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Guest Editorial

"A European Competition Policy for today and tomorrow"

Mario MONTI*

I am grateful for the opportunity to welcome readers to this edition of *World Competition*. It provides me with an occasion to describe briefly some of the reforms which have recently been introduced, and others which I am proposing, in order to deal with the new realities faced by the European Commission in the field of competition policy at the beginning of this new Millennium.

We must ensure that our competition policy remains effective in meeting the challenges of today and of tomorrow. The nature of the world's economy is evolving with astonishing speed: technological advances and rapidly disappearing trade barriers are contibuting to a globalisation of markets, thereby complicating the task of effective competition law enforcement. Here in the EU, most of our Member States are now using a single currency, and the European Community is preparing itself for the arrival of a host of new members. These new economic and political realities are changing the nature as well as the scale of the tasks to be carried out by the Commission.

I will focus on three of the main avenues which the Commission is pursuing in order to adapt our competition law enforcement policy to these new challenges: first, we are proposing far-reaching procedural reforms for the application of the competition rules; secondly, we are in the process of modernising and rationalising our substantive secondary legislation; and thirdly, we are intensifying cooperation between the Commission and competition agencies located in different parts of the world, and at the same time advocating the creation of a multilateral competition law framework.

PROCEDURAL REFORM: THE "MODERNISATION" WHITE PAPER

Conscious of, indeed anticipating, the changing realities facing it, the Commission has—over the past few years—undertaken a major review of the procedures for the enforcement of the competition rules, and of Council Regulation No. 17 in particular. The result of these deliberations is the White Paper on "Modernisation" adopted in the spring of last year. The White Paper proposes that Article 81 of the Treaty should be rendered directly applicable as a whole, and that the current system of *ex ante* notification should be abandoned. Put simply, we are proposing that competence for the enforcement of the Community's competition rules should henceforth be shared

* Member of the European Commission with responsibility for competition policy.

between the Commission, on the one hand, and our Member States' national competition authorities and courts on the other.

This reform would not only enable enforcement to, in many instances, be carried out closer to the companies and consumers affected by competition problems, but would furthermore enable the Commission to concentrate its efforts on the most serious instances of anti-competitive behaviour, on investigating major cross-border mergers, as well as on progressing the liberalisation of new sectors and policing state aid. The reforms should result in enhanced enforcement by effectively increasing the number of potential prosecutors, and by facilitating private enforcement. I am moreover convinced that, in an enlarged Community, it will become increasingly difficult for a single enforcement body to ensure the effective protection of competition throughout the Union. It is a logical evolution for the Community to implicate the courts and competition authorities of the Member States in this task, to a much greater extent than today.

I am also very conscious of the fact that this reform must take into account the need to ensure the maintenance of an adequate level of legal certainty for market participants. It should be stressed, however, that uncertainty already exists with the parallel application of Community law and the national competition laws of the fifteen Member States. The application of one set of competition rules in a single integrated market, and the association of national bodies in the application of that set of rules, is, in my view, a better guarantor of legal harmony. The White Paper also foresees a number of safeguards designed to guarantee that the competition rules continue to be enforced in a coherent and consistent manner. To that end, a degree of centralised guidance would need to be preserved, and this would be the role of the Commission.

Reform of Substantive Secondary Legislation

The Commission is also in the process of modernising and rationalising much of the Community's substantive secondary legislation in the competition field. This reform is driven, on the one hand, by a desire to simplify these often cumbersome and complicated provisions and, on the other, to bring the legislation into line with current economic thinking.

Recognising these imperatives, the Commission undertook the recent radical overhaul of its policy in relation to vertical restraints. On 1 June of this year, a new "block exemption" Regulation entered into force covering all categories of vertical agreements except motor vehicle distribution. The new legislation identifies a number of serious restrictions which will not normally be exempted from the prohibition contained in Article 81. In the absence of such restrictions, it provides a "safe haven" for all vertical agreements entered into between companies with a market share of less than 30 percent. Only vertical arrangements between enterprises with higher market shares will require individual scrutiny, and in May of this year the Commission published guidelines indicating the approach which it will take in such cases. This reform amounts to a major simplification and harmonisation of the treatment of vertical arrangements across all sectors, thereby reducing unnecessary regulation and the consequent compliance burden on companies.

The Commission is, at the same time, reviewing its policy toward horizontal agreements between competitors. The Commission has proposed that this should take the form of a revision of the existing block exemptions for specialisation and research and development agreements, complemented by a comprehensive set of guidelines outlining the Commission's enforcement policy toward horizontal cooperation arrangements generally. The approach we are proposing is currently the subject of wide prior public consultation.

International Cooperation

The challenges presented by globalisation, as vividly illustrated by the seemingly incessant increase in the number of large-scale, trans-national mergers, have sharpened our awareness of the important benefits to be gained from effective cooperation between competition authorities in the enforcement of our respective competition rules.

The 1991 and 1998 EU/US competition cooperation agreements have been a marked success. Our experience with bilateral EU/US cooperation has been that it works very effectively—and particularly so in merger cases, substantially reducing the risk of divergent or incoherent rulings. Indeed, Commission staff are in close and daily contact with their counterparts at the Antitrust Division of the US Department of Justice and Federal Trade Commission. The trend towards increasing convergence in the analysis being made by the Commission and the US agencies in cross-border competition cases, particularly in the merger field, is particularly encouraging.

The Commission is moreover seeking to expand and intensify its bilateral cooperative network in the competition field. Last year, the Community concluded a competition cooperation agreement with Canada, and the Commission has recently been granted a mandate to negotiate a similar agreement with Japan. In the long run, however, I am convinced of the need to also put in place a multilateral framework ensuring the respect of certain basic competition principles.

The Commission has been the principal advocate of such an initiative, and has, through the deliberations of the WTO Working Group on Trade and Competition, been attempting to persuade member countries of its merits. We are convinced that a framework providing for substantial equivalence between antitrust regimes, and for a basic instrument of cooperation between trading partners, would greatly facilitate the effective combatting of anti-competitive behaviour. This would serve to underpin the impressive progress which has been made in trade liberalisation over the past few decades, by ensuring that governmental barriers to trade are not replaced by private ones which have the same effect. Despite the collective failure to launch the new trade round at Seattle last December, I am nonetheless convinced that our trading partners will recognise the importance of this initiative and that substantive negotiations will soon be undertaken.

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Preliminary Analysis of the Commission's Reform Concerning Vertical Restraints

Romano SUBIOTTO* and Filippo AMATO*

I. INTRODUCTION

Vertical arrangements can provide significant assistance to undertakings in penetrating new markets. However, they can sometimes prevent other competitors from relying on similar arrangements or result in a compartmentalisation of the common market along national boundaries. These risks led the European Commission (the "Commission") to consider almost any vertical arrangement as falling within the scope of Article 81(1) of the EC Treaty.

Article 81(1) proscribes restrictions on commercial conduct that have an appreciable effect on competition and on trade between Member States. Such restrictions are null and void, pursuant to Article 81(2), and may expose the parties to the agreement containing such restrictions to fines and third party claims for damages in national courts, unless they have been notified to and authorised ("exempted") by the Commission under Article 81(3). The effect of the nullity of individual clauses on the validity of the agreement in which they are contained is determined by the law governing the agreement.

In 1962, the Council of the European Communities (the "Council") adopted Regulation 17 ("Regulation 17/62").[1] Regulation 17/62 implements Articles 81 and 82 and confers upon the Commission the sole power to grant exemptions pursuant to a notification to the Commission of the arrangement requiring exemption. Article 6 of Regulation 17/62 provides that, except for the categories of agreements listed in Article 4(2) of Regulation 17, exemptions cannot produce effects for the period preceding the date of notification, thereby potentially subjecting companies to all the consequences of a violation of Article 81(1) described above (nullity, fines, damages) prior to the date of notification. Notification thus soon became a preferred option for many companies, burdening the Commission with a mass of notifications (nearly 30,000), many of which concerned vertical restraints.

To solve this problem, the Council adopted a regulation in 1965 ("Regulation 19/65") that enabled the Commission to declare, by way of regulation, that Article 81(1) does not apply to certain categories of agreements and practices (so-called "block exemptions").[2] Despite the adoption over the years of a number of block exemptions and notices clarifying the scope of application of Article 81(1) to vertical restraints, the

* Cleary, Gottlieb, Steen & Hamilton, Brussels, Belgium.
[1] Council Regulation No. 17/62, OJ 1962 13, pp. 204/62.
[2] Council Regulation No. 19/65, OJ 1965 36, pp. 533/65.

Commission is still unable to deal with the mass of notifications. In most cases, instead of adopting formal exemption decisions, the Commission provides the notifying parties only with a so-called "comfort letter".[3] These letters not only place the notifying companies in a situation of legal uncertainty,[4] but do not even reduce substantially the Commission's workload, since their adoption can also require significant work, including an examination of the relevant facts and circumstances, a legal review of the agreements, and an economic assessment of the effects that such agreements may have on competition.

In 1997, the Commission launched a debate on possible reforms of its policy on vertical restraints.[5] Following consultations with industry and interested parties, the Commission published, a year later, a communication outlining its intention to change its approach to vertical restraints (the "Communication").[6]

The Communication essentially proposed: (i) to amend Article 4(2) of Regulation 17/62 to increase the category of vertical agreements for which an exemption decision may take effect before the date of notification; (ii) to amend Regulation 19/65 to enable the Commission to adopt block exemptions with a broader scope of application, and to enable national competition authorities, under certain circumstances, to withdraw the application of such block exemptions in the territory under their jurisdiction; (iii) to adopt a broad vertical restraints block exemption; (iv) to adopt a set of guidelines illustrating the Commission's policy towards vertical agreements that are not covered by the new block exemption.[7]

Part of the proposed reform has already been implemented. In June 1999 the Council adopted two regulations, one amending Regulation 19/65,[8] and the other amending Article 4(2) of Regulation 17/62.[9] In December 1999 the Commission adopted Regulation 2790/1999 on the application of Article 81(3) of the Treaty to categories of agreements and concerted practices ("Regulation 2790/99").[10]

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[3] These letters are commonly known as "negative clearance comfort letters" where the Commission expresses the opinion that the agreement is not caught by Article 81(1); "comfort letters" where the Commission states that, even if caught by Article 81(1), the agreement could qualify for an exemption; and "discomfort letters" where the Commission informs the parties that, although the agreement restricts competition and does not qualify for exemption, the Commission will not issue a formal prohibition decision.

[4] In Case C-99/79, *SA Lancôme and Cosparfrance Nederland BV v. Etos BV and Albert Heyn Supermarket BV,* [1980] ECR 2511, the European Court of Justice held that a comfort letter does not bind national courts, but only constitutes an element of fact which national courts and national competition authorities may take into account.

[5] Green Paper on Vertical Restraints in EC Competition Policy, of 22 January 1997 (COM(96) 721 final). For comments on the Commission's proposed reform concerning vertical restraints, see V. Korah, *The Future of Vertical Agreements under E.C. Competition Law,* [1998] ECLR 506; D. Schroder, *The Green Paper on Vertical Restraints: Beware of Market Share Thresholds,* [1997] ECLR 430; H.H.P. Lugard, *Vertical Restraints under EC Competition Law: A Horizontal Approach?*, [1996] ECLR 166; F.M. Carlin, *Vertical Restraints: Time for Change?*, [1996] ECLR 283.

[6] Communication from the Commission on the application of the Community competition rules to vertical restraints (Follow-up to the Green Paper on Vertical Restraints), [1998] OJ C365/3.

[7] For comments on the Communication see J. Nazareli and D. Cowan, *Reforming E.U. Distribution Rules—Has the Commission Found Vertical Reality?*, [1999] ECLR 159; F. Bortolotti, *The Revision of the Block Exemptions on Vertical Restraints*, [1999] RDAI/IBLJ 207; Editorial Comments, *The modernization of the Community competition rules on vertical agreements*, [1998] CMLR 1227.

[8] Council Regulation (EC) No. 1215/1999 of 10 June 1999 ("Regulation 1215/99"), [1999] OJ L148/1.

[9] Council Regulation (EC) No. 1216/1999 of 10 June 1999 ("Regulation 1216/99"), [1999] OJ L148/5.

[10] Regulation No. 2790/1999, [1999] OJ L336/21.

Guidelines on vertical restraints are expected to be adopted around May of this year (the "Guidelines"). However, a draft version of guidelines was published for comments in September 1999 (the "Draft Guidelines").

It is therefore possible to conduct a preliminary analysis of the main practical consequences of the Commission's reform of the regulatory framework applicable to vertical restraints.

II. THE NEW BLOCK EXEMPTION ON VERTICAL RESTRAINTS

Regulation 2790/99 replaces the block exemption regulations on exclusive distribution ("Regulation 1983/83"),[11] exclusive purchasing ("Regulation 1984/83"),[12] and franchising agreements ("Regulation No 4087/88"),[13] which expired on 31 December 1999 (the "Replaced Regulations").

Unlike the Replaced Regulations, Regulation 2790/99 follows a black-clause approach, i.e. it mainly defines the restrictions that prevent the application of the block exemption (so called "hardcore restraints") instead of defining the restrictions that are exempted. This removes the so-called straitjacket effect of the Replaced Regulations,[14] allowing companies that do not exceed a certain market threshold more flexibility in the negotiation of vertical agreements.

Regulation 2790/99 is structured as follows: Articles 1 and 11 contain a list of definitions, Article 2 describes the type of agreements covered by the block exemption; Article 3 excludes the applicability of the exemption when the supplier (or the buyer, if the buyer is the only entity purchasing the contract goods within the community) holds a market share exceeding 30 percent; Article 4 contains a "black list" (i.e. the list of hardcore restraints), and a "grey list" (i.e. restrictions expressly exempted); Article 5 lists restraints exempted only if they meet certain conditions; Articles 6 to 8 lay down rules on the power to withdraw the block exemption; Articles 9 and 10 explain how market shares and turnovers should be calculated; Articles 12 and 13 address the date of entry into force, the date of application, and the transitional period.

A. SCOPE OF APPLICATION

1. *Type of Agreements Covered*

Regulation 2790/99 applies to vertical agreements as defined by Article 2(1), i.e. "agreements or concerted practices entered into between two or more undertakings each of which operates, for the purpose of the agreement, at a different level of the

[11] Regulation No. 1983/83, [1983] OJ L173/1.
[12] Regulation No. 1984/83, [1983] OJ L173/5.
[13] Regulation No. 4087/88, [1989] OJ L359/1.
[14] Such effect resulted from the fact that the Replaced Regulations applied only as long as the agreement did not contain other restrictions than those specifically exempted. Consequently, companies willing to benefit from a block exemption were practically obliged to model their agreements to the applicable regulation.

production or distribution chain, and relating to the conditions under which the parties may purchase, sell or resell certain goods or services". It also applies, pursuant to Article 2(2), to agreements between associations of retailers and their members, or between such an association and its suppliers, provided that no individual member of the association, together with its connected undertakings, has a total annual turnover exceeding 50 million Euro.[15]

The scope of application of the block exemption determined by Article 2(1) seems very wide. However, Articles 2(3), 2(4), 2(5), and 3 contain limitations with regard to: agreements containing the assignment or licensing of intellectual property rights, agreements between competitors, agreements covered by other block exemption regulations, and agreements concluded by parties holding market shares above 30 percent.

2. *Assignment and/or Licensing of Intellectual Property Rights*

Regulation 2790/99 applies to vertical agreements containing provisions that assign or license intellectual property rights, provided the assignment or license of the intellectual property right: (i) does not constitute the primary object of such agreements, (ii) is directly related to the use, sale or resale of goods or services by the buyer or its customers, and (iii) does not impose upon the buyer or its customers hardcore restraints.[16]

In the light of condition (i) above, one might wonder whether Regulation 2790/99 applies to franchising agreements, since the license or assignment of a package of intellectual property rights constitutes the "primary object" of such agreements.[17] The Draft Guidelines say that Regulation 2790/99 applies to franchising agreements, although it is not clear to what extent.[18]

Concerning broadcasting agreements,[19] they would likely fall outside the scope of the block exemption, since broadcasting agreements confer a right to use copyrighted material that would constitute the primary object of the agreement. A similar reasoning applies to sponsorship agreements pursuant to which a sponsor acquires the right to use a logo relating to a specific sports or other event and to associate itself in communications to the public with that event by referring to its status as sponsor.

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[15] The exemption however does not apply to the horizontal agreements concluded between the members of such associations or to the decisions adopted by such associations.

[16] Article 2(3).

[17] Recital 2 of Regulation 4087/88 states that "franchising agreements consist *essentially* of licenses of industrial or intellectual property rights relating to trade marks or signs and know how, which can be combined with restrictions relating with the supply or purchase of goods" (emphasis added).

[18] See section III.C, below.

[19] That is, agreements assigning or licensing to a broadcaster or sport rights' agency the right to broadcast a sport or cultural event or any other TV production.

3. *Agreements Between Competitors*

Regulation 2790/99 does not apply to vertical agreements between competing undertakings.[20] However, it applies to non-reciprocal vertical agreements concluded between competing undertakings when any of the following conditions is satisfied: (i) the buyer's annual turnover (together with that of its connected undertakings) does not exceed 100 million Euro; (ii) the supplier is a manufacturer and distributor of goods, while the purchaser is only a distributor and not a manufacturer of competing goods; or (iii) the supplier and the purchaser of services are not actual providers of competing services at the level of trade to which the contract refers.

This provision raises a number of issues of interpretation. First, Article 1(1) defines competing undertakings as all "actual or potential suppliers in the same product market". As a result, the application of Regulation 2790/99 will very likely cause uncertainties, particularly in relation to product markets characterised by very low barriers to entry, where it might not be easy to determine whether the buyer is a "potential" competitor of the supplier.[21]

Second, it is not clear why condition (i) above applies only to the buyer's turnover and does not apply when the supplier, rather than the buyer, has a turnover not exceeding 100 million Euro.[22] Why should a small-sized manufacturer, willing to enter a new market by means of a non-reciprocal distribution agreement with a large competitor already operating in that market, not benefit from the block exemption?

Third, when buyers, such as large supermarkets chains, sell own-branded products manufactured by subcontractors, are such buyers "manufacturers" within the meaning of condition (ii) above? Informal Commission sources have argued that such a qualification will depend on whether the buyer supplies specifications to the subcontractor which merely describe the goods to be manufactured, or whether the buyer imposes more stringent specifications on how such goods should be manufactured: only in the latter case should the buyer be considered a manufacturer. This approach raises certain difficulties. It is not immediately clear why the block exemption should apply in the former case but not in the latter, except to the extent that the buyer can be more easily assimilated to a mere distributor, in the former case, as contrasted from a manufacturer acting as a principal in the context of a genuine subcontracting agreement, as in the latter case. Furthermore, there might be borderline situations where it might not be easy to determine the nature of the specifications given by the buyer. Since this determination is a necessary step in defining the buyer as a manufacturer within condition (ii) above, the application of Regulation 2790/99 to a supply relationship between a third party manufacturer and the buyer would remain

[20] Article 2(4).

[21] See Opinion of the Economic and Social Committee on regulation 2790/99 (the "ESC Opinion"), [2000] OJ C51/5, ¶ 3.1.4.

[22] Articles 3(1)(b) of Regulation 1983/83 and 3(b) of Regulation 1983/84 did not discriminate between the two situations.

uncertain as long as it remained unclear if the buyer should be deemed a "manufacturer" of competing goods.

Fourth, it is not clear why the Commission deemed it necessary to insert in the final text of Regulation 2790/99[23] condition (iii) concerning a case in which the supplier and the buyer of services are not even competitors, and when this condition will apply in practice.

4. *Vertical Agreements Covered by Other Block Exemption Regulations*

Regulation 2790/99 does not apply to vertical agreements that fall within the scope of application of any other block exemption regulation.[24] In practice, the only block exemption regulations applicable to vertical agreements concluded after 1 June 2000, will be the regulation on motor-vehicle distribution ("Regulation 1475/95")[25] and the regulation on technology transfers ("Regulation 240/96").[26]

5. *Market Share Threshold*

Regulation 2790/99 applies only if the market share of the supplier (and its connected undertakings) on the market on which it sells the contract goods or services (e.g. the wholesale market, or the retail market) does not exceed 30 percent.[27] However, if the supplier is obliged to sell the contract goods or services to a single buyer within the Community, regardless of whether it is for resale, the threshold of 30 percent applies to the market share held by the buyer (and its connected undertakings) on the market in which it purchases the contract goods or services.[28]

The *De Minimis* Notice[29] provides that vertical agreements between parties that do not hold, on any relevant market, an aggregate market share exceeding 10 percent, do not fall within the scope of application of Article 81(1) (so-called "agreements of minor importance"),[30] provided the agreement does not contain provisions fixing resale prices or conferring absolute territorial protection on the parties or on third parties,[31] and provided that in the relevant market competition is not restricted by the

[23] There was no such provision in the Draft Regulation.
[24] Article 2(5).
[25] [1995] OJ L145/25.
[26] [1996] OJ L31/2. It is not excluded that, in certain cases, agreements whose primary object appears to be the licensing of intellectual property rights, and therefore excluded from the scope of Regulation 2790/99, should be considered in reality to be disguised distribution agreements. This might happen, for instance, when, for tax reasons, the supplier licenses a patent to the distributor, and the latter sub-contracts the manufacturing of the patented products to the supplier. In such cases, the proper approach in determining the applicable block exemption regulation (Regulation 2790/99 or Regulation 240/96), should be to look at the economic reality of the relationship between the parties to the agreement, rather than at the contractual framework established by those parties.
[27] Article 3.
[28] See Article 3(2) in connection with Article 1(c).
[29] *Notice on agreements of minor importance which do not fall within the meaning of Article 81(1) of the Treaty,* [1997] OJ C372/13.
[30] Ibid., at ¶ 9.
[31] Ibid., at ¶ 11.

cumulative effects of parallel networks of similar agreements established by several manufacturers or dealers.[32] The Commission is contemplating deleting some hardcore restraints from the *De Minimis* Notice that currently prevent its application even when the aggregate market share of the parties is below 10 percent.[33]

Regulation 2790/99, therefore, will in practice apply to vertical agreements concluded by a supplier (or a buyer, if it is the only one to purchase the contract goods within the EU) holding a market share between 10 percent and 30 percent.[34]

Pursuant to Article 9 of Regulation 2790/99,[35] market shares must be calculated on the basis of the value of sales relating to the preceding calendar year or, if such data are unavailable, on the basis of other reliable market information, including sales volumes. Moreover, the market share must include any goods or services supplied to integrated distributors for the purpose of sale. Thus, for instance, if the supplier sells to both owned and independent wholesalers, "captive" sales to the former must also be taken into account in calculating the supplier's share of the market for supplies to wholesalers.

If the market share is originally not more than 30 percent but subsequently increases without exceeding 35 percent, the exemption will continue to apply for a period of two consecutive calendar years, following the year in which the 30 percent market share was exceeded. However, if the increase is more than 35 percent, the exemption will continue to apply for one calendar year only, following the year in which the 35 percent market share was exceeded. The two rules cannot be combined in order to make the block exemption applicable longer than two years after the 30 percent market share was exceeded for the first time.

B. RESTRAINTS EXEMPTED, CLEARED AND BLACKLISTED

Article 4 of Regulation 2790/99 contains a so-called "black list" of hardcore restraints that prevent the application of the block exemption, together with a list of exceptions to the black list. Some of these exceptions are restrictions normally caught by Article 81(1) and covered by the block exemption ("grey list"). Other exceptions do not normally fall within the scope of application of Article 81(1) ("white list").

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[32] Ibid., at ¶ 18.

[33] See J. Nazareli and D. Cowan, *Unlocking E.U. Distribution Rules—Has the European Commission Found the Right Keys?*, [2000] ECLR 52. The authors also state that, under the new rules, the *De Minimis* Notice would not apply to an agreement containing any of the clauses blacklisted by Article 4 of Regulation 2790/99. However, neither Regulation 2790/99 nor the Draft Guidelines seem to support such a statement.

[34] It will also apply, provided the conditions of Article 1(4) are satisfied, when the supplier (or the buyer, if it is the only one to purchase the contract goods within the EU) has a market share below 10% if the vertical agreement is concluded with a competitor and the aggregate market share of the supplier and the buyer exceeds 10%.

[35] In the absence of any specific rule concerning the calculation of market shares in the *De Minimis* Notice, Article 9 of Regulation 2790/99 could probably apply by analogy to determine whether a vertical agreement is of minor importance.

1. *The Black List*

Any of the following restraints would prevent the application of the block exemption to the entire agreement:

– The obligations to sell at a fixed price, or the prohibition to sell below a minimum price (Article 4(a));
– The prohibition to sell into certain territories or to certain customers (Article 4(b));[36]
– The restriction on the members of a selective distribution system operating at the retail level of trade to make active or passive sales to end-users (Article 4(c));
– The restriction of cross-supplies between distributors within a selective distribution system, including between distributors operating at different levels of trade (Article 4(d));
– The prohibition on a component supplier to sell these components to independent repairers or service providers (Article 4(e)).

