UNILATERAL CONDUCT WORKBOOK
CHAPTER 1: THE OBJECTIVES AND PRINCIPLES OF UNILATERAL CONDUCT LAWS

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Presented at the 11th Annual ICN Conference
Rio de Janeiro, Brazil
April 2012

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I. Introduction

1. Unilateral conduct laws prohibit dominant[1] enterprises from misusing their market power to distort competition.

2. This introductory Chapter of the Unilateral Conduct Workbook aims to provide a foundation to the following Chapters that deal with specific types of unilateral conduct. By describing the objectives and principles underlying unilateral conduct laws, the Chapter attempts to increase awareness and understanding among competition law enforcers of the rationale for their intervention.

3. The Chapter has its origins in the ICN Report on the Objectives of Unilateral Conduct Laws, Assessment of Dominance/Substantial Market Power, and State Created Monopolies from 2007.[2] The Report reflects the responses of thirty-five ICN Members and fourteen non-governmental advisors to a UCWG questionnaire. In their answers to the questionnaire, virtually all competition agencies cited ensuring an effective competitive process as an objective in its own right, a means to achieve other desirable objectives such as consumer welfare, economic freedom or efficiency, or both an objective and a means to achieve other objectives. Of the nine other objectives that respondents identify as objectives in and of themselves, a significant number of respondents relied on the

[1] Different jurisdictions use such terms as "substantial market power," "monopoly power," or "dominance" to describe a firm that has a high degree of market power that can be maintained for a long duration. See Recommended Practices, at 1. In order to avoid confusion, in this Chapter all these terms will be referred to as "dominance".

[2] See ICN Report available at http://internationalcompetitionnetwork.org/uploads/library/doc353.pdf.

economic concepts of promoting consumer welfare and enhancing efficiency.[3] Section I of this Chapter therefore focuses on the objectives of ensuring an effective competitive process, promoting consumer welfare and enhancing efficiency. Most of the remaining objectives, which are present only in some jurisdictions, are addressed more briefly in Section II.

4. Section III addresses the standards of intervention, economic tests and approaches used by agencies in carrying out the difficult task of distinguishing between procompetitive and exclusionary conduct. It also examines the risks of enforcement errors inherent to every approach and how the approach may influence the cost of administration, predictability and accuracy of an agency's decision-making.

5. Finally, Section IV examines the relationship between unilateral conduct rules and other competition-related rules, in particular by addressing the interplay between competition rules, on the one hand, and IP-laws and sector regulation, on the other hand.

6. The Chapter only covers exclusionary abuses. Exploitative abuses may, however, be addressed in the future Chapters of the Workbook which deal with specific types of abuses. This introductory Chapter may also be expanded at a later stage to cover the objectives and principles of unilateral conduct laws when addressing exploitative abuses.

[3] *Ibid*., at 2.

II. Objectives of Unilateral Conduct Laws

7. The objectives of unilateral conduct laws, which tend to coincide with the objectives of competition law in general, may be regarded as intermediate steps in achieving broader economic policy objectives such as total welfare[4] and equality.[5] Competition policy focuses on achieving these broader policy objectives only via effective competition.

A. Ensuring an Effective Competitive Process

8. Having an objective of ensuring an effective competitive process implies that the enforcement of unilateral conduct laws aims at safeguarding the competitive process, not particular competitors.

9. In an effective competitive process producers compete for customers by offering low prices, high quality, innovative products and attractive services. This benefits consumers, fosters the most productive allocation of resources (allocative efficiency) and puts pressure on firms to reduce costs and improve quality in order to stay competitive.

10. Absence of competition, on the other hand, tends to be detrimental to welfare and equality in a number of ways.[6]

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[4] Total welfare is the sum of consumer and producer welfare.

[5] An efficient allocation of resources maximizes total welfare, while increased equality divides the welfare more evenly.

[6] The listed concerns are applicable to firms possessing buyer market power, as well as to firms with seller market power, with appropriate alterations to items 1 and 2. Buyer market power that simply balances seller market power, however, tends to be beneficial.

