrust laws.

Another way in which vertical restraints might raise rivals' costs and hurt competition is the following. Suppose a dominant firm in a manufacturing market possesses market power but is not a monopolist, that is, it faces competition from other manufacturers, which restrains the price that the manufacturer can charge its dealers. Suppose also that downstream dealers typically carry products of many upstream manufacturers. Finally, suppose that the manufacturer negotiates with its downstream dealers contracts that contain vertical restraints - say, an exclusive dealing provision. Unless rivals can find alternative dealers, the manufacturer's exclusive dealership network raises rivals' costs of distributing products. Thus prices paid by consumers for rival products increase, permitting the manufacturer with the exclusive network to raise the wholesale price to its exclusive dealership network. Consumers are hurt as a result.

Two additional points should be made about this vertical restraint. First, there must be barriers to entry into the dealer market. If, instead, services provided by a dealer in the exclusive network could be easily replicated by other dealers (that is, barriers to entry are low), then costs of the dominant firm's rivals would not increase and there would be no harm to consumers.

Second, the competition agency must strive to link the exclusive dealership network to higher costs incurred by the manufacturer's rivals. (In some jurisdictions, profits lost are also taken into consideration.) This can be difficult, but it must be done to distinguish an anticompetitive use of vertical restraints from a procompetitive one. Note that it is not sufficient to simply look at the effects of the vertical restraint on rivals. Regardless of whether the network has anticompetitive or procompetitive effects, rivals will experience a decline in market share.

Vertical restraints, even when used by a dominant firm, can promote efficiency. One such use is the prevention of free riding. For example, a manufacturer may use exclusive dealing to prevent dealers from promoting its product to lure consumers into the store but then selling them a rival's product. Alternatively, a manufacturer may require dealers to set a higher retail price to induce retailers to provide important service to consumers or to carry additional inventories to reduce the chances that consumers will be unable to find the product if demand is particularly strong. Finally, upstream manufacturers may use exclusive territories to provide its retailers with a stronger incentive to promote its product, thereby promoting an increase in interbrand competition at the expense of intrabrand competition.

Abuse and intellectual property. Competition policy and intellectual property rights (including patents, trademarks, copyrights, registered industrial designs, and integrated circuits) are receiving increasing attention from policymakers. Intellectual property rights have figured importantly in several recent competition law cases in western jurisdictions. There are various reasons for this phenomenon. First is the growing importance of knowledge-based industries and the role of technology in such industries. Second, as the world has shrunk and the notion of distinct national markets has become less reflective of commercial realities, there appears to be a growing focus on intellectual property rights as a way to facilitate market control.

In most cases the exercise of intellectual property rights is consistent with the goals of competition policy. Such rights generally strengthen competition in the long run by providing incentives for the development and production of new products and production processes. In most cases it is possible to find a number of substitutes in the market also for products that are

protected by intellectual property rights [see, for example, McGrath 1984: 355-65]. As a result, the existence and exercise of such rights should not usually be a source of concern to antitrust authorities.

Nevertheless, abuses in the acquisition and exercise of these rights can be a legitimate concern for competition authorities in some cases. Practices that may raise competition issues fall into three main categories: the acquisition of patents, the transfer of technology through licensing arrangements, and cooperative arrangements among innovating firms. These practices raise concerns when they constitute attempts to extend market power by excluding entry into a market, suppressing innovation. At the same time, these practices may also serve legitimate, efficiency-related purposes [OECD 1989].

Licensing agreements are an important means of transfer of technology between firms, especially in the international context. Such contracts are often complex and include an array of vertical and other restrictions on the licensee, including technology grant-backs, tie-ins, territorial market limitations, and field-of-use restrictions in technology licensing agreements. Broadly speaking, the factors to be considered in distinguishing anticompetitive from procompetitive licensing are the same as those in relation to other anticompetitive practices.

In 1995 the U.S. antitrust authorities issued new Antitrust Guidelines for Intellectual Property Licensing. The guidelines emphasize that the treatment of licensing arrangements depends importantly on whether the relationships between the firms involved are primarily horizontal or vertical. Competition is more likely to be harmed when the firms are horizontally related (that is, they are, or in the absence of the license would be, competitors). In this case the licensing arrangement may harm competition by raising prices in an existing market or reducing the pace of innovation. But the licensing arrangement's possible efficiency-enhancing effects should also be considered.