A vertical agreement containing any of the above listed hardcore restraints falls entirely outside the scope of application of Regulation 2790/99. It would also very likely not even qualify for an individual exemption under Article 81(3).

2. *The Grey List*

Regulation 2790/99 expressly exempts agreements that restrict the buyer's freedom:

– to make active sales[37] into the exclusive territory or to an exclusive customer group reserved to the supplier or allocated by the supplier to another buyer, provided that such restriction does not limit sales by the customers of the buyer[38] (Article 4(b), first indent);
– to sell components, supplied for the purpose of incorporation, to customers who would use them to manufacture the same type of goods as those produced by the supplier (Article 4(b), last indent);
– to operate out of an unauthorised place of establishment, if the buyer is a member of a selective distribution system (Article 4 (c)).

[36] Such restriction is blacklisted regardless of whether it refers to active or passive sales. Therefore, restrictions of active sales are in principle not covered by the block exemption, unless the requirement contained in the grey list are satisfied (see also section III.A, below). This is undoubtedly a major change of the Commission's policy concerning distribution agreements.

[37] Regulation 2790/99 does not contain any definition of active sales. On the basis of Article 2(2)(c) of Regulation 1983/83, active selling can probably be defined as comprising all the promotional activities, including the establishment of branches and the maintenance of distribution depots, carried on by a seller to seek custom. The Draft Guidelines state, at ¶ 42, that the promotion of a product on a Internet web site does not constitute active selling but a form of passive sale, whose prohibition always constitutes a hardcore restraint. It seems doubtful, however, that the concept of active sales might be interpreted so narrowly to exclude internet advertising, particularly when such advertising is done in a language other than the language of the country in which the advertising originates.

[38] This condition means, in practice, that no restrictions may be imposed upon the buyer having the object or effect of limiting parallel imports.

A vertical agreement containing obligations not included in the above list[39] is also exempted by Regulation 2790/99, provided such obligations do not constitute hardcore restraints. Although not stated expressly, this clearly appears from the combined provisions of Articles 2(1) and 4 of Regulation 2790/99.

3. *The White List*

Certain restraints contained in Article 4 of Regulation 2790/99 are not always caught by Article 81(1), and have been listed only to clarify that they do not constitute hardcore restraints. They are the following:

– The prohibition against selling above a maximum price or the recommendation to sell at a certain price (Article 4(a));[40]
– The restriction of sales to end-users by a buyer operating at the wholesale level of trade (Article 4(b), second indent);[41]
– The restriction of the buyer's freedom to sell to unauthorised distributors if the buyer is a member of a selective distribution system (Article 4(b), third indent);[42]

C. RESTRAINTS EXEMPTED PROVIDED CERTAIN CONDITIONS ARE MET

Pursuant to Article 5 of Regulation 2790/99 non-compete obligations[43] and post-term ban clauses[44] are exempted only if certain conditions are met. However, if these conditions are not met, the block exemption will continue to apply to the rest of the agreement in question.

In particular, non-compete obligations are exempted provided that their duration does not exceed five years (a non-compete clause that is tacitly renewable beyond a period of five years is deemed to exceed five years).[45] No time limitation applies if the

[39] As, for instance, the obligation on the supplier not to sell into the territory or to the customers allocated to the buyer; or the obligation on the supplier to advertise or to maintain a stock of goods.

[40] The Draft Guidelines state, at ¶ 103, that "maximum and recommended resale prices, while *as such not having negative effects*, may work as fixed RPM" (emphasis added). This may happen either for subjective reasons, such as the pressures or incentives created by the supplier, or for objective reasons, such as a market structure (e.g. if it is oligopolistic) that practically induces distributors to align themselves to the maximum or recommended price. As a result, when maximum and recommended resale prices are caught by Article 81(1), they constitute a hardcore restraint preventing the application of Regulation 2790/99 to the entire agreement.

[41] In *Saba*, [1976] OJ L28/19, at ¶ 34 the Commission stated that such a restriction is never caught by Article 81(1) when the supplier sets up a multi-level distribution system with a clear definition of function between wholesalers and retailers.

[42] According to the principles developed by the Commission and the European Court of Justice, restrictions of sales to unauthorised distributors by the members of a selective distribution system are not caught by Article 81(1) if certain conditions are met (see section III.D, below).

[43] According to Article 1(b) of Regulation 2790/99, non-compete obligations include any direct or indirect obligation causing the buyer: (i) not to manufacture, purchase sell or resell goods or services which compete with the contract goods or services; or (ii) to purchase more than 80% of the buyer's total purchases of the contract goods or services and their substitutes, calculated on the basis of the value of its purchases in the previous calendar year, from the supplier or a third party designated by the supplier.

[44] Post-term ban clauses impose an obligation on the buyer not to manufacture, purchase or distribute goods or services after termination of the agreement.

[45] The Guidelines should clarify the circumstances under which long-term investments may justify non-compete obligations of a longer duration.

purchaser sells or provides the contract goods or services from premises and land owned by the supplier or leased by the supplier from third parties not connected with the buyer.

The obligation "not to sell" the brands of particular competing suppliers is never exempted when imposed on the members of a selective distribution system. However, the obligation imposed on the members of a selective distribution system "to sell" specified brands of competing suppliers, seems exempted without limitations,[46] however illogical that might seem.[47]

Post-term ban clauses are exempted provided that: (i) their duration does not exceed one year after termination of the agreement; (ii) they relate to goods or services competing with the contract goods or services; (iii) they are limited to the premises and land from which the buyer has operated during the contract period; and (iv) they are indispensable to protect know-how transferred by the supplier to the buyer.

D. Withdrawal of the Benefit of the Block Exemption

1. *Individual Withdrawal*

Pursuant to Article 6 of Regulation 2790/99 the Commission has the power to withdraw the application of the block exemption to specific agreements when they have effects which are incompatible with the conditions laid down in Article 81(3), and in particular where access to the relevant market is significantly restricted by the cumulative effect of parallel networks of similar vertical restraints practised by competing suppliers or buyers.

Article 7 of Regulation 2790/99 mirrors Article 7(2) of Regulation 19/65,[48] that allows national competition authorities to withdraw the benefits of a block exemption where effects of a vertical agreement incompatible with Article 81(3) are felt in the territory of a Member State which has all the characteristics of a distinct market.[49] Neither Regulation 19/65 nor Regulation 17/62, however, define the concept of "distinct market".[50] Furthermore the conditions for withdrawal by national competition authorities are rather vague.[51] Finally, no procedural guarantees have been

[46] Article 4(c) of the Draft Regulation provided that the block exemption did not apply to the obligation on the members of a selective distribution system "[…] to sell or not to sell specified brands of competing suppliers". However, the verb "to sell" has been dropped in Article 5(c) of Regulation 2790/99. Informal Commission sources have confirmed this interpretation.

[47] For instance, in *Parfums Givenchy,* [1992] OJ L236/11 at 13, the Commission exempted the selective distribution system set up by Givenchy only after the latter had deleted from the criteria for admission to the system the requirement that the retailers sold certain brands specified by Givenchy.

[48] Article 7(2) has been added in Regulation 19/65 by Regulation 1215/99.

[49] See H. Lesguillons, *Withdrawal of the Benefit of the Block Exemption Regulation on Vertical Restraints by Member States' Competent Authorities*, [1999] RDAI, IBLJ 509.

[50] Reference is thus likely to be made to the Commission's definition of this term under Articles 9(2) and (3) of the EC Merger Regulation ([1989] OJ L395/1) that contain a similar concept.

[51] Note that in the Communication, see note 6 above, at p. 20, the Commission had stated that it intended to empower national competition authorities to withdraw the future block exemption "on the basis of clear and well specified criteria".

provided to reduce the risk of inconsistent application of the block exemption by national authorities and the Commission.[52]

2. *Withdrawal for Categories of Agreements*

On the basis of Article 1(a) of Regulation 19/65,[53] Article 8 of Regulation 2790/99 empowers the Commission to declare, by regulation, the inapplicability of the block exemption to vertical agreements containing specific restraints where parallel networks of similar vertical restraints cover more than 50 percent of a relevant market.[54]

It is not clear why the Commission decided to depart from the original proposal to limit such a power only to cases where "on a market … more than *two-thirds* of the total sales is channeled through parallel networks of *selective distribution*".[55] Furthermore, no rules have been established to determine on which basis the Commission will choose whether to withdraw the block exemption by individual decisions, pursuant to Article 6, or by regulation, pursuant to Article 8.[56] To avoid arbitrariness and possible discriminations, it would have been more appropriate to exclude the applicability of Article 6 where the 50 percent threshold of Article 8 is satisfied.

E. ENTRY INTO FORCE AND APPLICABILITY

Regulation 2790/99 entered into force on 1 January 2000.[57] However, it applies only from 1 June 2000. According to informal Commission sources, the delayed application of the new block exemption is explained by the Commission's inability to finalise the Guidelines before the adoption of the new block exemption. However, this explanation is not convincing. For example, the applicability of Regulations 1983/83 and 1983/84 was not deferred to the date of adoption of the Commission Notice on Regulations 1983/83 and 1983/84.[58] Furthermore, although it is true that the

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[52] The Draft Guidelines state, at ¶ 68, that the consultation mechanism provided for in the Notice on cooperation between national competition authorities and the Commission ([1997] OJ C313/3) would avert the risk of conflicting decisions and duplication of procedures. That Notice provides, at ¶ 49, that "as regards cases which they deal with under Community law, it is desirable that national authorities should systematically inform the Commission of any proceedings they initiate". The problem remains, however, that the provision of such information is entirely voluntary, and that it does not allow the Commission to take remedies if it does not agree with a national competition authority's decision to withdraw the block exemption, unless the concerned parties decide to notify the agreement for an individual exemption. Only in such a case could the Commission open proceedings according to Article 9(3) of Regulation 17/62, depriving the national competition authority of the power to apply Article 81(1) and probably also of the power to withdraw the block exemption.

[53] Article 1(a) has been added in Regulation 19/65 by Regulation 1215/99.

[54] The Draft Guidelines explain, at ¶ 72, that "such a measure is not addressed to individual undertakings but concerns all undertakings whose agreements come within its scope of application".

[55] Communication, see note 6 above, at p. 21, emphasis added.

[56] The Draft Guidelines simply state, at ¶ 74, that the choice will depend on the number of competing undertakings contributing to the cumulative effect or on the number of affected geographic markets within the Community.

[57] Article 13. It will expire on 31 May 2010

[58] [1984] OJ C101/2 (the "Commission Notice").

Guidelines will contain important guidance on the Commission's interpretation of certain provisions of Regulation 2790/99, the Draft Guidelines would already constitute sufficient guidance for companies willing to benefit from the wide scope of application of Regulation 2790/99. Finally, if the Commission's concern was to avoid the application of the new block exemption without the Guidelines, one might wonder why it did not simply adopt a regulation extending the applicability of the Replaced Regulations until 31 May 2000, postponing to 1 June 2000, the publication of the new block exemption together with the Guidelines, rather than publishing the new block exemption regulation five months before its application.

Logic suggests that vertical agreements concluded before 1 June 2000, that do not comply with one of the Replaced Regulations but that do comply with Regulation 2790/99, although not automatically covered by Regulation 2790/99, be open to quasi-automatic individual exemption. This solution appears to be the only way of explaining the publication of Regulation 2790/99 five months before its application.

Interestingly, informal sources within the Commission have indicated that they would consider any pre-1 June 2000 agreement complying with Regulation 2790/99 to be covered by it, and that this coverage would be deemed to be retroactive to the date of signature of the agreement, even if it occurred before 1 January 2000. The legality of this position is, of course, questionable and would make the delayed application of Regulation 2790/99 totally pointless. For, if Regulation 2790/99 applied to such agreements and did so retroactively, then Regulation 2790/99 might as well have applied as from 1 January 2000.

Vertical agreements concluded before 1 June 2000, that do not comply with Regulation 2790/99, can nevertheless benefit from automatic exemption until 31 December 2001, provided they fall within the scope of application of one of the Replaced Regulations.[59]

Although not stated expressly, vertical agreements concluded before 1 June 2000, that comply with one of the Replaced Regulations and with Regulation 2790/99 should be deemed automatically covered by Regulation 2790/99 as from 1 June 2000.

III. Practical Impact

To assess the practical impact of the reform, differences in treatment of certain categories of vertical agreements under the Replaced Regulations and under Regulation 2790/99 are analysed below.

A. Exclusive distribution

Regulation 1983/83 applies to distribution agreements whereby the supplier undertakes to sell goods for resale only to one distributor within a certain territory

[59] Article 12(2).

(so-called "sole distribution"). The exemption also applies when the supplier undertakes not to sell to final customers within the territory allocated to the distributor (so-called "exclusive distribution"), and when the distributor is subject to other obligations exempted by Article 2 of Regulation 1983/83.

Exclusive distribution agreements concluded before 1 June 2000, and falling within the scope of application of Regulation 1983/83 will also fall within the scope of application of Regulation 2790/99,[60] and therefore will not need to be renegotiated before 31 December 2001, provided the 30 percent market share threshold is not exceeded, and provided they do not contain the types of restriction on active sales or on cross-supplies blacklisted by Regulation 2790/99. These restrictions are considered below.

1. *Restrictions on Active Sales*

Article 2(2)(c) of Regulation 1983/83 exempts exclusive distribution agreements preventing the distributor from making active sales "outside the contract territory and in relation to the contract goods". Regulation 2790/99 is considerably less flexible than Regulation 1983/83 as regards the possibility of restricting a distributor from making active sales outside the contract territory.

In principle, Article 4(b) of Regulation 2790/99 blacklists any restriction on the buyer to sell into certain territories or to certain customers regardless of whether such a restriction concerns active or passive sales. Article 4(b), first indent, of Regulation 2790/99, exempts a prohibition on the buyer from making active sales into other territories or customer groups *only if* these territories or customer groups are *exclusively reserved* to the supplier or *exclusively allocated* to *another* buyer.

Thus, Regulation 2790/99 does not seem to apply to an agreement under which a distributor is prevented from making active sales into a territory or customer group allocated to more than one competing distributor.[61] Moreover, a distribution agreement would not fall within the scope of Regulation 2790/99 when the territorial restriction is imposed by the supplier merely "to compel the exclusive distributor to concentrate his sales efforts on the … contract territory".[62] Under Regulation 2790/99, such a restriction seems to be exempted only if it can be justified by the need to protect other exclusive distributors.

It is unclear, however, when a territory or customer group might be considered *exclusively allocated* by the supplier to another buyer within the meaning of Article 4(b),

[60] However, if they contain a non-compete clause whose duration exceeds 5 years (as allowed by Regulation 1983/83, provided the duration of the non-compete clause does not exceed the duration of the agreement), such a clause will not be block exempted by Regulation 2790/99 unless the distributor operates from premises owned or leased by the supplier.

[61] An agreement whereby a supplier appoints more than one exclusive distributor for the same area, although not falling within the scope of application of Regulation 1983/83 (see *Junghans*, [1977] OJ L30/10), would fall within the scope of application of Regulation 2790/99.

[62] Recital 8 of Regulation 1983/83 recognised that such an objective was a good reason to justify a restriction of active sales outside the contract territory.

first indent, of Regulation 2790/99. Would it be sufficient if such a buyer is appointed as a sole distributor within the allocated territory or customer group, or should it also be an exclusive distributor? Should the buyer also be protected from active sales coming from distributors appointed by the supplier for other territories or customer groups?

The requirement contained in Article 4(b) of Regulation 2790/99 seems to be designed to permit restrictions on active sales only when they are genuinely justified by the need to protect the investments of another distributor. If so, a territory or customer group should be deemed *exclusively allocated* to such a distributor when the distributor is protected from active sales made by other distributors in(to) that territory or customer group. In other words, active sales into a certain territory or customer group could be prohibited, provided (i) the territory or customer group in question is allocated to *only one* buyer, whether or not that buyer is protected from sales by the supplier,[63] and (ii) the distributor for that territory or customer group is protected from active sales coming from any other distributor appointed by the supplier for *other* territories or customer groups.[64]

The meaning of the words "exclusive territory or … customer group … *reserved* to the supplier" (emphasis added) is also unclear.[65] For instance, could a supplier simply provide in the agreement that the whole of the common market, except the territory allocated to the buyer, is reserved to itself, and so prevent the buyer from selling outside the contract territory, regardless of whether the supplier has appointed other buyers outside the contract territory? Probably not, since the supplier could otherwise easily overcome the restrictions on a supplier's ability to impose a prohibition on active sales contained in Article 4(b). It would therefore seem that a territory or customer group should be deemed exclusively reserved to the supplier where either the contract goods *are not sold at all* in such a territory or to such a customer group (because, for instance, the supplier has decided to enter such markets or customers only at a later stage), or where the supplier exclusively sells the contract goods in such a territory or to such a customer group *directly* to end-users (e.g. through owned outlets).

[63] On the grounds that, in cases in which the buyer is merely a sole distributor, i.e. if the supplier maintains the right to supply final customers within the territory or customer group allocated to the buyer, the buyer could still be expected to incur significant investments, even though the amount of investments and the degree of protection achieved by the buyer might not be as great as if that buyer were also protected against sales from the supplier. Note that Article 2 of Regulation 1983/83 refers to "the exclusive distributor", suggesting that a distributor should be considered exclusive if it has been allocated a specific territory, regardless of whether the supplier reserves the right to sell to final customers in that territory. However, the Draft Guidelines (¶ 150) state that "[I]n an exclusive distribution agreement the supplier limits its *sales for a certain area* to one particular exclusive distributor for that territory"(emphasis added), suggesting that the supplier must channel all sales (and not simply those *for resale*) to that distributor.

[64] According to informal Commission sources, it would be discriminatory to prevent buyer A from actively selling within the territory or customer group allocated to buyer B if buyer C, appointed for another territory or customer group, is not also prevented from actively selling within buyer B's territory or customer group.

[65] Since the Draft Regulation did not contain this expression, the Draft Guidelines do not explain its meaning. Neither does Regulation 2790/99 define this expression. Article 1(1)(3) of Regulation 2349/84, on the application of Article 81(3) to certain categories of patent licensing agreements ([1984] OJ L219/15), now replaced by Regulation 240/96, contained a similar expression: "territories reserved for the licensor". Recital 12 of that Regulation explained that such an expression meant "territories within the common market in which the licensor has patent protection and has not granted any licences".

2. *Restrictions on Cross-Supplies*

A combination of exclusive and selective distribution at a different level of the distribution chain does not preclude the application of Regulation 1983/83. Under that regulation, all the exclusive distributors operating at the wholesale level may be obliged, at the same time: (i) to purchase exclusively from the supplier, (ii) not to make active sales outside their contract territory, and (iii) to sell only to dealers meeting certain qualitative criteria.[66]

The combination of the above obligations will no longer be possible under Regulation 2790/99. In particular, a combination of obligations (i) and (iii) above would constitute a restriction on cross-supplies between members of a selective distribution system operating at the wholesale level, blacklisted by Article 4(d) of Regulation 2790/99.

It is not clear, however, whether a combination of restrictions (ii) and (iii) above, at the wholesale level of trade, will still be possible under Regulation 2790/99. Considering that Article 4(b), first indent, of Regulation 2790/99 expressly exempts the prohibition of active sales into the exclusive territory allocated to another distributor, one might argue that "cross-supplies" would not be restricted if the members of the selective distribution network operating at the wholesale level were prevented from actively selling, though remaining free to make passive sales, to other members of the system operating in other exclusive territories.

B. EXCLUSIVE PURCHASE

Regulation 1984/83 applies to agreements whereby a distributor agrees not to buy the contract goods from suppliers other than the other party to the agreement or a person designated by the latter. The supplier must be free to supply any other distributor within the area where the exclusive purchaser operates, although it may undertake not to directly compete with the latter in such an area. The exclusive purchaser may be prevented, for a period not exceeding five years (or ten years, in exclusive purchase agreements for beer and petrol), from manufacturing or selling goods competing with the contract goods.

Since no hardcore restraints contained in Regulation 2790/99 are exempted by Regulation 1983/84, exclusive purchase agreements falling within the scope of

[66] The Commission Notice, see note 6 above, stated at ¶ 20 that "as part of the obligation to take measures for the promotion of sales and in particular to maintain a distribution network (Article 2(3)(c) of Regulation (EEC) No. 1983/83 …), the reseller may be forbidden to supply the contract goods to unsuitable dealers. Such clauses are unobjectionable if admission to the distribution network is based on objective criteria of a qualitative nature relating to the professional qualifications of the owner of the business or his staff or the suitability of his business premises, if the criteria are the same for all potential dealers, and if the criteria are actually applied in a non-discriminatory manner. Distribution systems which do not fulfil these conditions are not covered by the block exemption". The Communication, at p. 20, followed the same approach, as the hardcore restraints were there limited to "the combination, at the same level of distribution, of selective distribution and exclusive distribution containing a prohibition or restriction on active reselling" and "the combination, at the same level of distribution, of selective distribution and exclusive customer allocation".

application of that regulation will continue to be automatically exempted after 31 December 2001, provided only that the 30 percent market share threshold contained in Regulation 2790/99 is not exceeded.

However, exclusive purchase agreements for beer and petrol concluded before June 1, 2000, will have to be renegotiated before 31 December 2001, if they prevent the purchaser from manufacturing or selling goods competing with the contract goods beyond 31 December 2006.

C. Franchising

Regulation 4087/88 defines franchising agreements as agreements "whereby one undertaking, the franchisor, grants to the other, the franchisee, in exchange for direct or indirect financial consideration, the right to exploit a franchise for the purposes of marketing specified types of goods and/or services".[67] A "franchise" is "a package of industrial or intellectual property rights relating to trade marks, trade names, shop signs, utility models, designs, copyrights, know-how or patents, to be exploited for the resale of goods or the provision of services to end users".[68]

The word "franchising" is never mentioned by Regulation 2790/99, and no provision addresses specifically this form of distribution. This is because, according to the Commission, franchising should "not be given any preferential treatment … as it is a combination of … selective distribution and non-compete obligations in relation to goods which are the subject matter of the franchise".[69]

It seems anomalous, however, that the only reference to the fact that Regulation 2790/99 covers franchising agreements might be found in the Draft Guidelines,[70] considering, in particular, that Article 2(4) of Regulation 2790/99 seems even to exclude franchising from the scope of application of the block exemption,[71] and that the Guidelines will not be binding on national courts and national competition authorities.

According to the Draft Guidelines, distribution and service franchising would both be covered by Regulation 2790/99. Also some forms of industrial franchising seem to be covered by Regulation 2790/99,[72] as "licence agreements to dilute and bottle a concentrated extract for a drink before reselling and licence agreements to reproduce software before reselling".[73]

It is hard to understand, however, why Regulation 2790/99 should not cover all forms of industrial franchising: if the Commission had really decided to adopt an economic-oriented approach to vertical restraints, an industrial franchising agreement

67 Article 1(3)(b) of Regulation 4087/88.

68 Article 1(3)(a) of Regulation 4087/88.

69 Communication, see note 6 above, at p. 22.

70 See ¶¶ 36 and 199 of the Draft Guidelines.

71 See section II.A.2, above.

72 Recital 4 of Regulation 4087/88 defines industrial franchising as "manufacturing licences based on patents and/or technical know-how, combined with trade-mark licences". The same recital expressly excludes industrial franchising from the scope of application of Regulation 4087/88.

73 See ¶ 29 of the Draft Guidelines.

not containing hardcore restraints and concluded by a franchisor (or a franchisee) holding a market share below 30 percent should not be treated differently from other categories of franchising agreements exempted by Regulation 2790/99.

A franchising agreement is exempted by Regulation 2790/99 even if it does not contain any of the obligations cumulatively required by Article 1(3)(b), and Article 4(b) and (c) of Regulation 4087/88,[74] and even if it contains the restraints blacklisted by Article 5(b), (c) and (f) of Regulation 4087/88.[75]

However, unlike under Regulation 4087/88,[76] pursuant to Article 4(c) of Regulation 2790/99 the block exemption does not apply if the franchisee is prevented at the same time from selling to unauthorised distributors and from making active sales outside the allocated territory. Furthermore, a non-compete obligation is no longer automatically exempted when it is imposed on a franchisee for a period exceeding five years, unless the franchisee operates from premises owned or leased by the franchisor. Therefore, franchising agreements that contain such restraints, and that have been concluded before 1 June 2000 in accordance with Regulation 4087/88, will have to be renegotiated before 31 December 2001.

D. SELECTIVE DISTRIBUTION

Selective distribution can be defined as a distribution system whereby the wholesalers or retailers approved by the supplier undertake to sell the contact goods only to wholesalers or retailers satisfying certain professional or technical requirements (so-called "qualitative requirements").[77]

Selective distribution is not covered by any of the Replaced Regulations.[78] However, a wide range of principles were developed by the Commission and by the European Courts.[79]

According to these principles, selective distribution does not fall within the scope of application of Article 81(1), and therefore does not need to be exempted, where the products or the brands supplied are of such complexity or exclusive nature that they justify a prohibition on the members of the distribution network from selling to

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74 That is, the obligations: on the franchisee, to use a common name or shop sign and a uniform presentation of contract premises, to indicate its independent status and, when it is obliged to honour guarantees for the franchisor's goods, to honour them in respect of such goods supplied by any member of the franchisor's distribution network; on the franchisor, to communicate know-how to the franchisee, and to provide the franchisee with commercial or technical assistance during the life of the agreement.