(i) The exercise of market power results in allocative inefficiencies. Since prices are set above marginal costs, output is reduced below what is socially optimal ("dead-weight loss"). This deadweight loss results in a reduction in both total welfare and consumer welfare.

(ii) The exercise of market power by producers redistributes wealth from consumers to producers by allowing producers to raise prices. This redistribution may reduce equality.7

(iii) Lack of competition may reduce the incentive to keep costs in check and, consequently, tend to inflate firms' costs ("X-inefficiency").

(iv) The existence of monopoly profits stimulates rent-seeking behaviour. Valuable resources can be wasted, e.g. on lobbying activities, when producers engage in a contest to obtain or maintain a monopoly.

11. From a static perspective,[8] prices equal to marginal costs maximize allocative efficiency. From a dynamic perspective, prices must also allow firms a return on sunk investment, e.g. from research and innovation, in order to encourage the development of new products. An effective competition policy promotes both static and dynamic efficiency and recognizes possible tensions between the two.

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[7] It should be recognized, however, that, though this may frequently result in a more unequal distribution of wealth, this is not always the case.

[8] *Static efficiency* is concerned with the most efficient combination of resources in the short run, while *dynamic efficiency* is concerned with the productive efficiency of producers over time, and, in particular, with the creation of new social surplus (accruing to both producers and consumers) through innovation, both in terms of new products and processes.

12. Dynamic efficiency may be stimulated by some degree of market power. Furthermore, in highly innovative markets, it is relatively common that, during the early stages of a new industry, successful firms have high market shares during a period of time, only to be displaced by a rival that makes a disruptive innovation. In such situations, temporary high profit levels should not automatically be seen as indicative of harmful market power.

13. Firms without an offer that is competitive in a market may try to encourage agencies to invoke unilateral conduct rules in order to restrain more competitive peers and reduce competitive pressure on the complainants. In an effective competitive process, some firms will lose market share as a natural result of competition. Competition authorities should therefore base their analysis of the legality of unilateral conduct on an assessment of whether or not the conduct harms the competitive process, not the complainant.

B. Promoting Consumer Welfare

14. While ensuring an effective competitive process is an indirect means to benefit consumers,[9] the objectives of unilateral conduct law are often formulated directly in terms of maximizing consumer welfare.

15. Consumer welfare as a unilateral conduct policy objective addresses the welfare of both direct buyers and consumers at the end of the distribution chain in a particular market. In this interpretation, producer welfare is not taken into account.

[9] 2007 Report, at 5.

16. The following are some of the reasons for placing a greater value on the welfare of end-consumers.

(i) End-consumers tend to be less well off than firms' owners. This argument is less relevant in modern economies with effective, broad based, capital markets in which ownership is becoming more and more dispersed via pension funds and other forms of collective investments.

(ii) Firms can become directly involved in the enforcement process. They therefore have a greater ability to influence decision-makers and have informational advantages in matters such as efficiencies. Focusing on the welfare of end-consumers to a greater extent than the welfare of direct buyers or total welfare can be an indirect way to account for this asymmetry.

(iii) A consumer welfare objective may be easier to implement. For example, fixed-cost savings may, as a rule, be ignored, since they are unlikely to affect prices, at least in the short run. A complex analysis of the extent to which cost reductions are passed on to consumers ("pass-on rates") may nevertheless have to be undertaken, in order to evaluate the effectiveness of particular competition enforcement efforts considered by an agency.

17. Promoting consumer welfare is not to be confused with price minimization, even if low prices are almost always a key concern. Examples of other parameters that are central to consumer welfare are high quality and product variety.

C. Enhancing efficiency

18. The objective to enhance efficiency strongly supports, and is closely related to, the objectives of protecting the competitive process and promoting consumer welfare, discussed above. These three objectives are interdependent.