The guidelines set out an antitrust safety zone, within which licensing arrangements will not normally be challenged. These include those in which there are no per se rules and in which the licenser and its licensees together account for no more than 20 percent of the relevant market or markets.

Arrangements falling outside the safety zones depend on various factors:

- Their implications for market structure, coordination of pricing or output, and foreclosure of access to inputs.

- The extent to which they impose exclusivity. The guidelines refer to two specific types: exclusive licenses, which restrict the right of licensors to license others or to use the technology themselves (or both); and exclusive dealing, that is, when a license restrains a licensee from using competing technologies.

- The history of rivalry and the pace of innovation in the markets affected.

- Efficiencies resulting from the arrangement. If these outweigh anticompetitive effects, the arrangements generally will not be challenged [U.S. Department of Justice and Federal Trade Commission 1995:18-22].

In the past, developing countries have been especially concerned with the use of restrictive licensing practices (for example, tying requirements, exclusive territories, exclusive grant-back clauses, or field-of-use restrictions) in international technology licensing agreements. Competition enforcement should address such practices case by case. A strict approach is likely to be self-defeating. Sweeping prohibition of restrictive practices in international licensing agreements would raise costs or reduce incentives (or both) for technology owners to enter into voluntary arrangements. Voluntary arrangements are also more likely to promote the host country's technological advance rather than to promote compulsory measures; they are more likely to be accompanied by transfer of non-patented know-how and capital investment, which are necessary to effectively use information protected by intellectual property rights.

Assessing abuse resulting from government intervention. Broadly, competition laws apply to firms' practices not to government decisions. If a (validly enacted) statute or regulation limits competition unnecessarily, however, a competition agency may have an important role in advocating pro-competitive change to the legislation.

In this context it is useful to introduce a kind of hierarchy of the discretionary power of firms. A firm is clearly responsible for its practices if it makes decisions independently of any public intervention. The same is true if the government merely encourages firms to move in certain directions but does not require them to follow specific practices. Further, even if there were a regulatory intervention and the firm had some discretion over its action, practices can violate antitrust rules if the firm could reasonably have engaged in a course of action less restrictive than that chosen.

There are jurisdictions in which a practice stemming from a government decision can still be subject to antitrust proceedings. For example, in the United States the State Action Immunity

doctrine imposes implied limits on conduct that may be shielded from liability under antitrust laws by regulatory actions of state and local governments. Behavior of firms subject to regulatory intervention is exempted from the law only if the conduct is undertaken pursuant to a "clearly articulated and affirmatively expressed" state policy and is "actively supervised" by the state.

The possibility of applying antitrust law to private behavior that originates from some legally binding rule or regulation is even stronger in the European Union. The Treaty of Rome, as interpreted by the jurisprudence, limits the possibility for member states to provide firms with special and exclusive rights in order to avoid conflict with other provisions in the treaty, including those on competition. In particular, a government decision can be challenged under EU rules if it leads to behavior by private firms that contradicts competition principles.

Thus public monopolies or the licensing of special and exclusive rights have been considered unlawful if they lead to a company abusing its dominant position to the disadvantage of consumers. In one case the European Commission ruled that a telecommunications service provider could not be given the power to set standards for telecommunications equipment of which it was a major supplier. Such power would inevitably be abused by the service provider, since it could decide whether the products of its competitors could enter into specific markets.

The concept of abuse developed by the European Court of Justice extends into broader applications in situations in which government action improperly restricts entry into a market. In the case Hofner and Elser the European Commission held and the European Court of Justice confirmed that the Federal Republic of Germany contravened article 90 of the Treaty of Rome when it granted exclusive rights to an employment agency. The European Commission concluded that the agency abused a dominant position because it was unable to fulfill consumer demand, an abuse that could exist only because entry into the market was forbidden by law. To eliminate the abuse, the court ruled that the market be opened up to competition.

In most jurisdictions private conduct that is required by regulatory intervention or by law is not subject to antitrust remedies; only practices in situations in which firms enjoy some freedom of choice are so constrained. Conduct by regulated firms outside the market in which they enjoy special or exclusive rights is most likely to be subject to antitrust scrutiny. Regulated monopolies have an incentive to extend their dominant position through exclusionary practices into other markets to gain unregulated monopoly profits.