75 That is: the prohibition on the franchisee against obtaining supplies of goods of a quality equivalent to those offered by the franchisor, the unjustified refusal by the franchisor to designate third parties proposed by the franchisee as authorised manufacturers of the contract goods, and the prohibition on the franchisee to challenge the validity of the intellectual property rights that form part of the franchise.

76 Article 2(d) and 3(e) of such regulation allowed the franchisor to impose, at the same time, upon the franchise, a prohibition to make active sales outside the allocated territory and to sell to unauthorised distributors.

77 Green Paper on Vertical Restraints, see note 5 above, at ¶ 127.

78 Only Regulation 1475/95 provides a specific exemption for selective distribution agreements in the car sector.

79 See J. Ratliff, *Selective Distribution: Is there a Case for a General Block Exemption or a Guidelines Notice?*, [1996] ECLR 299.

distributors that do not meet qualitative requirements set by the manufacturer, provided that such requirements are not disproportionate and are applied without discrimination.[80] On the contrary, an individual exemption is normally required where the supplier limits the number of the distributors admitted to the network or where it imposes equivalent obligations, such as the obligation to purchase minimum quantities or to display or stock a minimum range of goods (so called "quantitative requirements").[81]

Regulation 2790/1999 includes selective distribution agreements within its scope of application when they are caught by Article 81(1). Article 1(d) defines selective distribution as a "… system where the supplier undertakes to sell the contract goods or services, either directly or indirectly, only to distributors selected on the basis of specified criteria and where these distributors undertake not to sell such goods or services to unauthorised distributors".

This definition suggests major changes compared with the previous legal framework, namely: (i) the nature of the products or services sold is not relevant in considering whether Regulation 2790/99 applies to a selective distribution system;[82] and (ii) Regulation 2790/99 applies to selective distribution systems containing quantitative requirements (i.e. requirements having the effect of limiting the number of selected retailers, by excluding retailers meeting the selection criteria),[83] provided such requirements do not constitute hardcore restraints.[84]

Interestingly, under the Commission's new policy, a selective distribution system would not be covered by Regulation 2790/99 if the selected retailers are prevented from selling by the Internet.[85] The Draft Guidelines state that Internet sales are normally considered as a form of passive sales,[86] and restrictions of passive sales are hardcore restraints pursuant to Regulation 2790/99.

Informal sources within the Commission have however indicated that, although sales via the Internet cannot be prohibited as such, the supplier can impose qualitative conditions on the manner in which these sales must be conducted, and in particular on the quality of the web-site.

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[80] See, e.g. Case 27/76, *Metro v. Commission*, [1977] ECR 1875.

[81] Green Paper on Vertical Restraints, see note 5 above, at ¶ 128.

[82] Note that the European Courts' case law and the Commission's decisional practice requiring that products or services satisfy certain technical or luxury criteria will still be relevant in determining whether a selective distribution system falls within or outside the scope of Article 81(1). The difference is that, whereas a selective distribution system would not have been authorized for non-qualifying products or services under the old legal framework, such system will now be covered by Regulation 2790/99.

[83] So, for instance, under Regulation 2790/99, each member of the selective distribution network might be granted an exclusive territory.

[84] So, for instance, Regulation 2790/99 does not apply if the members of the selective distribution system operating at the retail level are prevented from selling (actively or passively) to end-users, or from supplying other members of the distribution network.

[85] By contrast, under the previous system (i.e. that is still applicable until 1 June 2000) it seemed questionable whether the selective distribution of luxury products could coexist with the marketing of the same products via Internet because of the risk of undermining the aura of luxury that justified the use of a selective distribution system for the products in question. According to Commission and to the European Court of First Instance, a selective distribution system for luxury products is not caught by Article 81(1), only if such products are marketed in a way consistent with their image of luxury and prestige (see, *Yves Saint Laurent*, [1992] OJ L12/24, at 29; and Case T-19/92, *Leclerc v. Commission*, [1996] ECR II-1851, at ¶ 120).

[86] ¶ 42 of the Guidelines.

E. AGENCY

The commercial agent is "a self employed intermediary who has continuing authority to negotiate the sale or the purchase of goods on behalf of another person, hereinafter called the principal, or to negotiate and conclude such transactions on behalf of and in the name of that principal".[87]

In its 1962 Notice on agency agreements, the Commission stated that Article 81(1) does not apply to exclusive agency agreements "… since these contracts have neither the object nor the effect of preventing, restricting or distorting competition within the common market. The commercial agent only performs an auxiliary function in the market for goods. In that market he acts on the instructions and in the interest of the enterprise on whose behalf he is operating. Unlike the independent trader, he himself is neither a purchaser nor a vendor, but seeks purchasers or vendors in the interest of the other party to the contract, who is the person doing the buying or selling …".[88]

The Commission intends to replace such Notice with a chapter of the Guidelines,[89] and to adopt a stricter and less clear approach to agency agreements than in the past.[90] The Draft Guidelines, in fact, state that agency agreements are caught by Article 81(1) where the agent bears the risk in relation to the contracts concluded on behalf of the principal,[91] but it does not clarify the nature of these risks.[92] Moreover, agency agreements would also be caught by Article 81(1) where one of the following situations occurs: (i) the agent carries out any of a series of listed activities, apparently not even related to the contractual relationship between the agent and its principal,[93] (ii) the agreement contains exclusive agency provisions and/or non-compete provisions that lead to foreclosure on the market for agency services,[94] or (iii) the agreement constitutes the means to implement a prohibited horizontal agreement or concerted practice.[95]

According to the Commission, where agency agreements are caught by Article 81(1), either Regulation 2790/99 or the Guidelines would apply.[96] To clarify this, Article 1(g) of Regulation 2790/99 includes in the definition of "buyer" also "undertaking[s] which, under an agreement falling within Article 81(1) of the Treaty, sell … goods or services on behalf of another undertaking".

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[87] Article 1(2) of Council Directive 86/653/EEC, of 18 December 1986, on the co-ordination of the laws of the Member States relating to self-employed commercial agents, [1986] OJ L382/17.

[88] Notice on exclusive dealing contracts with commercial agents, [1962] OJ 139/2921, at ¶ 5.

[89] Draft Guidelines, p. 13, note 8.

[90] ESC Opinion, see note 21 above, at ¶ 3.1.6.

[91] Draft Guidelines, ¶ 15.

[92] At ¶ 16 the Draft Guidelines simply state that such risks must be "specific and related to the contracts concluded by the agent on behalf of the principal".

[93] The list of activities is contained in ¶ 17 of the Draft Guidelines and is not exhaustive.

[94] Draft Guidelines, ¶ 20.

[95] Draft Guidelines, ¶ 21.

[96] Draft Guidelines, ¶ 13.

However, since agency agreements normally do not allow the agent to determine the prices of the goods sold on behalf of the principal, and since that constitutes a hardcore restraint pursuant to Article 4(a) of Regulation 2790/99, it is difficult to see in which cases Regulation 2790/99 could apply to these agreements.

F. Industrial supply

Agreements for the supply of goods used by the buyer for purposes of incorporation have never been covered by block exemption regulations. They are now covered by Regulation 2790/99, which specifically exempts clauses contained in agreements preventing the buyer from selling the contract goods to customers that would incorporate them in final goods competing with those of the supplier.[97]

IV. Vertical Agreements not Exempted by Regulation 2790/99

Vertical agreements that do not qualify for Regulation 2790/99, are not presumed to be illegal, but parties to such agreements will be "encouraged to do their own assessment without notification"[98] on the basis of the Guidelines since, "absent litigation in national courts or complaints, notifications of vertical agreements would not been given priority in the Commission's enforcement policy".[99] This is because, according to the Commission, Article 4(2) of Regulation 17/62 has been amended to allow parties to "all vertical agreements" to obtain individual exemptions from the date of the entry into force of their agreement, regardless of when the notification is made.[100] The Commission concludes that this amendment will avoid "precautionary notifications" because, if a dispute arises, an undertaking can still notify and the Commission "… must exempt the vertical agreement with retro-active effect from the date of entry into force of the agreement if all four conditions of Article 81(3) are fulfilled".[101]

These statements, however, do not reflect reality. First, it is not true that the amendment to Article 4(2) of Regulation 17/62 concerns "all vertical agreements". In fact, licensing agreements or agreements assigning industrial property rights, which in most cases are vertical agreements, are still regulated by the old version of Article 4(2) of Regulation 17, which excludes prior notification of these agreements only where they are concluded by two undertakings and only where they impose restrictions on the licensee or assignee on the exercise of the licensed or assigned rights.[102] This conclusion is clear from a comparison of the old and new wording of Article 4(2) of

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[97] Article 4(b), last indent, of Regulation 2790/99.
[98] Draft Guidelines, ¶ 52.
[99] Draft Guidelines, ¶ 55.
[100] Draft Guidelines, ¶ 53.
[101] Draft Guidelines, ¶ 53.
[102] So, for instance, any restriction on the licensor or assignor would automatically prevent Article 4(2) to apply (see *Toltecs/Dorcet*, [1982] OJ L379/19, at 27; on appeal Case 35/83, *BAT v. Commission*, [1985] ECR 363).

Regulation 17.[103] The provision concerning licensing agreements or agreements assigning industrial property rights has remained unchanged, suggesting that the Commission's existing decisional practice continues to apply to this type of agreement.

Second, companies will still need individual exemptions when, in the absence of clear guidance by Community case law or Commission practice, there are serious doubts whether their agreement is compatible with Article 81. The Guidelines will not surely solve all interpretative issues that companies may encounter in the assessment of the compatibility of their vertical agreements with EC competition law.

V. CONCLUSION

One of the main features of the Commission's competition policy for the new millennium should be a more economics-based approach to vertical restraints. Regulation 2790/99 represents a first step toward this approach, although the scope of the new block exemption could probably have been broader.

The reform of vertical restraints, however, will not increase legal certainty. As a result, companies might still wish to notify certain agreements, when the scope of application of Regulation 2790/99 or the Commission's approach to vertical restraints not covered by the block exemption is unclear.

In fact, realising that the reform on vertical restraints would not have been sufficient to increase legal certainty and to reduce its workload, the Commission issued a White Paper announcing a more radical package of procedural reforms (the "White Paper") a few months after the publication of the Communication.[104]

The White Paper essentially proposes the abolition of the exemption and notification system established by Regulation 17/62.[105] Under the proposed system, the Commission would lose its monopoly to apply Article 81(3). Parties to agreements, decisions or concerted practices could therefore invoke Article 81(3) before any national competition authorities and national courts.[106]

In light of these further reforms, the success of the new policy on vertical restraints will depend largely on the forthcoming Guidelines' ability to clarify the Commission's approach to agreements falling outside the scope of Regulation 2790/99, and the

[103] The original wording of Article 4(2) of Regulation 17 was as follows: "Paragraph 1 shall not apply to agreements, decisions or concerted practices where … (2) not more than two undertakings are party thereto, and the agreements only: … (b) impose restrictions on the exercise of the rights of the assignee or user of industrial property rights—in particular patents, utility models, designs or trade marks … ." Similarly, after the amendment of Regulation 1216/99, Article 4(2) states that: "Paragraph 1 shall not apply to agreements, decisions or concerted practices where … (2) … (b) not more than two undertakings are party thereto, and the agreements only impose restrictions on the exercise of the rights of the assignee or user of industrial property rights—in particular patents, utility models, designs or trade marks … ."

[104] White Paper on modernisation of the rules implementing Articles 81 and 82 EC, [1999] OJ C132/1.

[105] The White Paper states, at ¶ 75, that one of the main elements of the proposed reform is "the ending of the system of notification and authorisation".

[106] In addition to the main reform, the White Paper proposes to strengthen the Commission's powers of inquiry, to increase the importance of complaints, and to bring the system of penalties under Regulation 17/62, unchanged since 1962, into line with the penalties under the Merger Regulation.

interpretation of some provisions contained in Regulation 2790/99. The Draft Guidelines, however, already raise a number of legal issues that will need to be resolved over time.

It is hoped that most legal and economic issues arising from Regulation 2790/99 and from the Guidelines will be clarified before the implementation of the procedural reforms proposed in the White Paper.

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Post-Liberalization Challenges in Telecommunications: Balancing Antitrust and Sector-Specific Regulation

Tentative Lessons from the Experiences of the United States, New Zealand, Chile, and Australia

Michel KERF* and Damien GERADIN**

I. INTRODUCTION

A growing number of countries have now opened most or all segments of their telecommunications sector to competition. Experience reveals, however, that successfully introducing effective competition in telecommunications usually requires more than simply eliminating barriers to entry in the various segments of the market. Competition does not spread instantaneously to all segments of the telecommunications market. First, it might take time for new entrants to establish themselves and substantially erode the dominant position of hitherto monopolistic operators. Second, under current technological constraints, some telecommunications activities—such as the establishment and operation of the fixed local loop—tend to exhibit natural monopoly features which offer some measure of protection to the incumbent.[1] This means that some specific measures might be needed, at least for some time, to protect end-users and competitors against potential abuses of market power by the incumbent. In addition, as competition develops, some mechanisms must also be in place to prevent collusion between telecommunications operators, as well as excessive market consolidation through mergers and acquisitions.

Two main sets of rules can be used to promote competition and control market power in telecommunications. The first set of rules are antitrust rules, which are applicable to most economic activities, including the provision of telecommunications services, and which are generally designed: (i) to prevent the conclusion of anti-competitive agreements between operators; (ii) to prevent firms which enjoy substantial market power from abusing their dominant position with

* Special Assistant to the Vice-President, Private Sector Development and Infrastructure, The World Bank, Washington D.C.

** Associate Professor of Law, University of Liège Law School and, Professor of Law, College of Europe, Bruges, Belgium. The author would like to gratefully acknowledge the financial support received by the "PAI", a research programme initiated by the Belgian State, Prime Minister's Office, Science Policy Programming, and the "Network Industries Project" at the University of Liège.

[1] In the area of telecommunications, the fixed costs of establishing a fixed line local network are such that a single enterprise will generally be able to provide services to all users in a given area at lower costs than would two or more enterprises, each with its own network.

respect to end-users or competitors; and (iii) to prohibit mergers and acquisitions which have a strong negative impact on competition. Given their wide scope of application, such rules tend to prohibit relatively broad categories of behaviours and to leave a relatively wide degree of discretion to enforcing authorities.[2]

The second set of rules are sector-specific, or infrastructure-specific, rules which can be adopted: (i) to remove legal barriers to entry into telecommunications and to define the entry processes to be imposed upon operators; (ii) to set out procedures for number allocation, number portability,[3] dial parity,[4] and radio-electric spectrum allocation; (iii) to determine interconnection conditions and prices; (iv) to determine price and quality standards for universal services as well as for other services provided in insufficiently competitive markets. Such rules are usually relatively precise: they tend to leave less discretion to enforcing authorities than antitrust rules.[5]

In some countries, specialized regulatory authorities have been established to implement the types of rules presented above. Those institutions fall mainly into two categories as well. Specialized antitrust authorities can be entrusted with the task of promoting competition or controlling the use of monopoly power, generally in all or in most sectors of the economy. They tend to focus on implementing general antitrust rules, but might also, in some cases, be in charge of implementing sector-specific rules. Given the number of firms which fall within their sphere of competency, antitrust authorities tend to act on a case by case basis when needed, rather than to closely regulate enterprises on a permanent basis. Because of the technical capacity required to decide complex matters in the competition field, antitrust authorities will usually seek to attract highly qualified professionals in the legal and economic spheres. In addition, antitrust authorities are often granted some degree of protection from political interventions and from industry capture. Antitrust regulators might, for example, be protected against arbitrary removals by the Executive, and individual members of the antitrust agency are often required to refrain from intervening in cases involving firms with which they have financial or other links.

A second type of specialized regulatory institution are telecommunications, or infrastructure-specific agencies which tend to focus on implementing the more specific types of rules described above. Contrary to antitrust authorities, telecommunications regulatory agencies tend to regulate a small number of enterprises closely, on a quasi-permanent basis. Telecommunications and infrastructure specific agencies, like antitrust authorities, will often enjoy some degree of autonomy from political authorities and be independent from the enterprises which they regulate.[6] Those

[2] For a discussion of antitrust laws in the United States and other industrialized nations, see F. Scherer, *Competition Policies for an Integrated World Economy*, 1994.

[3] Ensuring number portability means ensuring that users are able to keep the same telephone number when switching telecommunications operators.

[4] Ensuring dial parity means ensuring that users do not have to dial additional numbers when they choose certain telecommunications operators rather than others.

[5] For an excellent overview of telecommunications laws and regulations in most industrialized nations, see C. Long, *Telecommunications Law and Practice*, 2nd Edition 1995.

[6] See W. Smith, *Utility regulators—The Independence Debate*, (1997) 127 Viewpoint, The World Bank.

features tend in fact to be even more apparent than for antitrust authorities. For example, telecommunications regulators will often benefit from strong legal protection against arbitrary removal and it is not rare to see telecommunications regulatory boards or commissions whose members have staggered terms in order to prevent a single government from presiding over the renewal of the whole regulatory body. In addition, telecommunications regulators are usually required to sever all the links which they might have with the regulated enterprises, rather than simply to refrain from intervening when a conflict of interests arises.

One should emphasize that even when antitrust authorities or telecommunications regulators have been set up, other entities—such as political authorities or the courts—do generally retain important functions regarding the promotion of competition or the prevention of abuses of market power in the telecommunications sector.

The present article seeks to shed some light both on how economy-wide and infrastructure or sector-specific components of the regulatory framework should be designed and on what the respective roles of such components should be to maximize the efficiency of economic regulation in telecommunications. We will attempt to derive some lessons from the experiences of four countries—the United States, New Zealand, Chile, and Australia—which have chosen to put different emphasis and give different roles to those different elements of the regulatory framework. Each of the four country models will be evaluated on its ability to achieve key objectives of telecommunications regulation, which are presented in the following section (Section II). Sections III to VI each review one of the country models and discusses how the model measures up with respect to each of the key objectives of Section II. Finally, Section VII summarizes the analysis by comparing the experiences of the four countries, while Section VIII presents the conclusions.

II. Key Regulatory Objectives in Telecommunications

The overarching rationale for regulating the telecommunications sector is to adequately protect and balance the interests of all concerned parties including users, operators, investors, and governments. This in turn requires that a certain number of inter-related, and sometimes conflicting, objectives be met to the largest possible extent. The main objectives can be summarily presented as follows.

The first objective is to provide operators with incentives *to meet users' demands by promoting competition or by imposing prices and quality controls which mimic the impact of competition on service provision*. Generating competition *in* the market might require: eliminating legal barriers to entry into various segments of the telecommunications market; ensuring interconnection and access to unbundled services under reasonable conditions, as well as number portability and dial parity; and in some cases, imposing accounting separation, or even the establishment of separate companies, for the pursuit of different activities in order to prevent various anti-competitive practices. Competition *for* the market, on the other hand, might be used to allocate some scarce resources—for example, radio-electric spectrum or public subsidies intended to cover some of the costs of providing telecommunications access to poor and remote areas—to the most efficient operators and to transfer some of the welfare gains associated with service provision to the Treasury (e.g. when spectrum rights are allocated to the highest bidder) or to the users (e.g. when public subsidies are allocated to the providers charging the lowest prices to the users). Finally, direct controls might be imposed on the prices and quality of various telecommunications services to protect users from potential abuses of a dominant position by monopolistic operators.

The second objective is *to strike the right balance between specificity and coherence*. The telecommunications sector does retain certain characteristics which tend to differentiate it from other industries. For example, it exhibits both natural monopoly features for some activities and network externalities.[7] It also presents some technical issues, such as numbering for example, which do not have an exact equivalent in other sectors. Such characteristics could, arguably, justify the adoption of telecommunications-specific rules and the establishment of telecommunications-specific regulatory authorities. However, ensuring that cross-sector rules and institutions are used to regulate telecommunications would also bring benefits, such as greater regulatory certainty (as operators could better forecast what to expect in their sector from the observation of how the regulatory framework is applied in other sectors) and lower risks of distortion between different activities.[8] It would also seem justified by the growing convergence which is observed between telecommunications and other sectors.[9] What an adequate balance is will depend, in part, on the extent to which the telecommunications sector is similar to, or different from, other sectors of the economy in a particular country. For example, the greater the degree of openness and liberalization of the telecommunications sector, the larger the scope for the application in telecommunications of cross-sector rules applicable to competitive activities in general.

The third objective is *to strike the right balance between flexibility and certainty*. Rules which leave a wide degree of discretion to implementing authorities and which are easy to change provide for a flexible regulatory framework. This has obvious appeal in a sector which changes as fast as telecommunications. On the other hand, rules which are more precise and more difficult to change (e.g. because their adoption requires cooperation between the executive and legislative branches of Government rather than unilateral decision by a Minister) provide for greater regulatory certainty, which also constitutes an advantage, for example when it comes to convincing private operators to

[7] A network externality is said to exist for a service if users of the service benefit when more people use it. Network externalities are present in the area of telecommunications since the value of a network increases, for each user, with the number of network subscribers. For a good discussion of the concept of network externalities, see N. Economides, *The Economics of Networks*, (1996) 14 International Journal of Industrial Organisation 673.

[8] See H. Ergas, *Competition Policy in Deregulated Industries*, (July/August 1995) International Business Lawyer, 305.

[9] See B. Lipschitz, *Regulatory Treatment of Network Convergence: Opportunities and Challenges in the Digital Era*, (1998) 7 Media and Policy Law 14.

sink large investments in a politically-sensitive sector. The right balance will depend, *inter alia*, upon the confidence which the adopting and the implementing authorities enjoy: more discretion can certainly be granted to those authorities if they are trusted by stakeholders than if they are not.

The fourth objective is *to ensure regulatory competence and ability to resist undue pressure from the Government and from the regulated industry*. Given the technical complexity of regulatory issues in telecommunications, ensuring that the regulator possesses sufficient competency is one of the main challenges of any regulatory model. In addition, given the scope for political as well as industry pressure on regulatory matters, adequate measures to promote the autonomy of the regulator of the kind mentioned in Section I above are of the utmost importance. Such measures are particularly important for sector-specific regulatory agencies which tend, in general, to be subjected to stronger pressures from politicians and operators than infrastructure-wide regulator and, *a fortiori*, than economy-wide regulators such as antitrust authorities. The level of competence required from the regulators can be somewhat reduced by relying to the maximum possible extent on competition to prompt operators to increase efficiency and by designing regulations so as to promote ease of implementation. Also, less than perfect regulatory autonomy will be less of an issue when the discretionary powers of regulatory authorities are very limited than when they are particularly large. No amount of regulatory engineering will, however, completely eliminate the need for competent and relatively autonomous regulators able to solve, in an impartial way, the complex regulatory problems which are bound to arise.

The fifth objective is *to promote regulatory accountability*. Indeed, autonomy needs to be combined with accountability in order to ensure the legitimacy of the regulatory process. Some of the main measures which can be taken in that respect include: ensuring that regulators publish reports of their activities and of the way in which they use their financial resources; promoting the transparency of regulatory processes, *inter alia* by requiring that the regulatory decisions themselves, as well as the rationale for those decisions, be published; establishing procedures to enable interested parties to present their views before final regulatory decisions are taken; devising processes for handling users' complaints; and providing for appeal mechanisms against the decisions of the regulator (without, however, unnecessarily undercutting the authority of the regulator).

The sixth objective is *to limit the costs of regulation*. The costs of regulation include, first, the costs of setting up regulatory agencies. Setting up a single cross-sector agency is usually more cost-effective than setting up several distinct sector-specific agencies, as it avoids, for example, duplication of a certain number of administrative departments. Secondly, there are the compliance costs imposed upon industry participants. These costs tend, on average, to increase with the complexity of the rules. Thirdly, there are costs associated with the potential inefficiencies of the regulatory regime. For example, when disputes are frequent and take a long time to be resolved, procedural costs might be high for the parties, and beneficial reforms might be postponed. Very important costs might also be incurred when regulatory mistakes are made. As regulation is imperfect and the risk of costly mistakes can never be completely eliminated, it is crucial to weigh the potential benefits of regulation against its potential costs. This trade-off needs to be fully taken into account when discussing, in particular, the merits of establishing detailed regulatory rules and specialized regulatory institutions in the telecommunications sector.

The seventh objective is *to allocate regulatory responsibilities efficiently*. Some pitfalls need to be avoided in that respect. When several institutions intervene in telecommunications regulation, their respective competencies should be defined clearly to avoid creating uncertainty: different institutions should not be designed to tackle the same issues if inconsistent decisions are to be avoided. It is important also to assess the respective capacities of these institutions in order to entrust each one with the functions which they are best equipped to perform. Both of the above points are of particular relevance when regulatory institutions are established both at the national and at the sub-national level. Finally, one should not lose sight of the inter-relations which exist between different regulatory issues when allocating regulatory responsibilities. Setting performance standards for telecommunications operators, for example, will have a direct impact on their costs and will therefore determine the price at which they can be expected to earn an adequate return. Failing to entrust a single entity with the task of administering performance and pricing rules to the same institution, or to provide at least for close coordination between the institutions in charge of those matters, would substantially increase uncertainty for the investors.