19. Efficiency may refer to *allocative efficiency* (allocation of resources to their most efficient use), *productive efficiency* (production in the least costly way), or *dynamic efficiency* (rate of introduction of new products or improvements of products and production techniques). It is probably true to say that most, if not all jurisdictions, make some reference to efficiency in their objectives.[10]

III. Other Objectives

20. Although ensuring an effective competitive process, promoting consumer welfare and enhancing efficiency are the most frequently cited objectives of unilateral conduct laws, various jurisdictions have cited a number of additional objectives.[11] Most of these are briefly summarized below.

A. Ensuring Economic Freedom

21. In some jurisdictions economic freedom is a specific objective of unilateral conduct law. This objective is often derived from broader constitutional principles, and is therefore not unique to competition law.[12] While the formal rights to engage in commercial activities are expressed in other fields of law, protection against anticompetitive unilateral conduct is sometimes seen as a

[10] 2007 Report, at 2 and 12.

[11] 2007 Report, at 9-20.

[12] 2007 Report, at 14.

necessary condition for the recognized freedom to become a real freedom, especially in an economy that has been historically dominated by state monopolies. This can, for example, be reflected in the rules relating to tying, discriminatory practices, and refusals to deal.

B. Ensuring a Level Playing Field for Small and Medium-Sized Enterprises

22. Small and medium-sized enterprises (SMEs) are an important part of many economies, making up the large majority of all firms and a sizeable fraction of employment and value added. SMEs can be highly innovative and are often the first to enter new markets. SMEs can often be more susceptible to exclusionary abuse than larger enterprises.

23. For these reasons, some jurisdictions have elevated the protection of SMEs to the level of an objective of unilateral conduct laws. A policy that actively favours SMEs over large firms, however, is likely to result in distortions that reduce overall efficiency. It therefore follows that unilateral conduct laws should be designed and interpreted, whenever possible, to ensure that protecting SMEs from anticompetitive conduct does not result in giving SMEs undue privileges.

C. Facilitating Liberalization and Privatization

24. Many jurisdictions are in the process of liberalizing, or have recently liberalized, different sectors of their economies. In recently liberalized markets and in markets where privatization is on-going, there will often be dominant firms. In these markets an effective enforcement of unilateral conduct laws is particularly important, because a dominant market position is more likely to be the result of

past government policies rather than an enterprise's superior skill, foresight and effort. It may also make sense to make the facilitation of effective competition in recently liberalized markets an explicit objective of the regulatory framework.

D. Promoting Market Integration

25. Integrating markets usually leads to increased competition, more product variety, as well as efficiency gains due to economies of scale. In addition, market integration can further political objectives such as peace and cultural affinity.

26. Firms may, for profit related or other reasons, want to segment markets and prevent or reduce the effects of market integration. Unilateral conduct laws can be applied to counteract these tendencies. In particular, it can be applied against hindrances and restrictions of parallel trade to make it more difficult for producers to price-discriminate between different markets.

IV. Principles for Designing Unilateral Conduct Rules

27. The objectives of unilateral conduct policy are operationalized, inter alia, in standards of intervention and tests.

28. *Standards of intervention* guide competition authorities in their assessment of the lawfulness of specific forms of unilateral conduct and, where applicable, in their exercise of discretion in prohibiting such conduct.

29. Tests are the tools used by enforcers in order to determine whether a certain standard of intervention is met. Within the field of unilateral conduct laws, several *economic tests* for competitive effect have been proposed that may guide the

application of unilateral conduct laws so that its objectives are attained. The consumer welfare balancing test and the profit sacrifice test are examples of such tests.

30. *Tests of legality* are tests that agencies apply to specific conduct. Examples of such tests are the *Brooke Group* rule that has been formulated as a test for illegal predatory pricing in US case law and the *Akzo* test that plays a similar role in EU competition law. The application of tests to specific types of unilateral conduct is discussed in subsequent Chapters.

31. Ideally, standards and tests should be as consistent as possible with the various objectives of unilateral conduct laws.