In Telsystem v. Sip, the Italian national telecommunications company, which has a legal monopoly over the public-switched network, refused to lease lines to a smaller company wishing to compete in providing closed user groups services, which had been liberalized under a European directive. Denial of access caused losses and closed the market to the potential competitor, denying also a service to consumers. The Italian Antitrust Authority ruled that the unjustified refusal was aimed at preserving a dominant position in a relevant market different from that in which the monopolist has exclusive rights. The authority decided that such behavior was an abuse of a dominant position.

Another case involving exclusive rights granted to state-owned companies, Sign v. Stet-Sip, concerned access to telephone subscribers' lists by a would-be competitor in the market for information services to subscribers. In Italy, as in many other countries, the national telecommunications company has exclusive rights over production and distribution of subscribers' lists and holds dominant positions in downstream activities that use these lists to sell services to consumers and businesses. The refusal to sell subscribers' lists on CD-ROM or to provide access to the on-line database to prospective new entrants was considered an abuse of a dominant position by the Italian Antitrust Authority. The authority observed that no single company could be allowed to duplicate the database and sell the information on the market. The legal monopoly that the company enjoyed could therefore be interpreted as imposing a duty to deal with everyone.

Evaluating the effects of business practiced on competition and efficiency. In abuse of dominance or monopoly cases it is important to ensure that the law does not inadvertently curb superior efficiency or adoption of efficient business practices. Firms may achieve a dominant position through methods that are perfectly legitimate (through innovation, adoption of superior production or distribution methods, or greater entrepreneurial efforts). Moreover, many practices that appear to be anticompetitive (vertical market restraints, such as tying or exclusive dealing requirements) can serve legitimate procompetitive purposes.

Determining whether these practices are, in fact, pro- or anticompetitive is a question that should normally be resolved on a case-by-case basis. This will involve reviewing the full implication of evidence and findings of fact establishing that firms occupy a dominant position and have engaged in anticompetitive actions. Thus a firm under investigation may have a high market share, and there may be substantial barriers to entry that would normally support a finding of dominance. Before reaching a

final decision, however, the competition authority should consider alternative explanations for structural dominance, such as whether an industry has the characteristics of a natural monopoly. Furthermore, an absence of multiple, independent suppliers in a market at any given time does not necessarily imply that competition has been suppressed, if there are minimal barriers to entry and evidence indicates that the market position of individual firms has shifted over time. Rather, it may be that competition within the market has been supplanted by potential competition.

The views of affected consumers are essential in an analysis of the impact of business practices. The issue to be resolved in abuse cases (as in other antitrust cases) is simply how do the practices under examination affect choices available to users (Pittman 1994)? For example, if a practice such as territorial market restraints has resulted in better service to consumers by preventing free riding, then the conduct would normally be considered procompetitive. However, if a practice makes it more difficult for alternative suppliers to enter the market without offsetting advantages for consumers, it is clearly anticompetitive. Unlike rivals, customers do not have the incentive to complain about practices that lower the dominant firm's costs, but customers maybe reluctant to state either informally or formally that the dominant firm is abusing its position.

Another useful analytical tool is to consider the effects of practices with reference to the dynamics of an industry. If a practice is efficiency enhancing, then small as well as large firms will have an incentive to adopt it. In this regard it is relevant to ask: did the firm engage in the practice when it was smaller? Or, if the firm never was small, do its smaller rivals engage in the practice? Or, if such firms do not exist, do firms of all sizes in the same industry in other countries (or similar industries in the same country) engage in the practice? Have the firms that have recently grown used the alleged abusive practice? If so, then the alleged practice may be important to those changes, and it may be counterproductive for competition authorities to intervene.

Determining appropriate remedies. Thinking about whether there is an appropriate remedy is a useful way to determine whether a case merits attention before significant public resources are committed to it. If there is no practical remedy for an apparent abuse (that is, a remedy that clearly improves the situation and does not entail excessive monitoring costs), then there may be no point in pursuing the case.

The first step in determining an appropriate remedy is to consider whether a case involves premeditated, flagrant anticompetitive conduct (say, harassment or threats of violence to potential

entrants) or merely involves conduct that has restricted competition unnecessarily but is not morally offensive or beyond the normal standards of business behavior. If it is the first, then it may be appropriate to seek fines or other punitive sanctions if the relevant legislation permits such remedies. In situations of outright criminal conduct, competition agencies should consider requesting the help of police or other competent authorities and bringing appropriate criminal charges.