III. United States

The United States substantially reformed its telecommunications regulatory framework recently through the adoption of the Telecommunications Act of 1996.[10] The 1996 Act is an unusually detailed piece of sector-specific legislation whose main objective was to introduce competition in the local telecommunications market, which had previously been monopolized by the local companies—generally the local Bell Operating Companies (BOCs)—and was the last segment of the telecommunications market still protected from competition. In order to reach that objective, section 253 of the 1996 Act bans all legal and regulatory barriers to entry on local markets. The 1996 Act also strengthened the powers of the federal sector-specific regulator, the Federal Communications Commission (FCC), by giving it a large role in the implementation of the new regulatory framework. The American regulatory model constitutes, therefore, a good benchmark of what can be achieved with a strong

[10] Telecommunications Act of 1996, Pub. L. No 104-104, 110 Stat. 56. Several articles detail the contents of this law. See, for instance, T. Krattenmaker, *The Telecommunications Act of 1996*, (1996) 29 Connecticut Law Review 123; M. Meyerson, *Ideas of the Marketplace: A Guide to the 1996 Telecommunications Act*, (1997) 49 Federal Communications Law Journal 252.

emphasis on very detailed sector-specific rules implemented, for a large part, by a sector-specific regulatory institution.

A. Competition and other incentives to generate and share efficiency gains

In order to promote competition in the local market, the 1996 Act contains a series of measures aimed at enabling competitors to use the local companies' infrastructure to provide local services. Thus, for example, Section 251 requires local operators to interconnect with other carriers,[11] to ensure number portability and dialling parity,[12] and to provide competitors unbundled access to their network.[13] The FCC determined that prices for interconnection and for the purchase of unbundled network elements should be based on the incumbent's Total Element Long-Run Incremental Cost (TELRIC).[14] Section 252 establishes a specific procedure for resolving interconnection disputes through intervention of the infrastructure-wide regulators established at the state level, the state utility commissions. Finally, Sections 271 et seq. allow BOCs to offer long distance services to their own customers provided, *inter alia*, that they meet their interconnection obligations under Sections 251 et seq. and that they create a separate affiliate to provide such services.[15]

The design of these various measures raises several important issues. First, some commentators consider that it is wrong to "mandate" incumbents to automatically grant interconnection to new entrants under the conditions established by law as competition would be more intense if competitors were forced to build their own facilities.[16] One can argue, however, that new entrants will only request access to the incumbents' network when obtaining such access does make them more competitive than building their own network. Otherwise, they can be expected to choose, on their own accord, to establish their own facilities.

A second set of concerns relate to the TELRIC pricing methodology devised by the FCC. One issue is whether this pricing methodology might discourage incumbents to invest by enabling new entrants to free ride on their facilities. Some authors argue that as it is based on the incremental cost of providing access, the TELRIC

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[11] 47 USC § 251(a)(1).

[12] Ibid., § 251(b)(2) and (3).

[13] Ibid., § 251(c)(3). "Unbundled access" means the availability of access to distinct parts of the incumbents network, at an appropriately lower cost than access to all elements of the network. Thus, a competitor can purchase only those network components and functions that it needs to offer its services.

[14] See *Implementation of the Local Competition Provision in the Telecommunications Act of 1996*, (1996) 11 FCC Rcd. 15,499.

[15] Because of the lack of a similar danger of unfair competition, BOCs are free to offer long-distance services to those customers not within their local service areas immediately. Generally on section 271, see T. Sloan, *Creating Better Incentives through Regulation: Section 271 of the Communications Act of 1934 and the Promotion of Local Exchange Competition*, (1998) 50 Federal Communications Law Journal 312.

[16] See, for instance, E. Nowicki, *Competition in the Local Telecommunications Market: Legislate or Litigate?*, (1996) 9 Harvard Journal of Law and Technology 353. Note that a similar criticism has been made with respect to the 1996 Act's provisions mandating Incumbent Local Exchange Carriers (ILECs) to provide new entrants with unbundled network elements upon request.

methodology might fail to ensure that the incumbent is able to cover its whole costs when average costs are higher than marginal costs, as is the case in industries exhibiting increasing returns to scale.[17] In addition, TELRIC does not compensate the incumbent for the opportunity costs of providing access and might therefore induce inefficient entry.[18] While one can point at such features of the pricing rule to argue that it provides insufficient compensation for the incumbents, one should keep in mind that the objective of ensuring that incumbents retain strong incentives to invest in their network should be balanced with the objective of promoting entry and therefore dynamic efficiency in a market segment where monopolistic operators have a variety of means at their disposal to hinder the operations of their competitors. In addition, in some respects, TELRIC methodology could in fact be deemed to be too generous with incumbents. Like all pricing rules aimed at reimbursing the actual costs of an incumbent, TELRIC might fail to provide the incumbent with strong incentives to reduce its costs.

A third type of issues raised with respect to the local competition provisions of the 1996 Act relate to the incentives devised to ensure the effective implementation of those provisions. Section 271—which conditions the BOCs' ability to offer long-distance services on meeting their interconnection duties under Section 251—is based on the assumption that the prospect of entering the long-distance market is a sufficiently attractive carrot to entice the BOCs to open their local networks. Conversely, it was assumed that long-distance companies would strive to enter the local market even if by doing so they would in effect help the BOCs establish that effective competition had been introduced in their markets and that they should therefore be authorized to provide long-distance services. Some observers have argued that these assumptions were in fact mistaken and that, on the whole, the BOCs seem to have made only a half-hearted effort to enter the long-distance market and have instead focused on maintaining their local monopoly, while, on the other hand, long-distance providers might have been reluctant to enter the local exchange market by fear that this may allow in turn the BOCs to enter the core of their business.[19] Linking BOCs' entry to the long-distance market to compliance with the Act's market opening provisions was a risky strategy that might eventually have led some

[17] See, for example, G. Sidak and D. Spulber, *The Tragedy of the Telecommons: Government Pricing of Unbundled Network Elements Under the Telecommunications Act of 1996*, (1997) 97 Columbia Law Review 1150–1151.

[18] The opportunity costs of providing access includes any monopoly profits which the incumbent is able to make on the provision of the service to the end-users, as such profits are lost when the service to end-users is provided by new entrants thanks to the access they receive from the incumbent. A price rule based on incremental costs, such as TELRIC, does not compensate the incumbent for those forgone profits when they exist. When such monopoly profits do exist, inefficient entry might occur under TELRIC, as a new entrant, less efficient than the incumbent, might be able to provide the service to end-users at lower prices than the incumbent if it accepts lower profits than did the incumbent.

[19] See, for instance, R. Waters, *New Communications Industry Takes Shape*, FT Telecoms, Financial Times Survey, 9 June 1999, p. 1 (arguing that few BOCs were not prepared to take the risk of opening their local market to gain access to the long-distance market, and that they chose instead "to extend their 'footprint' through merger, turning themselves into formidable giants").

telecommunications carriers to adopt a behaviour which was the opposite of the one that was initially sought by Congress.

It is still early to pass final judgment on the efficacy of the local competition provisions of the Act. So far, it is hard to argue that they have had much impact on the level of competition in the local segment of the market as interconnection agreements with local operators have been hard to negotiate and the BOCs tend to retain their monopolistic position for the provision of local services. As to the impact of provisions aimed at letting BOCs enter the long-distance market, it seems to have been fairly limited so far as well. It is only in 1999 that a BOC was, for the first time, considered to have sufficiently opened its local market to competition to be allowed to provide long-distance services under the provisions of Section 271.[20] The long-distance market was already very competitive prior to the adoption of the 1996 Act with several long-distance companies competing against one another and prices, already very low in 1996 by international standards, have been following a downward trend for the last decade which does not appear to have been fundamentally influenced by the adoption of the Act.

Cellular telephony was effectively introduced in the United States in 1984. In most geographical segments of the market, frequencies were allocated to two competing firms, first through a process of comparative hearings and then through lotteries. In 1993, Congress instructed the FCC to start awarding new cellular licences through competitive bidding. This competitive process is better designed than administrative hearings or lotteries to select the operators who value the spectrum most, thereby increasing the likelihood that the spectrum will be used by the most efficient operators. It also ensures transfers of some of the welfare gains associated with service provision to the Treasury. The FCC plans to introduce further flexibility into the system by allowing companies controlling frequencies to resell them on a secondary market.[21] Many of the new operators have now started operations and are injecting a higher degree of competition in markets which had been dominated by duopolistic incumbents for more than a decade. Prices, which had remained relatively high under duopolistic arrangements, have decreased sharply in recent years and are now among the lowest in the world.[22]

As far as universal services are concerned, the 1996 Act marks a progress compared to the previous regime, which relied, for a large part, on indirect and hidden subsidies

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[20] FCC News, *Federal Communications Commission Authorizes Bell Atlantic to Provide Long Distance Service in New York*, document available at <http://www.fcc.gov/Bureaus/Common_Carrier/News_Releases/1999/nrcc9101.html>.

[21] See *FCC to Promote a Trading System to Sell Airwaves*, New York Times, 13 March 2000. A first illustration of this approach can be found in the FCC's decision to create a new class of commercial FCC licence (known as the "Guard Band Manager license") pursuant to which "Guard Band" managers will engage in the business of subdividing the spectrum they acquire at auction and leasing it for value to third parties, including both commercial service providers and private wireless users. See FCC News, *FCC Adopts Rules for Guard Band Manager Auction*, available at <http://www.fcc.gov/Bureaus/Wireless/News_Releases/2000/nrwl0009.html>.

[22] In 1999, a basket of 100 minutes of cellular services cost US$ 25 in the US, compared to US$ 37.13 on average in 42 high income countries. See ITU, *World Telecommunications Development Report*, 1999.

between services and between operators to finance universal service provision.[23] Recognising the vulnerability of these implicit subsidies to competition,[24] the Act seeks to design universal service support in a way which is sustainable in an increasingly competitive marketplace. Thus Section 254 indicates that universal service support should be explicit, which is a first step toward a more competition friendly regime. It also attempts to put all competitors on a level playing field by stating that all telecommunications operators must contribute to the costs of universal service on an equitable and non-discriminatory basis,[25] and that these contributions must go to all operators that offer components of universal service throughout a designated area, whether these operators be incumbents or new entrants.[26]

B. Specificity vs. coherence

In a market such as the American telecommunications market where the pace of evolution is particularly rapid and where the technological and operational barriers between telecommunications and other sectors tend to be disappearing faster than anywhere else, a particularly strong case can be made for rules and institutions designed to operate in more than one sector. There would thus seem, for example, to be good reasons to question the need for a set of rules as detailed and as sector-specific as those contained in the 1996 Act, and to give serious consideration to the possibility of replicating, at the federal level, the cross-utility regulatory agencies that exist at the state level.

Paradoxically, it can be argued, however, that while too many detailed regulations have been adopted, on the whole, in the US telecommunications sector, there are issues on which additional telecommunications or infrastructure-specific rules do in fact appear to be needed. For instance, the general antitrust rules under which the Department of Justice (DoJ) has to assess mergers mandate the latter to base its decision on a criterion—whether or not the transaction lessens competition—that is wholly inadequate in industry sectors that are suddenly opened to competition after having been dominated by monopolies.[27] Indeed, the merger between two BOCs does not lessen competition in either Bell's market—because none existed in the first place. This problem could be solved by authorizing the DoJ to use in its review of telecommunications mergers a more flexible criterion than the "impact on competition" standard it is currently bound to use.

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[23] See E. Noam, *Will Universal Service and Common Carriage Survive the Telecommunications Act of 1996*, (1997) 97 Columbia Law Review 955, at 960.

[24] Because the most profitable services, such as business service, attract the most new entrants, competition decreases the profit margin on services typically used to subsidize universal service. As incumbents are forced to sell their previously profitable services at more competitive prices, their ability to cross-subsidize diminishes.

[25] I47 USC at § 254(d).

[26] Ibid., at § 254(e).

[27] See *William Kennard's Colosseum*, The Economist, 15 May 1999, p. 75.

C. Flexibility vs. certainty

One clear advantage of the detailed regulatory framework put in place by the 1996 Telecommunications Act is that it clarifies the respective rights and duties of telecommunications operators, and thus tends to reduce uncertainty in the marketplace. Unfortunately, while the 1996 Act does contain precise rules on a series of issues, it is extremely vague on some other key aspects. For instance, the 1996 Act fails to draw a clear line between the respective competencies of the FCC and the state utility commissions with respect to the implementation of its local competition provisions. This led to a three-year legal battle initiated by a group of local operators and state regulators arguing that primary responsibility to implement the local competition provisions of the Act belonged to the states rather than the FCC and that FCC rules, such as the one requiring that prices for interconnection and unbundled access be based on the TELRIC formula, were consequently invalid. The Supreme Court finally settled the case in early 1999 by confirming the FCC's authority,[28] but the proceedings were extremely costly and it seriously impeded the implementation of the Act during its first few years of existence.

On the other hand, the 1996 Act's detailed regulatory requirements over issues such as interconnection or the purchase of unbundled network elements may be excessively rigid and leave too little discretion to the regulatory authorities to tailor appropriate solutions in a constantly evolving market place. This problem of rigidity is, however, mitigated in two ways. First, though the FCC is mandated by the 1996 Act to implement a large set of detailed rules, there remains a series of matters for which this body retains large discretionary powers as it is requested to act in the "public interest", a concept whose definition is rather vague.[29] Second, Section 160 of the 1996 Act, entitled "regulatory flexibility", enables the FCC to forbear from applying provisions of this Act if it determines that forbearance from enforcing those provisions "will promote competitive market conditions".[30] Use of Section 160 is, however, restricted with respect to some of the provisions of the Act[31] and it also requires that a series of strict conditions be met.[32]

D. Regulatory competence and ability to resist undue pressure

Though the 1996 Telecommunications Act imposes a number of duties on the state utility commissions and the DoJ, the FCC is the major institutional player as far as implementation of the Act is concerned. The technical capacity of the FCC is generally

[28] *AT&T Corp. et al. v. Iowa Utils. Bd. Et al.*, (1999) 525 U.S. 366.

[29] For a critique of this criterion, see W. Read and R. Weiner, *FCC Reform: Governing Requires a New Standard*, (1998) 49 Federal Communications Law Journal 293.

[30] 47 USC 160(b). For a discussion of Section 160, see T. Hall, *The FCC and the Telecom Act of 1996: Necessary Steps to Achieve Substantial Deregulation*, (1998) 11 Harvard Journal of Law and Technology 797.

[31] The FCC may not forbear from applying the requirements of Section 251(c) or 271(a) until it determines that those requirements have been fully implemented. See 47 USC 160(d).

[32] See 47 USC 160(a)–(c).

highly regarded and the Commissioners who head the agency are usually highly qualified professionals. In addition, the 1934 Communications Act, which created the FCC, contains a series of requirements designed to ensure the independence of the Commissioners *vis-à-vis* political authorities and market players. For example, no more than three Commissioners (out of a total of five) can be of the same political party.[33] The Commissioners are nominated by the President but must be confirmed by the Senate.[34] The commissioners serve five-year terms, which are staggered so that no more than one Commissioner's term expires each year. The President may not remove a Commissioner, except for cause.[35] Finally, none of the Commissioners can have a financial interest in any Commission-related business.[36]

Another factor that would tend to reduce the risks of agency capture is the presence of detailed regulatory requirements in the 1996 Act. Indeed, the lower the discretion of the regulator, the less industry and political authorities may hope to influence the regulatory process. This line of reasoning is, however, subject to two caveats. First, as noted above, there are certain areas where the FCC does enjoy large discretionary powers.[37] Moreover, while the adoption of detailed regulatory requirements may contribute to reduce the risks of agency capture, it may also contribute to "legislative capture". Indeed, there is little doubt that Congressional debates over extremely complex and detailed provisions are influenced by armies of lobbyists funded by telecommunications operators. To some extent, legislative capture may succeed more easily than regulatory capture because politicians offer fewer guarantees of independence than regulators. This is not to say, of course, that regulatory agencies should be given a blank cheque. But one should be aware that the more detailed the legislative provisions, the greater the scope for attempting to influence the legislative process.

As discussed in Section I, while the FCC appears competent and reasonably autonomous, one could argue that establishing a cross-sector rather than a sector-specific agency would further reduce the risks of political or industry capture and might have a positive impact on the competency of the regulator.

E. Regulatory accountability

One of the advantages of relying on FCC proceedings is that it offers more room for public intervention than antitrust proceedings. The FCC has to give public notice of matters to be acted upon and an opportunity to comment on such matters. FCC decisions must also be published and reasoned. They are subject to review before federal courts on legal, but not substantive or factual grounds.[38] A clear downside of

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33 Ibid., § 4.
34 Id.
35 47 USC § 5(a).
36 Ibid., § 5(b)(2)(A)(i).
37 See text accompanying notes 29, above.
38 See T. Krattenmaker, *Telecommunications Law and Policy*, 2nd Edition 1998, 20.

some of these processes, however, is that they tend to be extremely burdensome. There is also a danger that certain actors use them—for instance, by filing large comments or by systematically challenging FCC decisions—to slow down the implementation of reforms that go against their interests.

F. Regulatory costs

One clear drawback of the American regulatory model is that it involves huge regulatory costs. The 1996 Act directs the FCC to make an impressive series of rulings, the elaboration and implementation of which absorb large administrative resources.[39] The FCC itself is a large bureaucracy with more than 2100 employees and a budget of more than US$ 200 million.[40] One also needs to add the resources spent on telecommunications regulation, at the state level, by the public utility commissions. Finally, telecommunications carriers also need to invest massive internal and external legal resources to ensure compliance of their operations with the requirements of the Act.

Finally, one should not overlook the costs of regulatory inefficiencies and mistakes. As mentioned above, uncertainty regarding the respective responsibilities of the FCC and state commissions has led to very costly judicial proceedings and has delayed the reform process. Also, it is not impossible that section 271 might have had the opposite effect to what had been intended by the legislator and might in fact have delayed the arrival of competition in the local exchange markets.

G. Allocation of regulatory responsibilities

The lack of clarity in the allocation of responsibilities between the FCC and the state utility commissions has already been pointed out. Other issues stem from the peculiar relationship between the FCC and the DoJ, which are requested to cooperate in some areas and have concurrent jurisdiction in others. Section 271 of the Telecommunications Act gives final authority to the FCC to rule on BOCs' applications to enter the long-distance market but, before taking a decision, the Commission must consult with the DoJ and give "substantial weight" to the latter's evaluation. By contrast, in the area of mergers and acquisitions, the FCC and the DoJ have concurrent jurisdiction to review transactions between telecommunications operators. Their review process is entirely separate and based on distinct statutory authority.

While the need for interaction between the FCC and the DoJ might constitute, to some extent, a source of synergy between the two institutions, the above arrangement presents clear drawbacks as well. It could be argued, for example, that instead of the FCC,

[39] As pointed out by Thomas Krattenmaker, the Act's local competition provisions "impose so many restrictions, and direct the Commission to write so many rules, that one must fear that the regulatory costs of this open access regime will exceed its payoff in reduced rates or improved service quality ". See Krattenmaker, note 38, above.

[40] See *FCC Budget of $212,977,000 Proposed for Fiscal Year 1999*, FCC News, available at <http://www.fcc.gov/Bureaus/Miscellaneous/News_Releases/1998/nrmc8011.html>.

it is a competition authority such as the DoJ, with experience in assessing the degree of competitiveness of different markets across the economy, which should be entrusted, under section 271, with the task of determining whether the local competition market is sufficiently open to competition.[41] As for the FCC-DoJ's dual jurisdiction over mergers between telecommunications operators, it certainly presents a series of difficulties. A first obvious problem is the risk that the two bodies adopt inconsistent positions. Moreover, from a practical standpoint, this dual review process is extremely slow (with parties having to wait sometimes for more than a year to have a transaction cleared by the two reviewing bodies), involves a great deal of duplication (with similar documents having to be sent to two different institutions) and, therefore, is unnecessarily costly. In our opinion, it would be preferable to concentrate merger review in the hands of the DoJ which has the advantage of reviewing mergers across different fields of activity. As mentioned above, however, the DoJ would have to be authorized to assess mergers in telecommunications according to a criterion different from the present one which focuses only upon whether or not the transaction lessens competition.

IV. New Zealand

The New Zealand experience is remarkable for the speed and extent of the telecommunications reforms which were implemented in the late 1980s. Over a period of about three years, telecommunications activities were separated from postal activities, the telecommunications operator was commercialized and then privatized, and all segments of the telecommunications sector were opened to competition.[42] Even more remarkable, however, was the extent to which the authorities decided to rely on the implementation, by the economy-wide antitrust regulator (the Commerce Commission) and the courts, of the general antitrust provisions contained in the Commerce Act 1986 to regulate the telecommunications sector. A few sector specific rules were adopted, but they were very limited in scope and numbers. The New Zealand model is therefore very much the antithesis of the American one, and it provides a particularly valuable test of the extent to which the objectives identified in Section II can be met through the application of general rather than sector-specific rules and institutions.

A. Competition and other incentives to generate and share efficiency gains

While relying to a very large degree upon general antitrust provisions to promote competition in telecommunications, the authorities also required Telecom, the

[41] This was the position taken by the DoJ during the congressional debate over the 1996 Act. See Hearing on Telecommunications Policy Reform Before the Senate Comm. On Commerce, Science and Transportation, S. REP. No. 104–218, 25 (1995) (statement of Anne K. Bingaman, Assistant Attorney General, Antitrust Division).

[42] For an analysis of the liberalization process in New Zealand telecommunications from 1987 to 1989, see P. McCabe, *Telecommunications in the Pacific Basin: an Evolutionary Approach*, in C. Green and D. Rosenthal, Eds, *Competition Regulation in the Pacific Rim*, 1996.

incumbent operator, to disclose information about the prices and conditions under which certain services were supplied both to its own subsidiaries and to competitors. In addition, Telecom committed, in two letters of undertakings to the Government, to deal with its own subsidiaries and with competitors on an arm's length basis and to provide interconnection on fair and reasonable terms. The Government, for its part, indicated that it would consider adopting additional regulation if operators failed to reach pro-competitive agreements. It quickly became apparent, in the aftermath of the implementation of the new regulatory framework, that these few sector-specific instruments were insufficient, in many cases, to get the various operators to reach mutually agreed arrangements on a number of issues. For example, Telecom failed to honour its commitment to deal with its own subsidiaries on an arm's length basis and as a result, the usefulness of the disclosure requirements imposed upon the company was reduced (for example, the interconnection agreement between Telecom and its mobile subsidiary which originally was a public document, is not publicly disclosed any more following the amalgamation of Telecom's various businesses).[43]

As a result, parties often turned to the courts to resolve disputes and a number of issues were dealt with relatively easily in that way. For example the courts unanimously pronounced that Telecom's attempts to impose that customers of its would-be competitors in the local market dial an access code, while Telecom's own customers would not have to do so were anti-competitive.[44] However, the courts proved very ill-equipped to solve difficult interconnection issues.

Telecom and Clear, a competitor seeking access to Telecom's local network, initiated judicial proceeding before the High Court, and subsequent appeals were lodged before the Court of Appeal, and finally before New Zealand's highest jurisdiction, the Privy Council in Britain. The process took five years and involved substantial costs. In addition, the three courts issued contradictory rulings and at the end, the parties were left without a decision specific enough to put a definitive end to the dispute as none of the three courts felt competent to impose a specific interconnection price.[45] The Privy Council ruled that the efficient component pricing rule (ECPR) could be used to calculate the interconnection price.[46] While the ruling might have provided a general framework to calculate interconnection

[43] Ross Patterson, *Light-Handed Regulation in New Zealand Ten Years On: Stimulus to Competition or Monopolist's Charter*, paper distributed at the TUANZ Competition Symposium, Wellington, New Zealand, 7–8 April, 1998, at 27.

[44] See *Clear Communications Ltd v. Telecom Corporation of New Zealand Ltd*, (1992) 5 TCLR 166.

[45] Numerous articles have been devoted to the analysis of these cases. See, for example, C. Blanchard, *Telecommunications Regulation in New Zealand—The Court of Appeal's Decision in Clear Communications v. Telecom Corporation*, (1994) 18 Telecommunications Policy 725; C. Blanchard, *Telecommunications Regulation in New Zealand—Light-Handed Regulation and the Privy Council's Judgment*, (1995) 19 Telecommunications Policy 465.