A. The difficulty of distinguishing between Procompetitive and Exclusionary Conduct

32. The crucial difficulty in designing standards for lawfulness of unilateral conduct is that both procompetitive and exclusionary conduct are characterized by similar forms of non-cooperative behaviour toward competitors and are, therefore, difficult to distinguish. For example, while competing with low prices that attract rivals' customers is the very essence of competition, pricing that is so low that it becomes predatory pricing is a classic example of exclusionary conduct. Devising standards that distinguish procompetitive unilateral behaviour from behaviour that is exclusionary must be done with due account of the inherent similarity between the two.

33. There is no universal, all-encompassing approach to identifying exclusionary behaviour. Establishing the existence of dominance is, however, always a prerequisite for intervention under unilateral conduct rules.[13] Laws differ in the way dominance is defined.[14] Having established dominance, there are several approaches to the assessment of exclusionary conduct.

34. Some jurisdictions apply a *formalistic, bright-line approach*. This approach tends to be based on the presumption that a particular conduct leads to anticompetitive or procompetitive effects. It allows little or no room for an agency or court to take into account the actual market effects of the prohibited conduct in the particular circumstances. Other jurisdictions apply an *effects-based approach* that requires a careful and often more complex analysis of the potential effects of a particular behaviour, generating fact-driven outcomes. In reality, most jurisdictions apply a *hybrid approach* that combines a formalistic approach with varying degrees of analysis of effects, usually using rebuttable legal presumptions.

35. Several alternative economic tests for an effects-based approach can be distinguished; the major alternatives include the consumer welfare balancing test, the profit sacrifice test, the no economic sense test, and the as efficient competitor test.[15]

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[13] ICN Dominance/Substantial Market Power Analysis Pursuant to Unilateral Conduct Laws, Recommended Practices, at 1 ("Recommended Practices"), available at http://internationalcompetitionnetwork.org/uploads/library/doc317.pdf**.**

[14] *Ibid*. Assessing the existence of dominance is described more fully in Chapter III of this Workbook.

[15] *What is competition on the merits?*, OECD Policy Brief, June 2006.

36. The *consumer welfare balancing test* directly balances the positive and negative effects that a dominant firm's conduct has on consumer welfare. However, a direct balancing of consumer welfare risks shifting the focus unduly towards short-run effects since long-run effects will inevitably be more speculative.

37. The *profit-sacrifice test* identifies exclusion by asking whether a conduct that tends to exclude rivals also requires a profit sacrifice that would be irrational absent the tendency to exclude.

38. The related *no economic sense test* asks whether any conduct that tends to exclude rivals – whether involving a profit sacrifice or not – would be irrational absent the exclusionary tendency. The question to be answered is, in other words, whether the conduct would make no economic sense but for the tendency to exclude.

39. A somewhat different principle underlies the *as efficient competitor test*, which identifies exclusionary behaviour by asking whether a dominant firm's conduct tends to exclude rivals that are at least as efficient as the dominant firm itself. Some versions of the test then proceed by balancing any identified exclusionary effects with efficiencies that may result from the conduct.

40. The latter three tests seek to protect the competitive process, rather than the consumer directly, and are therefore closely related to the objective of ensuring an effective competitive process. However, the tests are not mutually exclusive. For example, prerequisites for establishing illegal exclusionary conduct may include both exclusion of competitors and harm to consumers.

B. Risks of Enforcement Errors

41. All types of assessment of unilateral conduct risk leading to errors in enforcement. The prevalence and cost of errors is very difficult to quantify, but it is nevertheless important to be aware of these risks. Errors in enforcement consist of either over-enforcement (finding procompetitive conduct as liable of violating unilateral conduct laws), or under-enforcement (finding anticompetitive conduct as being in compliance with the laws).[16] Aside from the quality of the investigation and the legal proceedings, the likelihood of committing either type of error varies with the approach used.