If a case does not involve an anticompetitive intent, however, or if there is no evidence of such intent, then fines or imprisonment are not appropriate. Rather, it is simply a question of finding the most efficient way to reverse the anticompetitive effects. In many cases the appropriate measure will be a prohibitive order that requires the firm or firms to cease engaging in the alleged conduct. To the extent permitted by legislation, the agency may consider seeking a proactive but essentially behavioral remedy, such as requiring the compulsory licensing of technology or the provision of access to essential facilities to establish competition in markets in which it had been suppressed. Or, the agency may seek structural measures by actually breaking up the firm.

In designing and implementing such remedial measures, care must be taken to avoid imposing greater costs than those incurred by the anticompetitive conduct. For example, the most effective way to establish competition in a market may be to break up a dominant firm. If this remedy would prevent the realization of overwhelming economies of scale, however, then it would not be a responsible remedy for any agency to seek. Similarly, an investigation may determine that vertical market restraints (for instance, tied selling or exclusive dealing) have prevented the beneficial entry into a market by new competitors. Vertical market restraints, however, may also serve legitimate procompetitive purposes, such as preventing free riding. Remedies in such cases should seek to deter anticompetitive conduct while permitting contractual restrictions that achieve genuine efficiencies.

A checklist of possible remedies in abuse cases would include the following:

- Order to cease the abusive behavior. This will usually be combined with a fine if the infringement is continuing.

- Imposition of fines on the firm. Criteria for fixing fines include gravity of the infringement, length in time of the infringement, effect of the infringement, nonenforcement of the infringement, difficult market conditions, size and profitability of the undertaking, cooperation of

the undertaking, state of the law, repeated infringement, continuation of infringement following clarification of the law, governmental pressure, and amount of unlawful profit from infringement.

- Fines on individuals and imprisonment (or both). Except in extreme circumstances, however, these sanctions are inappropriate in abuse of dominance cases, which typically do not involve criminal intent.

- Order to repay "undue profits." In jurisdictions where such a remedy is possible, however, it is rarely used because such a calculation is extremely difficult to make.

- Divestment or division of firms.

- Order to take certain action, if, for instance, it is necessary to ensure fair treatment of competitors or other market participants.

- Informal settlements. These can sometimes be preferable to lengthy proceedings but should remain an exception.

- Award of damages.

- The special case of government-origin dominance. When dominance has been established by the state, or when the state owns the company, other considerations may come into play. In many countries state companies and state agencies do not enjoy immunity from remedies if they are involved in economic activity. The question may arise, however, whether the activity has taken place under state compulsion (result: no responsibility of the company, but the state maybe liable) or not (result: full responsibility of the company).

Conclusion

Investigating alleged abuses of a dominant position can be among the most challenging and difficult tasks for a competition agency. This is because practices that can qualify as abuses (predatory prices, tie-ins, vertical restraints) can also promote efficiency. Consequently, investigating alleged abuses of a dominant position will require a careful rule-of-reason analysis, in which possible anticompetitive harm is weighed against possible efficiency benefits.

In an investigation of an alleged abuse case the tasks are the same as in other investigations: define the relevant market(s), explain how the alleged abuse acts might harm competition, and explore possible efficiency benefits from the practice. The second task is often called "laying out the theory of the case." Key questions include: How would the practice harm

competition? Will it deter or prevent entry? Will it reduce incentives of the firm and its rivals to compete aggressively? Will it provide the dominant firm with an additional capacity to raise price? Will the practice enable the dominant firm to evade price regulation in one or more of its markets? If it is necessary to evaluate possible efficiencies (that is, anticompetitive effects are likely), the competition agency should expect the dominant firm to be able to explain how the practice at issue improves efficiency. Does it generate incentives to provide better service? Does it increase the amount of promotion or advertising? Do consumers benefit from lower prices or greater product availability?

In investigating an alleged abusive practice, the competition agency should obtain information from various sources including: customers of the dominant firm, rivals of the dominant firm, government officials who regulate some aspect of the dominant firm's behavior, competition officials in other countries, and officials representing the dominant firm. The views of rivals, of course, must be viewed with some skepticism because their interests are not necessarily consistent with the goal of competitive markets, and it is important not to equate harm to competitors with harm to competition. In this respect the views of customers are more reliable. How do they evaluate the effects of the alleged practice? Do the practices lower or increase prices and costs? Do they improve incentives? Or, do they tend to raise barriers to entry and expansion without any obvious efficiency rationale? Careful attention to these issues will ensure that abuse of dominance provisions are an effective tool for competition agencies in promoting a healthy and vibrant market economy.

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