[46] The ECPR dictates that the incumbent be compensated for the actual cost of providing interconnection, as well as for the opportunity cost of doing so. This opportunity costs includes the monopoly profits, if any, that the incumbent made when it provided services to the end-users and that it would lose if competitors, now granted access to the incumbent's network, served the end-users themselves. Application of the ECPR guarantees therefore that only competitors with lower costs than the incumbent will be able to enter the market and make a profit.

prices, it certainly did not specify what the exact price should be and, in fact, the parties settled, more than a year after the Privy Council rendered its judgment, on a price which, by most accounts, was well below ECPR levels. Many observers argue that this creates uncertainty and that this uncertainty, in turn, constitutes a barrier to entry and further hinders negotiated agreements, as the parties lack the judicial benchmarks which would focus negotiations upon a narrow set of possible outcomes.[47]

Number portability issues also proved very difficult to tackle in New Zealand. An agreement has finally been reached between some operators, but the process took a very long time and the Government had to intervene by imposing a deadline on the industry to reach agreement on those issues. In addition, the agreement does not set specific number portability rules, but only a process to eventually determine such rules.[48]

New Zealand has launched an interesting experiment with respect to the allocation of the radio-electric spectrum. Like many other countries, such as the US, Chile, and Australia, New Zealand has resorted to competitive auctions to allocate spectrum rights. This pursues both economic efficiency and welfare allocation objectives, as it ensures that the right to use various spectrum bands is awarded to the operators which value it most (and are therefore likely to be the most efficient) and that some of the welfare gains associated with the use of the spectrum are transferred from the operators to the State through payments of the bids. Whereas spectrum rights, allocated in this way, are generally very precisely defined and specify, for example, the type of technology to be used, New Zealand did, in some cases, allow resale of spectrum rights without specifying the specific use to which the frequencies had to be put. The goal was to allow sufficient flexibility to let the market decide which application would extract maximum value from spectrum utilization. So far, however, users have apparently failed to make full use of the possibility to resell spectrum rights and switch between different uses. This might be due to the fact that the New Zealand market is very small which might impede the development of an efficient secondary market for spectrum rights as well as the development of new equipment required to take full advantage of the possibility to switch between spectrum uses. While three operators have been awarded cellular licences, only two are actually providing mobile telecommunications services. Mobile phone prices are relatively high when compared with the average for high income countries.[49]

The system adopted to ensure that universal service obligations are met exhibits, for its part, some anti-competitive features. Telecom is chosen, *a priori*, as the party

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[47] See, for example, D. Biggar, *Legislative Principles Governing Access to Vertically Integrated Natural Monopolies in New Zealand*, paper distributed at the TUANZ Competition Symposium, Wellington, New Zealand, 7–8 April 1998, at 9.

[48] See *Commerce Commission Media Release 1999/64*, available at <http://www.comcom.govt.nz/publications/display_mr.cfm?mr_id=544>.

[49] In New Zealand, a basket of 100 minutes of cellular services in 1999 cost US$ 48.05, compared with US$ 37.13 on average in 42 high income countries. See ITU*, World Telecommunications Development Report*, 1999.

responsible for meeting universal service obligations.[50] As no market mechanisms are used to determine the true costs of universal service obligations and to identify the service providers best able to meet those obligations, there is no guarantee that the compensation Telecom receives does exactly cover its costs nor that Telecom is the party able to perform that task most efficiently.[51] To the extent that Telecom's competitors contribute to the costs of universal service obligations (through the access price—see the access to the local loop cases), there is a risk therefore that they might be overcharged and thus put at a competitive disadvantage *vis-à-vis* Telecom.

Some authors consider that on the whole, Telecom has been subjected to insufficient competitive pressures. While recognising that telecommunications performance has markedly improved over the past decade in New Zealand, those authors consider that such results are not that impressive when compared with those of other OECD countries. For example, comparing the prices of business telephone services using OECD power purchasing parity methodology, New Zealand ranked 12th most expensive (out of 26) in 1997.[52] Todd Telecommunications Consortium, for its part, estimated that Telecom was earning substantial monopoly profits, in the order of NZ$ 382 million per annum.[53]

Some of those who share these views argue that in order to accelerate the introduction of competition in the New Zealand telecommunications market, it would have been advisable to impose upon the incumbent some structural reforms such as the effective separation between cellular and wireline operations, for example, in order to increase the number of operators and of interconnection agreements, thereby increasing the amount of information available, and thus facilitating agreements between parties as well as specific decision-making by the courts.[54] Any decision regarding implementation of structural reforms should, however, only be taken after careful analysis. First, such reforms would entail substantial restructuring costs for the company. Second, the telecommunications market is in a state of very rapid evolution. This means that technological developments (such as the use of cable TV or electric wires to provide telecommunications services) might open new avenues for the introduction of competition through the entry of new types of operators, without the need to implement any structural reform. In addition, the progressive erosion of technical and operational differences between different telecommunications services might weigh against decisions to impose separation between some activities as

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[50] See, for example, C. Flood, *Regulation of Telecommunications in New Zealand—Faith in Competition Law and the Kiwi Share*, (1995) 3 Competition and Consumer Law Journal, at 214–218.

[51] Todd Telecommunications Consortium argues that, in fact, the provision of residential local services is not a loss-making activity in New Zealand and that, on the contrary, it generates monopoly profits. See Todd Telecommunications Consortium, *New Zealand Telecommunications: The State of Competition*, November 1998, at 46.

[52] See Ministry of Commerce, New Zealand Telecommunications 1987–1998, New Zealand Telecommunications Information Publication No. 6, December 1998, 32.

[53] Todd Telecommunications Consortium, see note 51 above, at 44.

[54] See M. Mueller, *On the Frontier of Deregulation: New Zealand's Deregulated Telecommunications Industry*, in D. Gabel and D. Weiman, Eds, *Opening Networks to Competition—The Regulation and Pricing of Access,* 1998, at 126–129.

it increases the economies of scope which one company might derive from providing several telecommunications services.

B. Specificity vs. coherence

The New Zealand model of economic regulation for telecommunications is clearly forward-looking in that relying on economy-wide rules and institutions to regulate the sector certainly promotes a coherent treatment between telecommunications and other sectors and reflects the growing similarities progressively emerging between the telecommunications sector and other parts of the economy.

On the other hand, however, it could be argued that the absence of specific rules on interconnection was the main cause of the long delays with which some interconnection disputes were resolved in New Zealand. As mentioned above, the uncertainty generated by the absence of more specific rules on this topic hindered the conclusion of agreements between parties as well as the adoption of precise solutions by the judges. More specific provisions on number portability issues might also have facilitated and accelerated the conclusion of agreements between operators.

In addition, antitrust rules pertaining to the use of a dominant position, such as section 36 of the New Zealand Commerce Act, are generally designed to prevent restrictions of competition. As mentioned with respect to the United States, they might therefore be ill-adapted when it comes to introducing competition in markets which were previously monopolized. They might also lead to non-efficient results, from an economic point of view, when they are applied to vertically integrated industries. For example, a monopolist operating a bottleneck facility might be forced, under rules such as section 36, to decrease the price at which it sells goods or services to operators with which it competes in a downstream market but might be free to price as it wishes when it does not compete in that market. Indeed, in the former case, when it imposes high prices, there is a risk that the monopolist distorts competition in the downstream market in its favour while, in the latter case, all competitors in the downstream market are treated in the same way. As a result of the application of section 36, in order to be able to keep charging high prices, the monopolist might decide to operate only in the bottleneck market and not in the downstream competitive market even if economies of scales or scope would dictate vertical integration.[55]

Finally, antitrust law does not necessarily constitute an appropriate instrument to distinguish between rules which are easy and rules which are very difficult to apply in practice. For example, in the case mentioned above opposing Telecom to Clear, the Privy Council supported the use of the ECPR to calculate the interconnection price because it considered that application of the rule would lead to the progressive elimination of the incumbent's monopoly profits if any existed. Practical difficulties,

[55] See G. Hay, *Reflections on Clear*, (1996) 3 Competition & Consumer Law Journal, 231, at 242–243.

such as the fact that application of the ECPR requires very detailed information on the incumbent's costs and that the ECPR can lead to the progressive elimination of monopoly profits only if regular reviews are performed to re-assess the value of the interconnection price,[56] were considered irrelevant by the Privy Council to determine the legality of an ECPR-based interconnection price under section 36. Ensuring adoption of a more practical rule—based, for example, on international benchmarks derived from the observation of interconnection prices in countries with competitive telecommunications sectors—would have required more specific regulations than section 36.

C. Flexibility vs. certainty

The New Zealand model, with its heavy reliance on general antitrust rules leaves a wide degree of discretion to judges in charge of applying the rules, as long as a binding precedent has not been set by a higher court. As mentioned above, this has the advantage of allowing for a high degree of flexibility in tailoring appropriate solutions. Conversely, it introduces, however, a high degree of uncertainty for operators and subscribers alike. This uncertainty is well illustrated by the several instances where different courts ruled differently on the same facts, such as in the interconnection cases opposing Telecom and Clear. The New Zealand model of spectrum allocation also provides substantial flexibility to operators, and this, on the other hand, appears, at least in theory, to constitute a clear improvement upon the more rigid way in which most other countries allocate spectrum rights.

The New Zealand regime might, in addition, be deemed to leave too much discretion to the Executive in at least two respects. First, Part IV of the Commerce Act contains a price control regime which leaves a large degree of discretion to political authorities and to the Commerce Commission: the criteria to be used by the Government to identify the goods or services which can be subjected to price controls are vague and no guidance is provided to the Commerce Commission as to how such price controls should be designed and administered. Investors could therefore legitimately be concerned that such broad powers could be misused, thus preventing them from receiving adequate returns on their investments. Second, the Government's threat of imposing more detailed regulation upon the industry is a very informal and

[56] If competitors using the incumbent's network are more efficient than the incumbent, they will be able, without losing money, to provide services to end-users at lower prices than the incumbent while compensating the incumbent for any foregone profits (which are part of the incumbent's opportunity costs of providing interconnection), as required by the ECPR. In that case, the incumbent might want to match the lower prices of its competitors. The incumbent's monopoly profits would then go down and interconnection prices could be recalculated to take this lower opportunity cost into account, thereby opening the door to another round of price reductions. This would however require that the profits of the incumbent be monitored in order to proceed to a re-evaluation of the interconnection price each time the level of profits varies (an additional caveat was added by the New Zealand Court of Appeal which pointed out that the incumbent might in fact prefer to keep its end-user prices high and retain its profits through a high interconnection charge, even if that meant that its subscribers would be captured by its competitors).

therefore rather uncertain regulatory instrument: the willingness of governments to act upon such threats is difficult to estimate and is likely to differ from one government to the next.

D. Regulatory competence and ability to resist undue pressure

The Commerce Commission which is in charge of monitoring application of antitrust law has a staff specializing in issues of economic law and the Commissioners themselves must be chosen on the basis of their knowledge of, or experience in, industry, commerce, economics, law, accountancy, public administration, or consumer affairs.[57] The Commission operates, however, on a limited budget (about NZ$ 6.5 million) and with a rather small staff (about 70 people) comprising very few analysts specializing in network industries.[58]

The courts, which rule on the appeals lodged against the decisions of the Commerce Commission on both substantive and legal grounds and which, alone, can impose pecuniary penalties for violations of the Commerce Act 1986, appear to suffer from a serious lack of expertise in regulatory matters, in spite of the presence of an expert lay member sitting in the High Court (but not the Court of Appeal or the Privy Council) on antitrust matters.[59] This lack of expertise might explain, at least in part, why contradictory decisions were taken by different courts on the same issues, as well as why the penalties imposed by the courts for violations of the Commerce Act appear, in some cases, to have been insufficient to compensate for the unlawful gains of the violators, thereby failing to deliver the intended deterrence effect.[60] In those conditions, it would probably be preferable to give a larger role to the specialized regulator—i.e. the Commerce Commission—which could be in charge of monitoring but also of ensuring implementation of the law, and to limit the role of the courts to reviewing, on appeal, the decisions of the Commerce Commission from a legal, but not a substantive, point of view.

One positive feature of the current scheme, which gives a major role to judges, is that it offers strong guarantees regarding the autonomy of the regulatory process. Indeed, judges enjoy protection against undue pressures from the Government and are independent from industry, so that the risks of regulatory capture are limited. Commissioners, for their part, also enjoy some protection against government pressure: for example, the Commission's budget is determined by Parliament and Commissioners can only be dismissed on grounds restrictively enumerated in the Commerce Act.[61] This protection is however somewhat limited as the Executive alone

[57] See Commerce Act, ss. 9 and 10.

[58] J. Small, *Light Handed Regulation of Network Industries in New Zealand*, paper distributed at the TUANZ Competition Symposium, Wellington, New Zealand, 7–8 April 1998, at 9.

[59] See Commerce Act, ss. 77 and 78.

[60] See A. Bollard and M. Pickford, *Utility Regulation in New Zealand*, (1996) Institute of Economic Affairs, Lectures on Regulation, London, 52.

[61] See Commerce Act, ss. 13 and 20.

is responsible for designating the Commissioners and the Commission must have regard to the economic policies of the Government.[62] The independence of the Commission from industry is, for its part, guaranteed by specific conflicts of interest rules.[63] If more responsibilities were to be transferred to the Commerce Commission, as suggested above, it would be important to strengthen the protection which the Commission enjoys against undue political pressures.

The fact that both the Commerce Commission and the courts are competent across the whole economy and tend to intervene on a case by case basis without getting involved in constant regulatory oversight limits the contacts which those institutions have with any particular sector minister or operator and thus further reduces the risks of regulatory capture by the Government or by the industry.[64] There remains, however, as indicated above, some risks of politically-motivated intervention under Part IV of the Commerce Act. If price control regulation is to be retained, it should be made much more specific and should be implemented by the regulator rather than by the Executive in order to eliminate the risk of politically motivated interventions in that area.

E. Regulatory accountability

A series of measures contribute to promote regulatory accountability: the Commerce Commission publishes, on the web, an annual report of its activities; its decisions are published and reasoned; appeals against those decisions can be brought before the courts; and the courts are also required to publish their decisions and the reasons explaining those decisions. However, heavy reliance on antitrust proceedings before the courts means that interested parties, if they are not parties to the disputes, are limited in their ability to intervene in the proceedings to present their views. As argued above, the role of the courts could be limited to ensuring that proceedings conducted by the regulator have met all legal requirements, and such requirements should be designed in a way which ensures that users and other interested parties can make their voices heard.

F. Regulatory costs

One obvious benefit of the New Zealand regulatory model is that it involves very limited direct costs as its regulatory institutions are not expensive to establish and

[62] See ibid s. 26. In practice the Government has communicated few statements of economic policies to the Commission, and when it does, it has to follow a relatively transparent process as the communications must be published and communicated to Parliament. See K. Vautier and A. Bollard, *Competition Policy in New Zealand*, in C. Green and D. Rosenthal, Eds, as note 42 above, at 390.

[63] The Commerce Act s. 14 requires Commission members to disclose their financial interests in businesses which are the objects of regulatory proceedings before the Commission and to discontinue their participation in such proceedings.

[64] See R. Kerr and B. Wilkinson, *The Regulation of Monopoly in New Zealand*, paper distributed at the TUANZ Competition Symposium, Wellington, New Zealand, 7–8 April 1998, at 36–39.

maintain. As mentioned above, the budget of the Commerce Commission, which enforces the Commerce Act across the whole economy, is very modest. In addition, as there are few sector-specific rules, compliance costs for the industry remain small and incentives to spend large sums on lobbying activity are reduced.

The parties incurred, however, substantial legal expenses during the protracted litigation which took place in New Zealand.[65] Besides, while very difficult to estimate, other costs are likely to be substantial in New Zealand. First, there are the costs which result from the delays incurred in reaching some final decisions, particularly on interconnection. The Clear–Telecom access dispute in the local loop cases, for example, postponed competition in the local markets by several years, which undoubtedly imposed a cost on the New Zealand economy. Second, costs will also be incurred if, as argued above, there is insufficient protection against regulatory mistakes in New Zealand.

G. Allocation of regulatory responsibilities

When compared with that of most other countries, the framework applicable to the economic regulation of telecommunications is relatively simple in New Zealand and the allocation of regulatory responsibilities appears to be quite clear. The main criticism which could be made in this area is that regulatory responsibilities might not have been allocated to those best equipped to handle them. It may seem somewhat paradoxical, for example, that decisions taken by the Commerce Commission, a body which comprises some experts on telecommunications regulatory matters, can be appealed before the High Court, which comprises only one economic expert, and that decisions of the High Court can then be appealed before the Court of Appeal, which comprises no expert at all on economic issues. Also, as argued above, the authority which the Executive retains with respect to price control could be transferred to the specialized regulator in order to reduce the risks of basing decisions on short term political considerations.

V. Chile

Chile was one of the very first countries to open all segments of the telecommunications market to competition in the early 1980s. This, in itself, makes the Chilean model an interesting case study since the workings of the post-liberalization regulatory framework can be analysed over a period of almost two decades. A second interesting feature of the Chilean model is that it represents, in a way, a compromise between the New Zealand and US approaches. There are more sector-specific rules in Chile than in New Zealand and, unlike in New Zealand, a

[65] Clear estimated that it had spent NZ$ 8 to 10 million for the High Court trial alone of the *Clear v. Telecom* case discussed above.

sector-specific regulator, SUBTEL, has been established in Chile. The Chilean Telecommunications Law is however much less detailed than the US 1996 Telecommunications Act and SUBTEL has much less power than the FCC. Finally, a third noteworthy feature of the Chilean model is that the regulatory framework has been substantially modified over the post-liberalization period: the price regime was made much more specific in the late 1980s than it was in the immediate aftermath of telecommunications liberalization, and conditions under which competition could take place in the long distance market were clarified in 1994. This provides therefore an opportunity to judge the efficacy of different regulatory options in a single country setting.

A. Competition and other incentives to generate and share efficiency gains

The General Law of Telecommunications, adopted in 1982, opened all segments of the telecommunications sector to competition.[66] The law imposed an obligation upon all providers of public services to grant interconnection to competitors under technical conditions determined by the regulator. Interconnection prices were to be determined by the parties themselves, which could present their case to the antitrust authorities if they failed to reach an agreement.[67] Telecommunications prices, for their part, were to be determined by market forces, except when the antitrust regulator considered that markets were insufficiently competitive.[68] In that case, the law indicated, through relatively vague provisions, that prices were to be set on the basis of the direct and necessary costs of providing the service.[69] Finally, telecommunications operators had to abide by technical norms adopted by the telecommunications regulator SUBTEL.[70]

This new framework proved ill-adapted to enable competition to emerge. The telecommunications sector remained dominated by two publicly owned monopolistic operators: CTC in the local market, and ENTEL in the long distance market. End user prices, which had to be regulated because of the lack of competition, tended to be set at economically inefficient levels through an informal negotiation process which involved the Ministry of Transport and Telecommunications, SUBTEL, and the regulated enterprises themselves.[71] New companies often found it quite difficult to reach satisfactory interconnection agreements with CTC or to obtain that CTC abide by the terms of such agreements. Several antitrust complaints were filed by the new

[66] See Law no. 18.168 of 1982, articles 12 and 13.
[67] See A. Galal, *Regulation and Commitment in the Development of Telecommunications in Chile*, (1994) 1278, Policy Research Working Paper, The World Bank, 11.
[68] See Law no. 18.168 of 1982, article 29, para. 2.
[69] See A. Galal et al., *Welfare Consequences of Selling Public Enterprises—An Empirical Analysis*, 1994, 257.
[70] See Law no. 18.168, at article 24.
[71] See Galal et al., as note 69 above, at 257.

companies against CTC. In every case, the antitrust regulator pronounced against CTC, but only after rather long and costly processes.[72]

In 1987, a Decree Law modifying the General Law of Telecommunications was adopted to address these issues. It established a very detailed pricing regime applicable to interconnection as well as to other services provided in insufficiently competitive markets.[73] This pricing regime exhibits a number of efficiency enhancing features. The prices of each services are supposed to be set individually so as to cover the costs of a benchmark efficient firm providing the same services, and the pricing formula remains in place for five years. Thus, because prices are not based on actual costs, but on the costs of a theoretically efficient benchmark, and because there is a five year lag before the pricing formula is recalculated, firms have strong incentives to reduce costs and keep up with international best practice.[74] Also, regulated prices are maximum prices only, which leaves some flexibility to the regulated enterprises and is fully consistent with the establishment of a market open to competition. Finally, while interconnection prices determined according to this regime do not compensate the incumbents for foregone profits and might therefore induce inefficient entry, they have the advantage of strongly promoting competition and therefore dynamic efficiency.[75] The main drawback of the scheme is its complexity and the information requirements which it imposes upon the regulators. Demand must be estimated for each service subjected to the price regime and the costs of an "efficient" firm must be calculated, a particularly difficult task when the regulated firm has no equivalent in the country so that comparisons can only be made with foreign firms operating in environments which might be substantially different from that of the regulated firm.[76]

The privatization of CTC and ENTEL in 1988 severed some of the links between the Government and the operators. This helped to establish a clearer separation between operational and regulatory responsibilities and contributed to ensure that SUBTEL would take the lead in implementing the price regime. The first price schedule designed in accordance with the provisions of the 1987 Decree Law and implemented from 1989 to 1994 brought prices closer to costs and promoted a rebalancing between local and long distance tariffs, with a progressive reduction of long distance prices. Such price reductions should probably have been faster however given the fact that ENTEL enjoyed rates of return of more than 40 percent in the early 1990s.[77] In addition, CTC and ENTEL still enjoyed substantial monopoly power in their respective markets and were able to adopt anti-competitive behaviours which

[72] See L. Guasch and P. Spiller, *Managing the Regulatory Process: Design, Concepts, Issues, and the Latin America and Carribean Story*, 1994, 114.

[73] See Law no. 18.168, at articles 30 to 30K.

[74] See B. Levy and P. Spiller, *Regulation, Institutions, and Commitment in Telecommunications: A comparative Analysis of Five Country Studies*, Annual Bank Conference on Development Economics, 1993, 27.

[75] See note 24, above.

[76] L. Jones, *Appropriate Regulatory Technology: The Interplay of Economic and Institutional Conditions*, Annual Bank Conference on Development Economics, 1993, 20.

[77] See E. Bitrán and R. Sáez, *Privatization and Regulation in Chile*, in B. Bosworth et al., Ed., *The Chilean Economy: Policy Lessons and Challenges*, 1994, 363.

were not always severely punished by the antitrust authorities.[78] Finally, doubts remained as to whether CTC and ENTEL could enter each other's markets.

Lengthy court proceedings, culminating in a Supreme Court judgment of 1993, finally settled the latter issue. The Supreme Court ruled that local and long distance companies could enter each other's market provided that they did so through the establishment of legally separate subsidiaries and that the provider of local services offer interconnection to all long distance providers through a multi-carrier system (i.e. a system enabling users to access the various long distance service providers by dialling different access codes). In 1994 the Telecommunications Law was amended again to require establishment of separate subsidiaries and to implement the multi-carrier system.[79] This led to a flurry of entries into the long distance market and price wars between competitors have made the Chilean domestic and international long distance market one of the most competitive in the world. Long distance prices were deregulated in 1994 and price reductions in that market have since then been much steeper than those envisaged by the rate setting formula which was in place before the introduction of the multi-carrier system.[80]

Competition has also gradually increased in the market for mobile telecommunications, despite the fact that SUBTEL could certainly have been quicker in defining and allocating spectrum frequencies in order to multiply the number of operators competing in that segment of the market. In 1988, three licence territories, together covering the whole country, were established for the provision of mobile services and licences were granted in such a way that two companies operated in each territory. Competition substantially intensified only recently however, after three new mobile licences were awarded in 1996 and ENTEL, which had obtained two of those licences, set up a new nation-wide PCS network. This increase in competitive pressure prompted mobile companies to lower their rates by 50 percent in 1998.[81]

In the fixed local market, competition appears to be slowly emerging as well and antitrust authorities decided in 1999 to subject only dominant operators to the price control regime in that market. Competition for the provision of local services does however remain very limited. One obstacle to competition was the absence, until the last rate setting process in 1999, of any specific rules on the pricing of unbundled elements of the local network. As a result, would-be competitors found it very difficult

[78] For example, in 1988 and 1989, CTC required payments from those who had requested a telephone line up to two years before the lines were actually provided. In addition, CTC discriminated between users by announcing that it would register requests for new lines, sold at a high price, up to a given date, and by starting, some time later, a new registration campaign for lines to be sold at a lower rate. The antitrust authorities intervened only in 1993 to condemn that conduct but judged that too much time had elapsed since the conduct had taken place to warrant imposing penalties upon the company. See P. Serra, *La Politica de Competencia en Chile*, (1995) 10/2 Revista de Analysis Economico, 72.

[79] See Law no. 19302 of 1994.

[80] For example, in 1997, a call from Chile to the USA cost US$ 0.34 per minute, while the price cap for such a call would have been set at US$ 2.40 per minute according to the previous rate setting formula. See L. Guash and P. Spiller, as note 72 above, at 120.