42. The two extremes within the *formalistic* approach are *per se* illegality and *per se* legality. *Per se* illegality is when specified conduct is held *ex ante* to be anticompetitive and illegal, while *per se* legality is when specified conduct is held *ex ante* to be procompetitive and legal. *Per* se rules should be used only when economic theory or empirical research support the conclusion that a particular type of conduct is almost always anticompetitive (*per se* illegality) or rarely, if ever, is anticompetitive (*per se* legality). Applying a rule of *per se* illegality to conduct for which there may be procompetitive justifications tends to result in over-enforcement. Conversely, applying a rule of *per se* legality to conduct that in some instances may be anticompetitive may result in under-enforcement. Between the two extremes of *per se* rules, there is scope for the use of 'soft' presumptions

[16] These errors are sometimes referred to as Type I-errors (false positives, i.e. finding procompetitive behavior as liable of violating unilateral conduct laws), and Type II-errors (false negatives, i.e. finding anticompetitive behavior as being in compliance with unilateral conduct rules).

and safe harbours, which can be displaced by plainly contrary evidence or expert economic testimony.

43. The *effects-based* approach allows for an analysis of the circumstances in the particular case, and is therefore particularly suitable where neither economic theory nor empirical research predicts *ex-ante* a procompetitive or exclusionary explanation for a certain type of conduct with a high degree of certainty.

44. The cost of over-enforcement is a lessening of procompetitive behaviour on the part of dominant firms. This may result in static efficiency losses from the dominant firm's reduced incentives to cut prices or compete hard, as well as from competitors having to compete less vigorously in response. It can also result in the loss of dynamic efficiency due to the dominant firm's lessened incentives to innovate and make initial investments. The negative effects of over-enforcement are, in some jurisdictions, amplified by the presence of strong private litigation.

45. The cost of under-enforcement is the risk of exclusion and the resulting reduction in competitive pressure faced by the dominant firm. Under-enforcement may also lead to a loss of dynamic efficiency flowing from competitors' lessened incentives to innovate and enter the market. It may furthermore result in redistribution of resources from consumers to producers, potentially inflated costs by dominant firms, and the inefficient devotion of resources to rent-seeking by firms that seek to obtain or maintain dominance.

46. In other words, both over-enforcement and under-enforcement can cause not only a loss of static efficiency but also of dynamic efficiency by reducing incentives to

invest and innovate. Over-enforcement may deter firms from making initial investments and taking risks as they may be penalized if successful. By contrast, under-enforcement will tend to reduce the pressure on an incumbent monopolist to innovate, improve, or expand and reduce the possibilities for innovative competitors to enter and expand.

47. An agency might be able to determine that the costs of over-enforcement are apt to exceed the costs of under-enforcement or the reverse. In such situations, the balance of over-enforcement and under-enforcement costs should be accounted for in agency decision making. A critical consideration can be whether the conduct subject to the potential enforcement action offers clear, direct, and tangible consumer benefits or potential harms to consumers or to the competitive process. While in many situations no balancing of error costs is possible, it is nevertheless useful for the agency to keep in mind that both over-enforcement and under-enforcement normally do have costs, both to the affected firms and to the agency itself.

C. Administrative costs, Accuracy and Predictability

48. Under a formalistic approach, the authority or the judge considers the general nature of the conduct of a firm as the sole, or main, deciding factor of its lawfulness. This reduces legal uncertainty, to the extent that firms can predict how their actions are likely to be classified. However, this also reduces the accuracy of the assessment and increases the risk of over-enforcement and under-enforcement, as was described above.

49. The effects-based approach tends to lead to a more accurate assessment of a particular case. However, because this approach generates fact-driven outcomes, it tends to lead to greater delays and costs for the agency and those under investigation. The approach also makes it more difficult for business planners and counsel to predict whether specific conduct is likely to result in an infringement decision. This uncertainty may result in a chilling effect, as firms avoid conduct that may in fact be procompetitive and lawful. The lack of predictability may, to some extent, be offset by competition authorities issuing general guidelines describing the methodology used in their assessments, as well as clearly communicating the methodology used in each individual case.