[81] See E. Bitrán et al., *Privatizing and Regulating Chile's Utilities, 1974–2000: Successes, Failures, and Outstanding Challenges*, in G. Perry & D. Leipziger, Ed., *Chile: Recent Policy Lessons and Emerging Challenges*, 1999, 372–73.

to reach agreements on unbundling with CTC and had to build their own infrastructure instead.[82] The absence of number portability still hinders competition as well. As noted above, CTC's monopoly position in the local market also makes price regulation more difficult as the absence of comparable firms in the market limits the information available to the regulator and complicates the evaluation of the cost structure of a benchmark efficient firm. The price of local calls has in fact tended to rise while the price of other telecommunications services substantially decreased and commentators argue that this is due at least in part to insufficient competition and to the fact that CTC has not been forced to pass efficiency gains to its clients.[83] This view is corroborated by the fact that CTC's returns are now higher than the returns earned by long distance companies even though the regulated provision of local services presents fewer commercial risks than the provision of long distance services in a competitive environment.[84]

Competitive auctions have been used, *inter alia*, to channel public subsidies to universal service providers in charge of improving telecommunications access in poor urban and rural areas. This initiative, launched in the mid 1990s, was particularly well designed. Licences were allocated to those requiring the smallest subsidies and the licences which were granted were not exclusive in order to maximize competitive pressures. In addition, the operators' obligations were limited and clear—mainly to install at least one public phone in each locality of the franchise territory—and the operators remained largely free to choose the technology and project design which would prove most cost effective. Finally, as the operators received their subsidy in a lump sum, without indexation, after the facilities were completed, they had clear incentives to ensure that the telephones would become operational as soon as possible.[85] The Chilean universal access programme has been extremely successful and it is widely considered today as international best practice.[86]

When comparing the evolution of end user prices, quality of service, and operators' rate of returns in the different market segments, it is clear that in Chile, vigorous competition has been a much more potent way to bring about, and spread the benefits of, efficiency gains than price regulation. Some commentators have argued that allowing companies to operate in different segments of the telecommunications market, as is currently the case in Chile, might however promote anti-competitive behaviours and hinder the development of truly competitive markets, especially when

[82] See J. Rosenblut, *Telecommunications in Chile: Success and Post-Deregulatory Challenges in a Rapidly Emerging Economy*, (1998) 51 Journal of International Affairs 7.

[83] See L. Guasch and P. Spiller, as note 72 above, at 116.

[84] See E. Bitrán et al., as note 81 above, at 337.

[85] See B. Wellenius, *Extending Telecommunications Services to Rural Areas—The Chilean Experience*, (1997) 105 Viewpoint 2.

[86] In the 1980s, when the network was far less extended and localities without phone easier to connect, the Government paid US$ 6 million to the incumbent operators to install only 300 rural phones, an average cost of US$ 20,000 per phone. By comparison, average subsidy per phone for the first set of auctioned projects in 1995 was only US$ 1,900. In addition, public subsidies leveraged substantial private investments: the US$ 2.1 million of public commitments in 1995, for example, leveraged private investments of about US$ 40 million. See B. Wellenius, as note 85, above.

some companies operate both in regulated and in unregulated market segments. While allowing companies to operate in various segments of the market does undoubtedly present some risks, it has some advantages as well. For example, the fact that CTC and ENTEL have been able to launch activities into each other's markets has probably accelerated the introduction of effective competition for the provision of some services. And today, it is the drive of some operators to offer the whole range of telecommunications services—because these operators see this as an essential condition to remain competitive in the Chilean telecommunications market—which is progressively increasing competition in the provision of local services.[87] In addition, at this stage, forcing companies to focus on a single segment of the market and to divest themselves of their subsidiaries operating in other segments would eliminate some potential economies of scope and entail substantial restructuring costs. These factors would have to be weighed against the potential advantages of complete market segmentation before taking a final decision in that respect. So far, the option adopted by Chilean authorities—i.e. to let companies operate in different segments of the market but only if they set up separate subsidiaries, and to sanction cross-subsidies between regulated and unregulated activities—appears to be working reasonably well, as demonstrated by the level of competition present in most segments of the market.

B. Specificity vs. coherence

The regulatory framework of the first part of the 1980s emphasized, overall, coherence over specificity. A sector-specific regulator had been in place since 1977 and the 1982 Telecommunications Law did provide for the award of telecommunications licences and for the imposition of technical standards upon all licensees. But few other sector-specific features existed. For example, the 1982 Law stated that the types of services to be subjected to price regulation would be identified by economy-wide antitrust authorities and very little was said about the regulated price regime except that it had to be cost-based. As noted above, implementation of the 1982 Law revealed some problems with the pricing of regulated services and the 1987 Law sought to remedy these deficiencies by introducing a detailed telecommunications-specific price regime. Similarly, it appeared in the late 1980s and early 1990s that the antitrust authorities were very slow in determining exactly which operators could compete in the long distance market and under what conditions. Once again the situation was clarified by law when legislative provisions were introduced in 1994 to specify the conditions under which local and long distance companies could enter each other's markets and to launch the multi-carrier system.[88]

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[87] P. Spiller and C. Gardilli, *The Frontier of Telecommunications Regulations: Small Countries Lead the Pack*, (1997) Journal of Economic Perspectives, 135.

[88] See L. Guasch and P. Spiller, as note 72 above, at 122.

It would be wrong, however, to construe these changes as simply reflecting a shift away from cross-sector consistency toward telecommunications specificity. Indeed, the new legislative provisions were instrumental in fostering competition in almost all segments of the telecommunications market, *inter alia* because they provided a firm basis to establish interconnection prices and determined the conditions under which one company could provide services in different markets. This in turn, made it possible to progressively reduce the number of services subjected to the telecommunications-specific price regime (as indicated above, the provision of long distance services was deregulated in 1994, and the provision of local services by non-dominant operators was deregulated in 1999). In the Chilean case, it can thus be argued that the adoption of some specific rules did in fact reduce rather than increase the extent of sector-specific regulation.

Overall, it can be argued that the Chilean model as it stands today represents a rather good compromise between cross-sector coherence and sector-specificity. One could argue, however, that the system might still be too sector-specific in some respects. For example, application of the 1997 price setting regime could be extended to other infrastructure activities characterized by increasing returns to scales and limited competition. Also, the need for a telecommunications-specific regulator could be reviewed with a view to determine whether an infrastructure-wide regulator could be set up instead, or whether all economic regulation in telecommunications could be left to economy-wide authorities such as the antitrust authorities.[89] And the need for sector-specific norms and technical standards could be reassessed when services are provided under competitive conditions. On the other hand, telecommunications-specific rules on number portability should probably be added to the regulatory framework.

C. Flexibility vs. certainty

The Chilean model, as it currently stands, certainly puts strong emphasis on the certainty of the regulatory framework. At first, as noted above, operators, and antitrust authorities, were granted wide discretion to determine interconnection prices and the Government, SUBTEL and the two main operators also had wide latitude to determine the prices of telecommunications services. With the adoption of the 1987 and 1994 laws, the situation substantially changed, however: the price setting mechanism is very sophisticated and extremely specific, leaving little room for discretion to the regulator; the conditions under which competition is allowed in the different segments of the market is now unambiguously defined; and those detailed rules are embedded in laws, which tend to be difficult to modify, particularly in Chile where presidents might not necessarily be backed by a majority in Parliament and

[89] Such an option could probably be envisaged only if antitrust bodies were substantially strengthened, as explained below.

where the need for compromises between the executive and legislative branches might therefore make it rather difficult to amend the legislative framework.[90] In addition, the decision to transfer a certain percentage of CTC's and of ENTEL's shares to the companies' employees and to the public at large, particularly through the holdings of the pension funds, was taken to foster support for the privatization of the utilities and to make a future reversal of the reforms unlikely.[91]

This is not to say, however, that no effort has been made at providing at least some measure of flexibility. For example, the scope of telecommunications services subjected to price regulation can be reviewed at any time by the antitrust authorities and the prices which are regulated are maximum prices, thus leaving regulated companies flexibility to adjust prices downwards if technological or market conditions warrant it. In addition, the fact that the Executive directly exercises some regulatory functions—for example, it is the Minister of Transport and Telecommunications who formally grants licences, and it is the Ministers of Telecommunications and Economy who formally adopt the pricing formulas applicable to regulated services—introduces a small, albeit unwarranted, degree of uncertainty in the regulatory process.

It can be argued that the strong emphasis on limiting discretionary power and on ensuring a high degree of regulatory stability is justified in a country such as Chile, whose regulatory institutions are far from perfect (this point will be developed below) and whose main objective has been to attract private operators and investors to promote competition and network development in an environment which is that of a developing country, and which is therefore likely to be perceived as relatively risky by most investors. In order to increase, yet further the certainty of the regulatory framework, the direct regulatory powers of the Executive could be reduced. In addition, some limited changes could be made, which would increase flexibility without jeopardizing the stability of the regulatory framework. Thus, for example, while defining the price regime by law and imposing that the pricing formulas remain in place for five years is probably wise both to provide sufficient certainty to investors and to give them strong incentives to limit costs, price caps could be set for baskets of services rather than for individual services in order to provide increased pricing flexibility which is an important advantage in the fast-changing telecommunications sector. Similarly, while the elaboration and monitoring of technical standards might be justified under price-cap regulation to ensure that regulated companies do not lower quality in order to decrease their costs, there should be room, as argued above, for eliminating or at least substantially reducing such regulatory activities for services which are now unregulated and provided in a fully competitive environment.

[90] See A. Galal, as note 69 above, at 28.
[91] See B. Levy and P. Spiller, as note 74 above, at 21.

D. Regulatory competence and ability to resist undue pressure

Several commentators have pointed out that SUBTEL has difficulty retaining its best staff, because its budget is rather limited and because the remuneration of its staff is set at civil service levels.[92] Given the complexity of the regulated price regime that SUBTEL has to administer, and the informational disadvantage that any regulator usually has *vis-a-vis* the regulated industry, any shortcomings regarding the technical capacity of SUBTEL's staff should be a serious cause of concern. The risk is that the regulator might not always be able to properly evaluate the tariff proposals submitted by the operators and might, at times, be unduly influenced by potentially better qualified experts hired by the regulated companies. Some authors contend that this is part of the reason why, in markets which are not yet effectively competitive, telecommunications operators have not been forced to pass efficiency gains to their clients.[93]

Competence is a problem as well for the various antitrust commissions in charge of monitoring implementation of the Competition Law, but for slightly different reasons. While the members of the commissions are not paid, they hold other offices and are, in some cases, highly trained professionals. The problem, however, is that since their regulatory mandate is non-remunerated and comes in addition to their "main" functions, commissioners tend to have insufficient time to devote to their regulatory responsibilities. In addition, the short duration of their mandate—two years only—leaves them little time to acquire expertise in the most difficult and specific aspects of the job. Finally, the courts, which can review regulatory decisions on appeal, on both substantive and legal grounds, are staffed with lawyers who are usually considered as generally competent but who lack, however, the experience and qualifications required to solve highly technical issues of economic regulation.[94]

Protection against undue influence by industry and by political authorities appears to be a problematic issue as well. Wages are much higher in the industry than in SUBTEL and that there are no provisions to limit the ability of SUBTEL's staff to seek employment in regulated companies. As a result, there is evidence that after a relatively short time with SUBTEL, the agency's best people tend to work for the operators, which spawns the risk of industry capture.[95] The Executive is also in a position to exert pressures upon SUBTEL, since SUBTEL is part of the Ministry of Transport and Telecommunications and since the Head of the regulatory agency is designated by the Minister of Transport and Telecommunications[96] and can be removed at will by the Executive.[97] In addition, an agency headed by a single person is arguably more at risk

[92] See E. Bitrán et al., as note 81 above, at 339.
[93] See E. Bitrán and P. Serra, *Regulation of Privatized Utilities: The Chilean Experience*, (1998) 20 World Development, 946.
[94] Id. at 75.
[95] See L. Guasch and P. Spiller, as note 72 above, at 115.
[96] See Decree Law 1762 of April 1977, article 13.
[97] See E. Bitrán and P. Serra, as note 93 above, at 960.

of industry or government capture than agencies headed by several commissioners. Finally, there is room for direct regulatory decision making by the Executive as pointed out above. Other regulatory players, such as the antitrust commissions and the courts appear better able to resist both industry and government pressures and have established a reputation of independence.[98]

While the various shortcomings of Chile's regulatory institutions are somewhat mitigated by the fact that the main rules, which are embodied in laws, are hard to change and leave relatively little discretion to the regulators, there is no doubt that much could be gained by strengthening the regulatory institutions. Reducing the direct regulatory powers of the Government would be a step in the right direction, as suggested above. Exempting SUBTEL from civil service salary rules and preventing its staff from accepting jobs in the telecommunications industry for some time after they leave the agency would help enhance SUBTEL's technical capacity and protect it against industry pressures. Conferring regulatory responsibility to a cross-sector or economy-wide body, headed by a commission rather than a single individual, and designing nomination and removal processes for commission members which reduce the scope for arbitrary intervention by the Government could also contribute to increase regulatory capacity and to protect regulators against both industry and political capture. Finally, with some of these measures in place to bolster the credibility of other regulatory institutions, the role of the courts, on appeal, could be limited to a review of purely legal rather than substantive or factual issues, as the judges would be better qualified to handle this more limited role.

E. Regulatory accountability

Allowing appeals against regulatory decisions to be introduced before the courts undoubtedly contributes to make regulatory institutions accountable, especially given the generally positive reputation of the judiciary in Chile. One can argue that limiting the role of the courts to a review of legal rather than substantive issues, as suggested above, would not unduly compromise regulatory accountability.

Many other accountability issues have, however, been left aside. The legislation is basically mute on the need for the regulators to prepare publicly available reports of their activities, to ensure the transparency of regulatory processes, and to let interested parties present their views, for example. In recent years, some steps have been taken to fill these gaps. For instance, in 1998, SUBTEL started publishing an annual report of its activities which is available on the internet. The other issues remain to be addressed however. Thus for example, just before the last rate setting process in 1999, the

[98] The Supreme Court, for example, insisted that the seizure of several factories by their workers were illegal, in spite of the assertion by the Allende administration that those seizures were valid. See A. Galal, supra note 69, at 28–29.

Chilean Association of Internet Users expressed fears that its voice would not be heard during that process.[99]

F. Regulatory costs

The direct costs of regulation are relatively limited in Chile. As mentioned above, the budget of SUBTEL is small, while the mandates of the various antitrust commissioners are not remunerated. While additional financial resources would arguably be needed to enable SUBTEL to retain their best staff, the financial resources needed to adequately regulate the telecommunications sector could still remain relatively modest. Indeed, the body of sector specific rules is limited and could even be narrower if technical regulation was kept to a minimum in the segments of the market where competition has effectively been introduced.

There are, however, three categories of indirect regulatory costs which have been, or still are, substantial in Chile. First, uncertainties in the 1982 Telecommunications Law gave rise to complex antitrust disputes which were costly for the parties involved and produced pro-competition outcomes only after long delays. Second, the wide degree of latitude left to the parties to lodge appeals before the courts against the decisions of the regulators and to obtain, in that way, a suspension of the implementation of those decisions, also led to a large number of judicial proceedings. The problem has been recently addressed, at least in part, by requiring hefty deposits to discourage frivolous complaints (limiting the grounds on which to introduce appeals, as suggested above, would help in this respect as well).[100] Third, the influence which the Executive retains over the regulatory process induces operators to spend substantial resources on lobbying activities.

G. Allocation of regulatory responsibilities

As mentioned above, given the weakness of many regulatory bodies and the regulatory powers left to the Executive, it certainly was wise to regulate by law some important issues, such as pricing, in great detail, and thus limit the discretionary powers of those in charge of implementing the regulatory framework. This state of affairs also justifies relying on the courts to exercise some functions. The fact that antitrust authorities are in charge of deciding whether specific telecommunications activities are provided in a sufficiently competitive environment to be deregulated is a unique and very attractive feature of the Chilean model. Indeed, antitrust authorities are arguably the best qualified to determine the intensity of competition which exists in a market,

[99] See, *Chile: Tarifas telefónicas en la polémica*, available at <http://www.noticias.com/noticias/1998/9810/n98101410.htm>.

[100] See B. Wellenius, *Regulating the Telecommunications Sector: The Experience of Latin America*, Conference on Regulation in Post-Privatization Environment, Buenos Aires, 21–22 May 1998.

and they are certainly better placed than SUBTEL to decide on this matter, as deregulation does in fact reduce the extent of the regulator's powers.

The main drawback of the Chilean model, on the other hand, relates to the excessive regulatory role and influence which the Executive can exercise. As argued above, the extent of the powers given to the courts on appeal are excessive as well and could be limited to a review of legal issues, especially if the credibility of the telecommunications regulator was increased through reforms aimed at improving its level of competency and autonomy.

VI. Australia

In Australia, during most of the 1990s, the right to provide fixed telecommunications services was reserved to two companies, Telstra, the publicly owned incumbent, and Optus, a private competitor. Mobile services could be provided by Telstra, Optus, and a third, private, operator, Vodafone. Then, in 1997, the regulatory framework was radically changed: barriers to entry into the different segments of the telecommunications market were eliminated; the provisions of the competition law, the Trade Practices Act, were declared applicable to telecommunications activities; additional telecommunications-specific rules were integrated within the Trade Practices Act, in particular on interconnection; the sector-specific regulator, AUSTEL, was eliminated; and the antitrust regulator, the Australian Competition and Consumer Commission (ACCC) was entrusted with the task of ensuring the implementation of the economic regulatory framework for telecommunications.

The Australian model, like the Chilean one, constitutes, in many ways, a compromise between the more "radical" and sharply contrasted approaches of the United States and New Zealand. The main features of the Australian model are, however, markedly different from those of the Chilean one. While Chile adopted a distinct Telecommunications Law and established a sector-specific regulator (respectively less detailed and less powerful than those of the US), Australia chose to integrate many of the telecommunications-specific rules into its antitrust legislation and to give responsibility to apply these rules to the economy-wide antitrust regulator (in this latter respect the Australian model resembles the New Zealand one, but the ACCC has more power than the New Zealand Commerce Commission and the role of the courts with respect to telecommunications regulation is therefore somewhat more limited in Australia than in New Zealand). These specific features of the Australian model make it an interesting object of comparison with the other three models discussed above. The Australian framework has, however, been in place for a very limited period only and the discussion of the respective advantages and disadvantages of the model must therefore be based on a study not only of how the model has actually worked in practice, but also on how well it appears to be designed and on how successfully it is therefore likely to work.

A. Competition and other incentives to generate and share efficiency gains

To complement the removal of barriers to entry, a sophisticated set of access rules were adopted in 1997. Those rules, contained in Part XIC of the Trade Practices Act, mandate access to some facilities identified by the ACCC as constituting bottlenecks for the competitive provision of telecommunications services, give priority to negotiated agreements between operators on the conditions under which access is to be granted, provide for regulatory arbitration by the ACCC when negotiated agreements cannot be reached, and enable access providers to advertise access undertakings setting out the conditions under which they are prepared to grant access, provided the ACCC declares that the terms of such undertakings are acceptable.[101] The ACCC developed access pricing principles which are to be used when the ACCC arbitrates access disputes or determines whether access undertakings are acceptable.[102] The model to be used to calculate access prices, the total service long run incremental cost model (TSLRIC), is very similar to the US TELRIC model.[103]

As is the case in the United States, some commentators have argued that mandating access for some categories of services is a mistake because it will reduce facilities-based competition and that application of the TSLRIC method, like application of the TELRIC formula, will result in interconnection prices which are too low to enable incumbents to recover the full cost of providing interconnection services.[104] The arguments presented on this issue under Section III, above, apply here as well.

Prices of end-user services, for their part, are regulated using both relatively demanding price caps on a basket of main services and less demanding price caps on some individual residential services.[105] These caps are maximum prices only, and therefore fully compatible with a competitive regime. In addition, as the caps remain fixed for several years, they provide strong incentives to the operators to reduce costs and enjoy higher than expected profits until the next rate setting.

The Australian regulatory framework also provides for mechanisms which should make it possible to meet universal service obligations in an efficient way. As in Chile, competitive bidding processes can be used to select the providers requiring the lowest subsidies to provide universal service. Different providers can be selected to cover

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[101] See Trade Practices Act, ss. 152AL, 152AY, and 152BV.

[102] ACCC, *Access Pricing Principles—Telecommunications*, July 1997.

[103] For a discussion of the access pricing principles, see Peter Waters, *LRICal Access: The ACCC's Pricing Principles*, Gilbert Tobin, 1997, available at <http://www.gtlaw.com.au/gt/pubs>.

[104] See, for example, R. Maddock and A. Marshall, *Access Regulation: The New Australian Model*, (1997) 6 Utilities Policy 73.

[105] On 1 January 1996, a price cap of Consumer Price Index (CPI) minus 7.5% was applied to Telstra's charges for a revenue weighted basket of services including: connections; line rentals; local, trunk, and international calls; cellular services; and leased lines. A price cap of CPI minus 1% was imposed, at the same time, on each of the following individual services: connections; line rentals; trunk and international calls. See ACCC, *Telecommunications Industry—ACCC Role: An Outline*, 1997, 51, available at <http://www.accc.gov.au/docs/teleinf/httoc.htm>.

different areas or to provide different services in the same area, which should facilitate yardstick competition between the different operators. Finally, all telecommunications operators must contribute to the costs of universal service provision in proportion to their share of total telecommunications revenues in order to avoid distortions of competition between those who take on responsibility for universal services and those who do not.[106]

It is still early to pass final judgment on the extent to which the regulatory framework is successful, in practice, in fostering competition and in keeping prices down. As in the other three countries discussed above, interconnection has proved to be a particularly contentious issue. The ACCC has initiated or completed arbitration processes with respect to a number of access disputes between new entrants and Telstra: some of these disputes relate, for example, to the price of access to Telstra's fixed long-distance network as well as to the price and conditions of access to Telstra's GSM mobile network.[107] A 1999 study of telecommunications charges in Australia found that Telstra's charges for national long distance appear to be about average for developed countries while the prices of international calls are above average.[108] Mobile prices appear to be among the lowest in the world,[109] however, and there are signs that Australia's new pro-competition framework is working, as access disputes are being resolved relatively rapidly by the ACCC and new entrants are beginning to offer services in the different segments of the telecommunications market.

Some authors argue that, as in New Zealand, insufficient attention was paid in Australia to the need for structural reforms in the telecommunications sector.[110] Some of them consider that the creation of Telstra through the merger, in the early 1990s, of Australia Telecom and Overseas Telecommunications Commission, the two publicly owned operators which provided domestic and international services respectively, reinforced the market power of the dominant player, thus making the telecommunications market less competitive and complicating to this day the task of the regulator which appears to have difficulty in obtaining accurate information on Telstra's costs.[111] In that context, as discussed with respect to New Zealand under Section IV, above, it might be advisable to consider whether some structural reforms of the telecommunications sector could help introduce more competition and generate more information, but the costs of such measures would have to be fully taken into account.

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[106] See Telecommunications Act 1997, ss. 147 to 156.

[107] See, for example, See ACCC, *Telecommunications—Access Disputes*, available at <http://www.accc.gov.au/media/mr015-99.html>.

[108] See ACCC, *Telecommunications Charges in Australia*, available at <http://www.accc.gov.au>.

[109] In 1999, a basket of 100 minutes of cellular services cost US$ 21.99 in Australia, compared to US$ 37.13 on average in 42 high income countries. See ITU, *World Telecommunications Development Report*, 1999.

[110] See, for example, P. Waters, *The Mystery of the Missing Ring Fence—Regulation of Vertically Integrated Telecommunications Operators*, Gilbert Tobin, 1998, available at <http://www.gtlaw.com.au/gt/pubs>.

[111] See P. Leonard, *Footprints Down a Narrow Path #2: Lessons of Australian Telecommunications Regulation, 1991 to 1997*, Gilbert Tobin, 5–6 (1997), available at <http://www.gtlaw.com.au/gt/pubs>.

B. Specificity vs. coherence

While establishing some telecommunications-specific rules—in particular on interconnection and on number portability—the Australian authorities have tried to take into account the growing similarities between telecommunications and other economic activities by bringing the regulation of telecommunications more closely in line with the general antitrust regime. Thus, in Australia, the general antitrust rules of the Trade Practices Act are applicable to telecommunications, many sector-specific rules have been integrated in the Act, and these various rules are administered by the economy-wide antitrust regulator. In addition, the Minister for Communications and the Arts must arrange for a review of some of the telecommunications-specific rules to determine whether they are still justified.[112]

In spite of the Government's efforts to align the regulatory regime applicable in telecommunications with the antitrust regime applicable in the rest of the economy, one could however argue that there are still too many telecommunications-specific rules. Four different sets of rules co-exist in the Trade Practices Act, which could be used in some cases to tackle the same problems: (i) economy-wide antitrust rules, contained in Part IV of the Trade Practices Act, prohibiting, *inter alia*, the misuse of market power; (ii) telecommunications-specific rules, contained in Part XIB of the Trade Practices Act, which strengthen the general antitrust regime, *inter alia* by providing for stiffer penalties and by expanding the scope of the concept of misuse of market power to include behaviours which lessen competition in telecommunications even if no anti-competitive purpose is established; (iii) infrastructure-wide access rules integrated in the antitrust legislation as Part IIIA of the Trade Practices Act in 1995 to facilitate access to all "services of national significance"; and (iv) the telecommunications-specific access rules described above, which constitute Part XIC of the Trade Practices Act and which are derived from Part IIIA rules. The complexity of this regulatory framework suggests that the need for some sector-specific rules has been exaggerated.[113] For example, it is not clear why there should be two slightly different definitions of the concept of misuse of market power, one for telecommunications and one for all other economic activities. A similar point can be made with respect to Part IIIA and Part XIC: if the access regime under Part XIC improves upon the one established under Part IIIA, why not adopt a unique access regime for all sectors based upon Part XIC rules?

C. Flexibility vs. certainty

The Australian approach constitutes an interesting attempt to combine flexibility and certainty. Thus, for example, the primary objective of Part XIC access rules is to

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[112] See Trade Practices Act, Section 151CN.

[113] See G. Taperell and R. Dammery, *Anti-Competitive Conduct in Telecommunications: Are Supplementary Rules Required?*, (1996) 4 Competition and Consumer Law Journal.

promote the long-term interests of end-users (LTIE), a concept which is rather vague and which leaves therefore a large degree of flexibility to the ACCC when it assesses access matters.[114] Also, the most stringent price caps are imposed not on individual services but on a basket of services, which leaves the operator free to adapt to changing circumstances by rebalancing tariffs within the basket. On the other hand, certainty with respect to the access regime is enhanced in a variety of ways: the ACCC has produced a discussion paper on the way it would assess the LTIE; the ACCC has also produced pricing principles which it applies when determining access prices; and overall, the process to be followed to determine access conditions under Part XIC is set out in details. In addition, some price caps on individual residential services complement those imposed on baskets of services in order to limit the extent to which price rebalancing can take place within a basket and thus provide some degree of protection to residential users.

Some aspects of the Australian regime are however likely to draw criticism. For example, the Minister for Communications and the Arts can exercise broad powers *inter alia* with respect to the pricing of universal service[115] and the adoption of performance standards in telecommunications.[116] Such rules, which leave a large degree of discretionary power to a political authority on issues which can have a substantial impact on the profitability of telecommunications operators are likely to raise private investors' concerns. To the extent that the Government remains one of Telstra's shareholders, these concerns will be even greater as there are clear conflicts of interests between the ownership and the regulatory functions exercised by the Government.[117] Also, the existence, within the Trade Practices Act, of multiple rules potentially applicable to the same issues could potentially lead to incoherent decisions, thereby introducing an unwarranted degree of uncertainty in the regulatory framework.

D. Regulatory competence and ability to resist undue pressure

Australia has adopted, in telecommunications, an administrative rather than a judicial regime: it is the ACCC which takes many of the important regulatory decisions while the role of the Federal Court is limited to a review of those decisions on purely legal rather than on substantive or factual grounds. The ACCC is staffed, for the most part, with specialists in matters of economic regulation. In addition, the cross-sector nature of the ACCC enables its staff to gain expertise from work in other sectors. Also, the ACCC now comprises a specialized Telecommunications Group,

[114] See Trade Practices Act, s. 152AB. For a discussion of the concept of LTIE, see A. Peters, *Competition in Telecommunications: Promoting the Long-term Interests of End-users*, (1998) 5 Competition and Consumer Law Journal 272–292.

[115] See Telecommunications Act 1997, s. 172.

[116] Id. at ss. 234 and 243.

[117] See P. Leonard, as note 111, above.

which should help to ensure that at least some ACCC staff possess in-depth knowledge of the telecommunications sector.

Some measures have been taken to ensure the independence of the ACCC from industry players and some degree of autonomy *vis-à-vis* political authorities. For example, conflicts of interests rules are in place to force commissioners to disclose interests which could conflict with the proper performance of their functions and to prevent commissioners from participating in the determination of specific cases when such conflicts of interests arise.[118] Also, while members of the Commission are appointed by the Governor-General, without intervention by Parliament or by the Judiciary, grounds for terminating the appointment of a commissioner are precisely specified and enumerated.[119] Finally, as in New Zealand, the Government may give directions to the Commission, but no directions can however be given in relation to Parts IIIA, IV, XIB, or XIC of the Trade Practices Act.[120] In addition, as the ACCC operates across all sectors of the economy, commissioners are therefore likely to have only limited contacts with particular operators or sector ministries, which decreases the risks of regulatory capture. The regulatory model does however leave some room for political intervention in the regulatory process because of the important powers which it leaves to the Minister for Communications and the Arts, as pointed out above.

E. Regulatory accountability

Important steps have been taken in Australia to ensure regulatory accountability. As noted above, appeals can be lodged before the courts against the decisions of the ACCC. The ACCC publishes, on the web, reports of its activities.[121] In addition, the Australian regulatory model is characterized by the scope which it leaves for stakeholder consultation. The industry plays a large role in shaping regulations: thus for example, the Telecommunications Access Forum (TAF), an association which must be open to all providers of telecommunications infrastructure, can recommend to the ACCC that it mandate access to some specific bottleneck facilities;[122] the TAF can also propose standard access undertakings to the ACCC on behalf of the industry;[123] and individual operators can propose individual access undertakings to the ACCC as mentioned above. The ACCC must, in addition, hold public inquiries before it can mandate access to bottleneck facilities, unless the TAF had recommended to the ACCC that it did so,[124] and the ACCC must invite public submissions before it can accept an individual

118 See Trade Practices Act at s. 17.
119 Id. at s. 13.
120 Id. at s. 29.
121 See <http://www.accc.gov.au>.
122 See Trade Practices Act, s. 152AL(2).
123 Id. at Sections 152BH and 152BF.
124 Id. at s. 152AL(3).

operator's proposed access undertaking.[125] Finally, a Telecommunications Industry Ombudsman (TIO) has been set up to investigate users' complaints.[126]

F. Regulatory costs

Efforts have been deployed in Australia to limit regulatory costs in telecommunications. For example, conferring the main regulatory responsibilities to an economy-wide body such as the ACCC is generally more cost-efficient than setting up a variety of distinct sector-specific regulatory agencies (the ACCC devotes only about AU$ 2.2 million per year on telecommunications issues). Measures have also been adopted to avoid long and costly litigation on interconnection issues by promoting industry-designed solutions and by granting to a specialized body, the ACCC, the power to arbitrate when a negotiated agreement cannot be found. On the other hand, the resources allocated to the technical regulation of telecommunications appear relatively high. A specialized agency, the Australian Communications Authority (ACA), is responsible for most technical aspects of telecommunications regulations.[127] It is, for example, responsible for managing the radio-electric spectrum and for developing and monitoring the application of performance standards.[128] With about 470 staff and a budget of about AU$ 50 million, the ACA has far more resources to perform those functions than does the ACCC to deal with the economic aspects of telecommunications regulation.

G. Allocation of regulatory responsibilities

As in New Zealand, the allocation of responsibilities with respect to economic regulations of telecommunications appears to be clear. One source of concern, however, stems from the way responsibilities are shared between the ACCC and the ACA. For example, it is the ACCC which administers the price control regime which applies to various telecommunications services while it is the ACA, on the other hand, which is in charge of developing performance standards and of monitoring the performance of telecommunications operators. The ACCC's and ACA's responsibilities are therefore closely inter-related since a modification of performance standards will affect the operators' costs and therefore the prices at which they can maintain the same level of profitability. In order to try to ensure that both institutions will adopt coherent decisions, the Australian legislation provides for a degree of coordination between the ACCC and the ACA. For example, the ACA must consult the ACCC on a number of matters including, for example, variations of technical

[125] Id. at s. 152AH.
[126] See A. Stuhmcke, *The Corporatisation and Privatisation of the Australian Telecommunications Industry: The Role of the Telecommunications Industry Ombudsman*, (1998) University of New South Wales Law Journal 807.
[127] See Australian Telecommunications Authority Act, s. 14.
[128] See Telecommunications Act 1997, s. 234.

standards.[129] In addition, to further reduce the risks of conflicts or overlaps between the two institutions, the Chairperson of the ACA is currently an associate member of the ACCC, while a member of the ACCC is an associate member of the ACA. It remains to be seen whether these measures will be sufficient to prevent slow or incoherent decision-making processes.

VII. Comparative Analysis

This Section seeks to compare the experiences of the United States, New Zealand, Chile, and Australia in an attempt to draw some lessons on how to design, and balance the relative importance of, the different components of the regulatory framework in order to ensure that the seven objectives identified in Section II are met to the largest possible extent.

A. Competition and other incentives to generate and share efficiency gains

All four countries have now established what are some of the most competitive telecommunications markets in the world. In each case, all explicit legal barriers to entry into any segment of the telecommunications market have been removed and general antitrust rules are fully applicable to the telecommunications sector. Beyond that, however, the options chosen to generate and share efficiency gains in telecommunications differ in substantial ways among the four countries.

New Zealand constitutes a good benchmark of what can be achieved with few additional rules. In New Zealand, general antitrust rules constitute the main component of the framework for the economic regulation of telecommunications and implementation of those rules has yielded satisfactory results with respect to some issues such as the imposition of dial parity for example. With respect to interconnection, on the other hand, New Zealand's light-handed approach left much to be desired as operators often proved unable to reach negotiated agreements while the courts were unable to formulate specific decisions on the level of interconnection prices, even after very long judicial proceedings. Chile, which had at first adopted only relatively vague rules on interconnection, had a somewhat similar experience until a much more detailed pricing regime, to be applied by a specialized regulator, was adopted in 1987. In view of these experiences, the best option, which is the one adopted in Chile after 1987 and in the United States and Australia as well, is arguably to adopt a detailed interconnection regime and to confer responsibility for implementing such a regime to a specialized regulatory entity.

The incentives given to operators to open local markets to competition might however not be optimally designed in the United States: by conditioning the entry of

[129] See ACCC, as note 65 above, at 46.

the Bell companies into the long distance market to the effective opening of local markets to competition, the 1996 Telecommunications Act might in fact have contributed to delay, rather than to accelerate, competition in local services. On the whole, limiting the regulation of interconnection to the imposition of precise conditions of access to certain bottleneck facilities, as in Chile and Australia, might well yield the best results.

While interconnection costs, in the absence of negotiated agreement between the parties, are supposed to be calculated on the basis of the incremental costs of providing the service in both the United States and Australia, in Chile, on the other hand, they are supposed to cover the costs of a benchmark efficient firm. The Chilean approach has the advantage, at least in theory, that it does not require evaluating the actual costs of the regulated companies and that it can provide stronger incentives for cost minimization. On the other hand, evaluating the costs of a benchmark efficient firm might constitute a particularly difficult exercise, especially in a country where there are no obvious yardsticks, as the regulated owner of the local loop has a quasi-monopoly in the local market.

Unlike New Zealand, the US, Chile, and Australia are also regulating the prices of some end-user services. There is evidence that Telecom might have unduly benefited from the absence of price regulation in New Zealand and has been able to earn substantial profits. On the other hand, while the price cap regimes adopted in Chile and Australia provide, in theory, strong incentives for cost reduction on the part of the operators (particularly in Chile where end-user prices, like interconnection prices, are regulated in relation not to actual but to benchmark costs), it appears that in these two countries, price regulation has in fact been much less successful than effective competition in promoting efficiency and keeping prices low. The Australian regulator appears to have difficulty evaluating the costs of Telstra and in Chile, prices which had been regulated for years because of lack of competitive pressures decreased sharply in market segments where effective competition finally spread and where, consequently, price regulation was in fact suspended.

All four countries have imposed universal service obligations to telecommunications operators. It is the Chilean experiment which has, by far, produced the most impressive results. The Australian model appears to be well designed also, as it shares many of the features which made the success of the Chilean scheme: it makes it possible to competitively select the operators on the basis of the lowest subsidies required to provide universal service and it enables different providers to operate in different geographic or service markets thereby establishing the conditions for yardstick competition. The US system, for its part, also leaves open the possibility of having several universal service providers within a designated area and it seeks to ensure, through price regulation, that universal service providers' compensation covers no more than the real costs of providing the service, but it does not envisage competitive selection of universal service providers on the basis of the level of subsidies required. Finally, serious distortions of competition appear to be possible in New Zealand since a single operator is chosen, *ex ante*, to provide universal service and there does not seem to be any guarantee that the fees levied upon all operators to compensate the universal service provider are adequately calibrated to cover the true costs of the service.

On the whole, the market for fixed local services remains, in the four countries, the segment of the telecommunications sector where effective competition has yet to be fully introduced. The provision of fixed long distance services appears to be most competitive in the United States and in Chile (see Table 1 below). In the United States, the markets for local and long distance services remained separated until 1996 but strong competition had, by that time, developed between different long distance providers. In Chile, the markets remained quasi-separate as well until 1994 and, unlike in the US, were each monopolized by one dominant operator. From 1994 onward, the multi-carrier system, and the strength of the local operator's challenge in the long distance market quickly introduced a substantial degree of competition in the provision of long distance services. Both New Zealand and Australia might have been somewhat handicapped by the presence of a dominant company operating in both the local and the long distance market. In addition, the introduction of strong competition might have been hampered by long judicial processes to settle interconnection disputes in New Zealand, and by the fact that the telecommunications market remained a legal duopoly until 1997 in Australia.[130]

Finally, in the market for mobile services, New Zealand pioneered the allocation of spectrum rights without preventing the resale of those rights and without specifying the exact use to which the frequencies had to be put, in an attempt to ensure that the spectrum would, at all time, be put to the uses generating the highest returns. So far, however, the prices of cellular services remain relatively high in New Zealand. New Zealand might suffer, in that respect, from the small size of its market and from the fact that only two operators compete in that market (even though three mobile licences have been awarded). In Australia, three operators have been competing since the early 1990s and in the United States and Chile, prices substantially decreased only after at least three operators started to operate in any given geographic area.

TABLE 1: LONG DISTANCE PRICES IN CHILE, USA, NEW ZEALAND, AND AUSTRALIA (1997)

	Chile	USA	New Zealand	Australia
Price per minute (US$)				
– Domestic long distance	0.17	0.15	0.47	0.25
– To the USA	0.34	–	1.22	1.02
– From the USA	0.51	–	0.39	0.45

Source: Pablo Spiller and Carlo Gardilli, *The Frontier of Telecommunications Regulations: Small Countries Lead the Pack*, (1997) Journal of Economic Perspectives, 136.

[130] P. Spiller and C. Gardilli, as note 87 above, at 136.

Some authors have argued that in New Zealand, Chile, and Australia, structural reforms of the telecommunications market should have been implemented to ensure the emergence of a more competitive market structure or to facilitate regulation of the incumbent. The presence of dominant operators in one or more segments of the market and the absence of comparable firms in those segments might indeed have stifled competition or made regulation more difficult. In the US, while the local market is still dominated by the regional local operators, there are at least several comparable companies operating in different regions of the country. This makes regulation easier and reduces the risk that any company will be able to use its dominant position in the local market to stifle competition in the long distance market as a whole. This probably explains why relatively few commentators seem alarmed by the possibility which the 1996 Act gives to BOCs and long distance operators to launch activities into each other's markets. As mentioned above, however, the benefits to be derived through structural reforms in any given market must be weighed against the costs which such restructuring would impose upon the companies concerned as well as the risks that an imposed separation between different types of services might become artificial and unduly costly because of rapid technical evolution.

B. Specificity vs. coherence

The United States model, with its emphasis on detailed sector-specific rules applied by a sector-specific regulator, could arguably be criticized for losing sight of the growing similarities which are developing between telecommunications and other sectors of the economy, especially in a market which is as completely liberalized and which is evolving as fast as the American telecommunications market. Paradoxically, in some specific areas where the US model relies on general competition law to regulate telecommunications activities, problems arise as well. This is the case in the area of merger control, for example, where antitrust rules seem ill-suited to introduce competition in markets where none existed before. The experience of New Zealand, which relies heavily on competition law to regulate telecommunications, reveals other insufficiencies of general antitrust rules. For example, those rules seem insufficiently precise to adequately solve interconnection or number portability issues; they do not distinguish between regulatory solutions which are relatively easy or very difficult to apply in practice; and their implementation could lead in some cases to sub-optimal vertical disintegration. Such problems are compounded, in New Zealand, by the lack of specialized regulators to apply the rules.

The Chilean and Australian models both attempt to strike a balance between the more extreme approaches adopted in the United States and in New Zealand, and to add to general competition law where needed without establishing an unduly specific regulatory regime. In Chile, specific rules were adopted on pricing and quality standards, for example, but the range of services to which those rules apply is determined by the economy-wide antitrust authorities. Also, some of the sector-specific rules have actually facilitated the introduction of effective competition in some segments of the market and, as a result, a growing number of services have been exempted from the application of some sector-specific rules. Some further steps could however be considered to strengthen the overall coherence of the regulatory framework, such as entrusting the main regulatory functions to an infrastructure-wide regulator or limiting the application of sector-specific norms and technical standards to services provided in non-competitive markets.

In Australia, efforts have been deployed to ensure the overall coherence of the regulatory framework by incorporating sector-specific rules within the economy-wide antitrust legislation and by conferring responsibility for implementing those rules to a single economy-wide antitrust authority. Another particularly interesting feature of the Australian model is that the need for some sector-specific rules is to be reassessed by the authorities. As mentioned above, and as is the case in Chile, still more could arguably be done to align the regime applicable to the economic regulation of telecommunications with the one adopted in other sectors of the economy. Some sector-specific rules either do not seem to add much to economy-wide or infrastructure-wide rules, or could be used as a basis for establishing a single set of better designed rules applicable to the whole economy or at least to multiple sectors.

C. Flexibility vs. certainty

As modified by the 1987 and 1994 amendments to the General Telecommunications Law, the Chilean model is arguably the one which puts the strongest emphasis on regulatory certainty: the price regime is very precise, conditions of entry into various segments of the markets are set out in details, and the overall regime is particularly difficult to modify because numerous regulatory details are embedded in laws and because the transfer of shares of the privatized companies to a wide range of stakeholders makes a reversal of the reforms unlikely. As argued above, the direct regulatory powers which are retained by the Executive introduce a small but unnecessary degree of uncertainty, and they could therefore be reduced. In addition, imposing price caps on baskets of services rather than on individual services and limiting the scope for the imposition of quality standards could probably increase flexibility without introducing much additional uncertainty. Overall, however, the Chilean regime, as it stands, appears to have served the interests of the country rather well, as it has convinced numerous private investors and operators to get involved in the telecommunications market in spite of the risks normally associated with developing economies.

New Zealand, on the other hand, has opted for the most flexible of the four regulatory models and it has arguably introduced too much uncertainty in the regulatory process. Contradictory decisions have, for example, been rendered by different courts on the same issues. Also, the reliance on government intervention to secure certain agreements between operators and the existence of a price-control regime which—although it has not been used so far—gives broad powers to the Government could certainly cause concern among investors as it opens the door to politically-motivated and unstable regulatory decisions. The New Zealand experiment with respect to spectrum rights allocation, on the other hand, appears well designed to increase flexibility without introducing unwarranted uncertainty.

Both the United States and Australia, have, for their part, striven to accommodate both flexibility and certainty requirements in more equal measures. In the United States, the risks of excess rigidity often associated with the adoption of a large set of specific rules have been reduced, *inter alia*, through the use of a broad public interest test which leaves relatively wide discretion to the FCC and through the power which is given to the FCC not to apply some provisions of the 1996 Telecommunications Act when certain conditions are met. In fact, implementation of the 1996 Act has so far been hindered less by excessive rigidity than by the uncertainty created by the absence of clear rules on some issues, such as the allocation of competencies between federal and state regulators.

In Australia, flexibility comes, in a somewhat similar fashion to that in the United States, from the discretion which is given to the ACCC through the application of the broad LTIE test. Applying price caps to baskets of services also brings a certain degree of flexibility to the price regime. A range of measures have however been adopted to maintain a sufficient degree of certainty thanks, *inter alia*, to the individual price caps which complements those imposed on baskets of services and to the guidelines and discussions papers published by the ACCC on the way it would perform its functions. However, it can be argued that the broad regulatory powers left to the Minister for Communications and the Arts with respect to the pricing of universal service and the adoption of performance standards, as well as the existence, within the Trade Practices Act, of multiple rules potentially applicable to the same issues, introduces an unwarranted degree of uncertainty in the regulatory framework.

D. Regulatory competence and ability to resist undue pressure

In the United States, New Zealand, and Australia, the specialized regulatory bodies (the FCC, the Commerce Commission, and the ACCC) strive to recruit high-caliber specialists and are generally recognized as very competent institutions. The ACCC, in particular, has both economy-wide competencies—which favour cross-fertilization of experiences across sectors—and a department specializing in telecommunications—which should facilitate the acquisition of in-depth sector-specific knowledge—a combination which appears well suited to provide a high level of expertise. In Chile, on the other hand, SUBTEL, the telecommunications regulator, has limited financial resources and therefore experiences difficulties retaining its most qualified staff, a particularly serious problem given the degree of complexity of some aspects of the regulatory regime, such as the pricing provisions. Chilean antitrust regulators, for their part, exercise their regulatory functions on a part-time basis only and their mandates are of short duration, two factors which make it difficult for them to develop the required level of expertise for the regulation of telecommunications. In addition, in both New Zealand and Chile, judges have to pronounce on legal as well as substantive issues in telecommunications regulation, a task for which they are generally ill-qualified (and the presence of a single expert lay member in the New Zealand High Court is insufficient to correct that problem).

The importance of attempting to ensure a sufficient degree of autonomy for those entrusted with the task of regulating telecommunications has been recognized in the United States, New Zealand, and Australia, and at least some measures are in place, in those three countries, to protect the regulators against undue pressures, both from political authorities and from the regulated industry. However, more could certainly be done in each of these countries to further reduce the risks of political capture and in particular in New Zealand, where the Commerce Commission must have regards to the economic policies of the Government, and where the Executive retains the power to impose price controls. The Chilean model, for its part, is the one where the risks that the regulatory process might be captured by the industry or by the Executive are highest: there are no provisions to limit the ability of SUBTEL's staff to seek employment in regulated companies; the Executive is also in a position to exert pressures upon SUBTEL, since SUBTEL is part of the Ministry of Transport and Telecommunications and since the Head of the regulatory agency can be removed at will by the Executive; and finally, there is room for direct regulatory decision making by the Executive as pointed out above. While other regulatory players, such as the antitrust commissions and the courts appear better able to resist both industry and government pressures, and while SUBTEL's lack of autonomy is somewhat compensated by the fact that the agency has limited discretionary powers, there is little doubt that much could be gained by better protecting SUBTEL's staff from undue influences.

E. Regulatory accountability

In each of the four countries, the possibility to lodge appeals against the decisions of the regulators before the courts, and the publication of reports of activities by the regulators (whether mandated by law or not) provides for some degree of regulatory accountability. Beyond this, Australia is probably the country which has done most to provide the greatest possible degree of regulatory accountability. For example, a series of measures—such as the promotion of industry-designed rules, the launch of public inquiries on a variety of regulatory topics, and the establishment of the TIO scheme—have been adopted to promote stakeholder participation in the regulatory process. In the United States, stakeholder participation is also ensured in FCC proceedings. On the other hand, in New Zealand, reliance on traditional court proceedings might not provide the best vehicle to ensure that the opinions of stakeholders who might not be parties to the disputes, such as end-users for example, are heard and taken into account, and in Chile the regulatory framework contains very few measures to ensure the transparency of regulatory processes and to enable interested parties to present their views.

F. Regulatory costs

Given the existence of a large sector-specific regulatory institution at the national level and of other regulatory bodies at the state level, and given the very detailed nature of the regulations themselves, the direct costs of establishing regulatory institutions and of complying with existing rules are much higher in the United States than in the other three countries. With very few telecommunications specialists within the economy-wide Commerce Commission and very few detailed rules, New Zealand, for its part, has kept such costs to a minimum. Both Chile and Australia are somewhere in between. Chile has a sector-specific regulator (albeit with a small budget) and the price regime imposes non-negligible compliance costs to the operators. Australia, for its part, has an economy-wide regulator but with much more responsibility than the New Zealand's Commerce Commission and regulations which are more detailed than those of New Zealand but less so than those of the United States.

When the costs of judicial proceedings, delays, and possible regulatory mistakes are taken into account, comparisons between the four models might yield somewhat different results. The US model certainly remains by far the most expensive, *inter alia* because of the long and costly judicial procedures which were necessary to define the roles of the FCC and state utility commissions. Some substantial costs are incurred in New Zealand as well, however, because of long judicial processes and because of the risks of regulatory mistakes. In Chile, the number of appeals lodged against the decisions of the regulator (at least before relatively high deposits were required to discourage frivolous complaints) and the incentives which the operators have to lobby the Executive in the hope of influencing the regulatory process entails costs as well. The Australian model appears well designed, on the other hand, to limit delays and mistakes.