V. Unilateral Conduct Rules in Relation to Other Competition-Related Rules

A. Exemptions and Exceptions

50. Whole sectors or certain undertakings may, in some jurisdictions, be exempted from the ambit of unilateral conduct laws by either statutes or legal decisions. The most common categories of exemptions and exceptions relate to services of general economic interest, public interest concerns, intellectual property rights and regulated sectors.[17]

51. The objectives underlying the exemption from unilateral conduct laws are not always in conflict with the objectives of the unilateral conduct laws themselves. For example, a sector-specific regulation may in some cases be a more efficient means of achieving the objectives of effective competition and consumer welfare.

[17] See the 2007 UCWG Report on the objectives of unilateral conduct laws, assessment of dominance/substantial market power, and state-created monopolies, at 24.

However, in other cases, exemptions may reflect public policy objectives that cannot easily be reconciled with the promotion of competition.

B. Intellectual Property Laws

52. Historically, competition law and intellectual property laws governing patents, trademarks, copyright, and design rights (“IP laws”), have often been regarded as opposite extremes: one establishing monopoly rights and the other combating them. The preference for one over the other has varied over time.

53. IP laws and antitrust provisions are nowadays perceived as complementary tools in creating a dynamic economy. Intellectual property rights tend to promote dynamic competition by encouraging undertakings to invest in developing new or improved products and processes. Competition rules also encourage innovation by fostering a competitive environment where companies have to innovate in order to keep or improve their market position.

54. The fact that intellectual property laws grant exclusive rights of exploitation does not imply that intellectual property rights are immune from competition law intervention. It is also broadly recognized today that IP rights do not automatically confer market power on the holder, let alone dominance.

C. Sector Regulation

55. The aim of sector regulation may be to respond to market failures, avoid abuses of a dominant position, and preserve effective competition. This is often the case with regulation in infrastructure markets – such as telecommunications, energy, rail transport and postal services – where former monopolies are opened up for

some degree of competition. This latter type of regulation is often based on the same or complementary objectives as unilateral conduct laws. The two sets of rules can therefore often be applied in ways that are consistent with each other in dealing with a dominant firm, provided that the competition agency and the sectoral regulator desire to do so.

56. Other times, however, the purpose of regulation is to pursue objectives other than those advanced by unilateral conduct laws, for example, the protection of consumers from hazardous products, or depository institutions from failure, or the environment from degradation.

57. Conflicts between sector regulation and unilateral conduct laws may arise if a regulation is based on objectives that are wholly or partly incompatible with the objectives of unilateral conduct laws. Examples include situations where companies are entrusted with the operation of services of public interest, such as the provision of a baseline level of services to every resident of a country in the postal, electricity, and telecommunications sectors. The operation of services of public interest normally involves substantial cross-subsidies in which the lower cost customers subsidize the higher cost customers (e.g., in remote rural areas). The sectoral regulator will therefore often support the monopolist in its efforts to resist new entry and competition for lower cost customers. These potential conflicts raise the question of whether, and under what conditions, unilateral conduct laws may be applied to undertakings subject to regulation.

58. Many jurisdictions apply the so-called "regulated conduct doctrine" to address situations where the application of unilateral conduct rules and regulation are incompatible. Under this doctrine, companies are shielded from competition law consequences where their conduct is required by regulation.[18] This is a narrower form of immunity than exempting an entire sector from the application of competition law and is generally to be preferred to the latter.

59. Competition law has increasingly been recognised as beneficial, also as a safeguard in already regulated sectors.[19] Nevertheless, regulatory authorities are in general better placed to deal with certain issues, such as price regulation and designing the terms and conditions for an obligation to give access to facilities.

60. In order to avoid legal uncertainty, there should be rules as to which framework prevails in cases where a conflict arises between regulation and unilateral conduct rules.[20]

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[18] For an overview of exemptions in different sectors and jurisdictions, see OECD (2011), The Regulated Conduct Defence, DAF/COMP (2011)3.

[19] 2004 AERS Report: General Introduction.

[20] For a discussion on different solutions, see the 2004 AERS Report: Limits and Constraints Facing Antitrust Authorities Intervening in Regulated Sectors (Chapter 1). See also the 2007 UCWG Report on the objectives of unilateral conduct laws, assessment of dominance/substantial market power, and state-created monopolies, at 24-27.