G. Allocation of regulatory responsibilities

Potential problems appear to exist in each of the four countries with respect to the allocation of responsibilities for economic regulation in the telecommunications sector. In the United States, the allocation of responsibilities between the FCC and the state utility commissions is not clear, and the way responsibilities have been divided between the FCC and the DoJ under the provisions relating to mergers and to local competition might lead to inconsistent decisions or might not necessarily confer the leading role to the institution best equipped to handle it. In Australia, the risk of inconsistent decisions also arises because two different bodies have been given primary responsibility on closely interrelated topics such as price and quality regulation. In New Zealand, it could be argued that the technical competence of the specialized regulator (the Commerce Commission)—which could have been further strengthened through the hiring of additional specialists in the economic regulation of network industries in general or of telecommunications in particular—would have been put to better use if the Commerce Commission had been granted more regulatory responsibilities. Finally, the main drawback of the Chilean model relates to the excessive regulatory role and influence which the Executive can exercise. The way regulatory responsibilities have been allocated in Chile presents however one particularly attractive feature: entrusting the antitrust authorities with the task of deciding whether specific telecommunications activities are provided in a sufficiently competitive environment to be deregulated is an excellent option as antitrust authorities are arguably the best qualified to determine the degree of competitiveness of a given market and are better placed than a sector specific agency to take such decisions in an impartial manner.

VIII. Conclusions

The above analysis of the experiences of the United States, New Zealand, Chile, and Australia with respect to the economic regulation of telecommunications yields some tentative lessons on how to design the regulatory framework, and in particular on how to design the sector-specific, infrastructure-wide, or economy-wide components of that framework and on how to organize the relationships between these components. It also shows, however, that one size does *not* fit all, and that regulatory solutions must be tailored to the specific conditions and objectives of the country concerned.

While elimination of legal barriers to entry and application of antitrust law to all telecommunications activities already contribute to improve the performance of the sector as demonstrated in New Zealand, the New Zealand experience also demonstrates that additional rules are required—on interconnection and number portability issues, for example—to maximize the benefits to be derived from competition. In particular, the policies—adopted in the United States, Chile, and in Australia—of mandating access to some facilities, such as the local loop, appear justified given the power which incumbents have to thwart competition in some segments of the market. On the whole, simply imposing precise terms and conditions for access to those facilities, as the Chileans and the Australians have done, appears to be a safer strategy than conditioning entry into one market to the effective opening of another, as in the United States, since that strategy presupposes that the legislator be able to correctly assess the way in which telecommunications operators will react to the complex set of incentives presented to them.

The Chilean price regime, which regulates the prices of both interconnection and end-user services in relation to the costs of a benchmark efficient firm provides strong incentives to improve efficiency. It is, however, difficult to calculate in practice and both the Chilean and the Australian experiences tend to demonstrate that regulating prices, even according to rules which seem well designed is a much less efficient way of fostering efficiency than ensuring effective competition between operators.

The four countries have allocated spectrum rights through competitive auctions. New Zealand has in addition pioneered auctions which leave a wide degree of flexibility regarding the way the spectrum is to be used, in order to generate maximum economic returns. So far, New Zealand mobile users do not seem to have greatly benefited from the process, however. This might well be due to the small size of the New Zealand market and to the small number of mobile operators competing in New Zealand, and it is likely that the New Zealand system of spectrum right allocation would yield greater benefits in larger and more competitive markets. In this regard, the FCC plan to allow the creation of a secondary market in spectrum rights in the United States is very promising.[131] Competitive bidding has also been used in Chile to extend the provision of universal services in poor and remote areas and results have been truly impressive. The Australian universal service model, which shares many of the features which made the success of the Chilean one appears well designed as well, but the US and New Zealand systems exhibit for their parts some anti-competitive traits.

Some commentators have argued, with respect to New Zealand, Chile, and Australia, that market structure reforms would be needed to promote competition and prevent abuses of dominant position by incumbent operators. Of those three countries, New Zealand, with its incumbent operator dominating both the local and long distance markets, its lack of specific pro-competition rules, and its absence of a specialized regulator, is the one about which the strongest case could be made for pro-competition structural reforms. In New Zealand, as in any other country, however, it is important, before deciding to implement such reforms, to evaluate their costs as well as the risks that technological evolution might make them obsolete or counter-productive.

The Australian decision to incorporate the main telecommunications-specific rules within the general antitrust law and to entrust a single economy-wide antitrust body with the task of implementing those rules would seem to reconcile the need to take the particular features of the telecommunications sector into account and to ensure the coherence of regulatory decisions across sectors. Australia and Chile have also conferred responsibility, to the Executive and to the antitrust regulator respectively, for re-evaluating the need for, and adequate scope of, sector-specific rules in the field of economic regulation. This is a very positive step since many sector-specific rules are likely to be needed during a transition period only. Indeed, while general antitrust rules might be ill-suited to deal with markets where no competition exists or to provide specific solutions to new technical issues, they might suffice when competition has developed and information has been generated on how to tackle

[131] See text accompanying note 21, above.

particular technical issues. The successful repeal of specific price rules for markets which had become competitive, in Chile, provides a vivid illustration of this point.

What can be considered an adequate balance between flexibility and certainty in the field of telecommunications regulation will depend upon a variety of country-specific institutional and physical endowments. Chile's decision to put strong emphasis on certainty through detailed rules embedded in laws appears broadly to make sense in a developing country keen to attract private investors to develop its network. In a very different context, the Australian approach which leaves relatively broad discretion to a competent regulator, while mandating that the regulator publish guidelines and discussion papers on the way it will exercise this discretion constitutes an interesting attempt to combine flexibility and certainty. Another solution, which could also be considered in some cases, would be to give relatively limited discretion to the regulator at the beginning but to provide for granting additional discretionary powers to the regulator after the latter has demonstrated its competency and credibility. In Chile, Australia, as well as New Zealand, however, it can be argued that the amount of powers which Executive retains with respect to regulatory matters somewhat raises uncertainty in an unnecessary way.

In order to ensure that regulatory authorities are sufficiently competent to tackle technically challenging telecommunications issues, establishing specialized regulators and providing them with sufficient resources (as has been done mainly in the United States and Australia) are two important steps. In this regard, SUBTEL's lack of adequate financial resources is particularly worrying given the complexity of the Chilean price regime. Simplifying the rules and relying on competitive pressures might, on the other hand, alleviate the need for specialized regulatory skills, but only up to a point as the New Zealand experience with interconnection disputes demonstrates. One can argue that, overall, economy-wide specialized regulators might have an edge, especially when they combine regulatory learning across sectors with sector specialization through the establishment of a telecommunications-specific department as the Australian ACCC does.

When it comes to protecting the regulatory process from undue political and industry pressures, some regulations can help, for example to provide for the intervention of multiple authorities to designate regulators, to specify and restrict the grounds on which regulators can be dismissed, and to prevent regulators from seeking employment in regulated firms until some time after the end of their mandates (once again, measures on which the United States and Australia have in general put more emphasis than the other two countries). Reducing the regulatory powers of the Executive, as in the United States for example, certainly helps as well. Limiting regulatory discretion, as in Chile, might palliate, to some extent, a lack of regulatory autonomy. It is however impossible to design detailed rules providing exactly the right answers to any future unforeseen regulatory issues. Some degree of regulatory discretion remains therefore necessary, and consequently, protection against undue pressure remains important. As pointed out above, cross-sector agencies might again have an additional advantage as it is somewhat easier for them to keep arm's length relations with individual ministries and firms.

All four countries have taken some measures to promote the accountability of regulatory authorities. It is in the United States and in Australia that most efforts have been made at ensuring regulatory transparency and stakeholder participation in the regulatory process. In the United States, this is achieved through participatory, but very costly, FCC processes. In Australia, the promotion of industry-designed rules, the launch of public inquiries, and the TIO scheme pursue the same objectives. Regular court proceedings, as in New Zealand, appear less suited to achieve wide participation in the regulatory process, and the Chilean legislation for its part does not address the issue very much.

With regard to the objective of limiting regulatory costs, the Australian model presents once again some attractive features. The combination of an economy-wide regulator, of detailed rules to reduce uncertainty on some contentious issues, and of mandatory arbitration by the regulator to resolve unavoidable disputes on topics such as interconnection, offers good prospects of limiting not only the direct costs of establishing and maintaining regulatory institutions, but also compliance costs for operators, as well as the costs of delays and regulatory mistakes.

Finally, in order to prevent overlaps or gaps in the allocation of regulatory responsibilities, and in order to ensure that regulatory responsibilities are entrusted to those best able to carry them out, an attractive option is to confer the power to exercise economic regulation in telecommunications to a single specialized cross-sector institution in charge of ensuring the application of competition rules in the whole economy. This is the option chosen in Australia, except that it might perhaps have been more rational to give to the ACCC a lead role in administering performance standards, for example, because of the impact that such issues have on pricing and interconnection issues for which the ACCC is already primarily responsible. While the Chilean model, like the New Zealand and Australian ones, arguably allocates too much regulatory power to the Executive, it presents a very positive feature which is, as argued above, the fact that it is the antitrust regulator, rather than SUBTEL, which is in charge of monitoring whether telecommunications-specific rules are still needed.

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Contracting, Incentives for Breach, and the Impact of Competition Law

Lewis T. EVANS and Neil C. QUIGLEY*

I. INTRODUCTION

Until the regulatory reforms of the late 1980s and 1990s, heavy-handed regulation and government ownership were pervasive in New Zealand. Under this regime, the bulk of large-scale infrastructure investment was undertaken by the public sector; long-term contracts between private sector entities were uncommon, and the scope for opportunistic action was limited by regulatory proscription of activity. The efficiency implications of the legal framework for contracting in New Zealand have been enhanced by the deregulation and privatisation of economic activity in the period since 1984[1] which has enhanced the importance of contracting for the performance of the economy as a whole. Considerable infrastructure management and investment is now in private hands, and the terms of private contractual agreements together with competition law provide the principal restrictions on the actions of market participants.

The enforcement of long term contracts is a critical issue in network industries because of their heavy investment in specific assets.[2] Kleit and Weisman[3] argue that the telecommunications industry is undergoing profound change and that it is in the interests of economic efficiency that telecommunications firms can offer long term contracts. They argue that it is not in the public interest to regulate these contracts. In this paper we provide a complementary analysis of the application of competition law to long-term contracts in the telecommunications industry.

Under New Zealand law, no provision of a contract may be enforced where it is in breach of the Commerce Act (s. 27(4)). Further, as Dammery[4] has indicated, the courts in New Zealand have taken the view that pending a decision on the substantive question of legality under the Commerce Act, a contract provision that is plausibly claimed to be in breach of the Act, even by a party to the contract, cannot be enforced.

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* Professor Lewis T. Evans and Professor Neil C. Quigley, both of Victoria University of Wellington and New Zealand Institute for the Study of Competition and Regulation. The authors wish to thank Terence Arnold, Sue Begg, Richard Dammery, Valentine Korah and James Mellsop for constructive comments on an earlier version.

1 L. Evans, A. Grimes, and B. Wilkinson with D. Teece, *Economic Reform in New Zealand 1984–94: The Pursuit of Efficiency,* (1996) Journal of Economic Literature, vol. XXXIV, pp. 1856–1902, December.

2 O. Williamson, *Transaction-cost economics: the governance of contractual relations*, (1979) 22 Journal of Law and Economics 233–61.

3 Andrew N. Kleit and Dennis L. Weisman, *Will Competitors be Allowed to Compete? The regulation of long term contracts in the telecommunications industry,* (1999) 1(5) Info: the journal of policy regulation and strategy for telecommunications, information and media, 441-118.

4 Richard Dammery, *Section 46 TPA: The Need for Prospective Certainty,* (1999) 6 Competition and Consumer Law Journal pp. 246–257.

From the perspective of economics, the efficiency of this decision depends very much on the incentives of the party that has sought refuge in an appeal to competition law. In this paper we use a dispute about an interconnection contract to examine the incentive problems created by parties' use of competition law to void contracts, and suggest, for the New Zealand case, some remedies.

In Section II we set out an economic framework for the analysis of contracts. In section III we provide an outline of a contract and relational framework between two firms. This contract contains certain of the key features of the *Clear v. Telecom* case analysed by Dammery.[5] We do not examine all of the relevant facts of that case: rather we use key features as a pertinent example. We set out and analyse the allocation of risk-bearing implied by the structure and pricing regime in the contract. We point out the implications of not treating a contract as a coherent bundle of rights and obligations, and thereby treating provisions as distinct elements. In Section IV we consider the interface between contract and competition law for the contract set out in Section III. We analyse the decision problem facing an entrant who has the option of appealing to competition law and is disadvantaged by the outcome of a contract with a dominant incumbent. We argue that the entrant will have inefficiently strong incentives to appeal to competition law. In addition, we show that the option for the entrant to appeal to competition law will have a pervasive influence on the terms and conditions of the contract, and will produce a marked reduction in the efficiency of the contracting process. In Section V we consider contractual and judicial means of addressing this incentive problem.

II. Contracts

The terms and conditions agreed by parties to a contract establish their legally enforceable rights and responsibilities. From the perspective of economics, contracts provide a transactions cost-minimising means of establishing constraints within which rational individuals maximise the pursuit of their goals consistent with the interests of other parties to the contract.

The literature in economics[6] views contracts as a means of limiting opportunism by constraining behaviour. As Posner[7] has observed:

> "… the fundamental function of contract law … is to deter people from behaving opportunistically toward their contracting parties, in order to encourage the optimal timing of economic activity and … obviate costly self-protective measures."

[5] *Telecom New Zealand Ltd. v. Clear Communications Ltd*, (Court of Appeal, CA 206/97, 9 December 1997, unreported) and (High Court, CL 20/97, 18 July 1997, unreported); Dammery, see note 4, above.

[6] See A.W. Katz, *Contract Formation and Interpretation*; and S. Shavell, *Contracts*, in *The New Palgrave Dictionary of Economics and The Law*, MacMillan: London, 1998, at pp. 425–432 and pp. 436–445.

[7] R.A. Posner *Economic Analysis of Law*, 4th edition, Little, Brown and Company, at 91.

Because the potential for opportunism is pervasive, all contracts establish explicit or implicit constraints on the actions of parties.[8]

Contracts typically contain a balance of incentive payments and provisions for monitoring that minimise transactions costs. Normally, the more reliance placed on incentives, the lower are monitoring costs. Contracts allocate property rights in specifying what components of any contract are held or owned by any party at any time. Because it is not possible to control the realisation of states of the world, contracts allocate risk both explicitly and implicitly. Risks are allocated between parties in a manner that, *ceteris paribus*, has parties that are more willing and able to carry risk assuming more risk relative to other parties. The terms of the contract will embody compensation for the risk explicitly and implicitly assumed by each party.

From the perspective of economics, all provisions of *legal* contracts should be enforced irrespective of the *ex post facto* distribution of gains associated with completion of the contract, and this maxim is applicable in all market situations. This is because contracts explicitly or implicitly allocate risk among the parties, and provide expected returns to each party that are consistent with information available to the parties at the time that the contract is signed. Greater *ex ante* investment in information relevant to the contract by either party will improve the efficiency of the contracting process. No increase in efficiency can be obtained by reinterpreting contracts in the light of information obtained during the term of the contract or after its completion, though such information may improve the efficiency of subsequent contracts.

The requirement that all provisions of legal contracts be enforced whatever the *ex post facto* distribution of gains from them has the greatest impact on dynamic efficiency; that is, the efficiency of ongoing economic interaction in society. Contracts stipulate actions and outcomes on which investment in information, assets and actions specific to the contract may be undertaken. Because these investments are based on the terms of the contract, a lower level of investment will result if there is uncertainty about the enforceability of the contract.

If an asset can be converted to equally valuable alternative uses at negligible cost, then it will be able to earn a return on its replacement value, irrespective of the withdrawal of one use. Assets specific to the contract are vulnerable to hold-up,[9]

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[8] Section 27(2) of the Commerce Act provides that contracts that have or may have the effect of substantially lessening competition are prohibited in the context of the view that all contracts provide constraints on behaviour, one might argue that many contracts are, or could be held to be, in breach of the Commerce Act.

[9] One of the recurring economic themes of repeated transactions is the benefit to be obtained by the opportunity to make a commitment (D. Fudenberg and J. Tirole, *Game Theory*, The MIT Press 1991, Cambridge, Mass, at s.3.2.3). The seemingly paradoxical result that commitment that necessarily constrains opportunism has value arises because it affects other parties' opportunities. The credibility of any commitment is termed "time consistency" in economics, where it means that incentives are such that terms of a contract will not be violated. Time consistency has had much currency in economic public policy literature, where a time consistent policy is one that the government has incentives to stick to the policy (for macroeconomics see G. Mankiw, *Recent Developments in Macroeconomics: A very quick refresher course*, (1988) 20 Journal of Money Credit and Banking pp. 436–459).

particularly where this takes the form of negotiation of a lower price for the use of the asset after it is in place than would have been agreed before the investment was made. Specific assets increase the transactions costs of contracting[10] by requiring either credible contracts or vertical/horizontal integration as a means of avoiding hold-up. Although contracts reduce transactions costs in many contexts, it is for specific assets that the enforceability of all contractual provisions is most important. It follows that it is in respect of investment in specific assets that a failure for the courts to enforce the *ex ante* bargain enshrined in the contract will result in the greatest reduction in dynamic efficiency.

Where a buyer of a service has only one seller with whom they may deal, the seller may be in a position to impose a wide range of terms on the buyer—in effect to offer a "take it or leave it" offer. It does not follow, however, that the buyer would be indifferent to the terms of the contract offered, or that the contract represented "the only option" for the buyer. As Posner[11] points out:

> "… since a monopolized product will be priced higher than it would be under competition, prospective buyers will invest more, rather than less, in search; and one form of consumer search is careful reading of the contract. It is also false to conclude that it will not pay the consumer to read the contract if he knows the monopoly seller will not bargain (haggle) with him, for he must still decide whether to buy the product or do without."

In other words, the existence of a monopoly seller may result in more rather than less contract-specific investment in information by the purchaser, and that information will include an assessment of alternative applications of the funds being used in the transaction with the monopolist.

In situations such as that considered by Posner, competition statutes have a prime effect on the operation of contracts. If there is a dominant firm in the market, competition statutes may require the firm to act as if the market were more competitive, and the courts may view failure to strike a contract as evidence of anti-competitive behaviour. Thus, competition law may constrain the contracts that firms, particularly dominant firms, may offer and accede to.

The application of competition law to contracts is justified by the social costs that result from contracts whose terms are shaped by or facilitate the exercise of market power. It is economically efficient for competition law to make such contracts unenforceable, and more generally, to provide a framework within which the costs and benefits to society may be assessed.[12] To use competition law to rule a contract unenforceable requires that there is some departure from efficiency that is correctable under competition law.

The complexity associated with assessing society's interest in the efficiency of contracts is most apparent in respect of the concept of dynamic efficiency. Dynamic

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[10] See Williamson, as note 2, above.

[11] Posner, see note 7 above, at 115.

[12] Shavell (see note 6 above, at 441–442) discusses the implications for efficiency of various measures of damages.

efficiency is provided when the legal and institutional framework in society provides the lowest costs and distortions to economic interaction in order that economic efficiency is optimised over time. It follows that inefficiency at one point in time need not be dynamically inefficient or imply that there is an alternative contract that will provide a better outcome for society as a whole. For example, rents earned by a dominant incumbent firm may not be dynamically inefficient: if those rents attract entry that increases output and stimulates technological innovation, then contracts in the market may be consistent with dynamic efficiency and maximising the present value of social welfare. Similarly, patents (which can be viewed as legal sanction to write exclusion contracts), provide a monopoly at one point in time, but competition in the process of developing patentable innovations. The institution of patents is designed to enhance dynamic efficiency, at the potential cost of static efficiency. Thus, actions aimed at static efficiency problems are consistent with improvements in social welfare only where they improve or do not reduce dynamic efficiency. Static efficiency problems must be perceived as very likely to persist into the future if there is to be any case for the application of competition statutes.

III. The Contractual Framework

A. Description of the contract

The contract that we consider in this paper is signed at time period T, and has the following features:

1. The contract is between two firms: Aco, a dominant firm in a network industry, and Bco, a new entrant to that industry. These two firms compete in offering a homogeneous product to households. Their networks have a large element of specificity.
2. Aco and Bco have a long running dispute about the terms on which Bco can utilise part of Aco's network for the delivery of services.
3. Aco and Bco agree on a contract that:
    - Settles all disputes arising from the past relationship between the two firms.
    - Establishes terms, including a pricing regime, under which Bco may use the Aco network for the delivery of services ("the terms of interconnection"). In particular, the pricing regime provides for payment of no access fee and a constant per minute charge for time on the network with no volume or duration discounts.
    - Applies for a fixed term of five years.

In time period T+1, Aco expands its use of a new off-peak charging regime for its households. This pricing regime was used on a trial basis in time period T-1, and this was public information at time T. The pricing regime in the contract between Aco and Bco makes it difficult for Bco to match the prices Aco is offering to households. At

T+2, Bco ceases to pay Aco for the interconnection services that it is consuming, and the courts find that payments may be withheld pending a decision on the substantive issue of whether provisions of the contract breach the Commerce Act.

B. Analysis of risk-bearing in the contract

The interconnection contract represents but one element of the class of two-part tariff interconnection contracts. This class includes the following three special cases:

1. A volume usage charge with the fixed connection fee set at zero. This is the interconnection pricing regime of the contract between Aco and Bco.
2. A volume usage charge and a fixed connection fee.
3. No volume usage charge and a fixed connection fee.

The choice between the three pricing structures, and the choice of the level of access and usage fee, will influence the expected return and other aspects of the agreement that each party requires to sign the contract. This is because the three pricing structures provide for different allocations of risk-bearing between the two parties to the contract.

To examine in more detail the implications of the choice of pricing structure for the allocation of risk, we will consider two types of uncertainty about the future:[13] uncertainty about states of the world and uncertainty about the strategies of parties to the contract; including final pricing and bypass.[14]

1. A contract with no fixed connection fee and a volume usage charge means that Bco does not carry any of the risk associated with the ability to obtain market share and the scale of its operation. Whatever the scale of Bco's business, it pays a flat per minute usage charge, and neither higher-than-expected or lower-than-expected volumes of business change the per minute rate. Conversely, this means that in terms of this contract Bco does not have access to any volume discounting that other forms of two-part tariffs would provide.

   This contract with no fixed connection fee and a volume usage charge allocates to the purchaser (Bco) the risk that either Aco or another supplier might adopt a pricing strategy that made the volume usage charge disadvantageous. While this risk is to some extent endogenous to the contractual relationship (Aco is a party to the contract), any disadvantage to Bco could be exogenous in that a third party might adopt such a pricing strategy. That is, outside the Aco-Bco contract, the contracts market, that we

[13] The inability to contract over all contingencies and quantities that are verifiable invariably means that contracts are incomplete.

[14] We make no claim to evaluate here all the relevant aspects of any actual interconnection contract. The properties of interconnection contracts and their relationship to economic efficiency is a vast topic. We do not consider, for example, any implications, under the contract, of Aco using Bco's network.

shall term the spot market, poses risk to Bco of pricing strategies that are costly to Bco because of the usage charge structure.

The usage-charge-only tariff places the risk of the investment in specific assets (network assets) that bypass Aco's specific assets squarely with Aco. Bco reduces its full unit payment to Aco for each unit switched to any network established by Bco.

In addition, the usage charge means that demand risk stemming from business cycle fluctuations is absorbed largely by Aco.

2. A network interconnection contract that has both an access fee and a user charge shares risk in that it allocates some of the state-of-the-world risk to the purchaser, as opposed to the party that supplies the network services who is paid through a lower usage charge.
3. A contract with a fixed connection fee and no volume usage charge provides strong incentives for the purchaser to increase business volume, and allocates to the supplier the risk that they will be able to do so. In this case Aco bears the risk that the volume of Bco's business will be larger than the expected volume on which the fixed connection fee was set. Under this contract Bco carries the risk that the state of the world will involve a downturn in demand for interconnection services. Bco also carries the risk that Aco will adopt a competitive strategy that limits Bco's market share. The risk of alternative final-pricing strategies is shared as compared to case 1. The risk of bypass to Aco is reduced and the incentive for Bco to bypass is also reduced.

Two other aspects of risk deserve attention. First, our contract requires the delivery of interconnection services for a fixed period and at a fixed price. This provision of the contract allocates to the purchaser the risk of a fall in the spot market price of interconnection services, while the supplier bears the risk of a rise in the spot market price.[15] Second, our contract establishes a price for a five-year period. This is a long term given the rate and uncertainty of technological change and new entry to the modern telecommunications market. Under the contract between Aco and Bco, the latter firm bears all of the risk that over the five years of the contract technical change or new competition will drive down the spot price of interconnection faster than expected. Where the industry is characterised by rapid technical change this provision would be disadvantageous to Bco, and the more so because if the spot price falls surprisingly quickly it may not be in Aco's interest to renegotiate. This provision and the relatively long term of the contract would strengthen Bco's incentive to bypass Aco's network in this event.

[15] By a rise in the spot price we mean a rise relative to expectations. The terms of the interconnection contract will have been influenced by each parties' expectation of future spot prices. In telecommunications these might well have been expected to decline over the period of the contract.

To summarise, Bco accepted a contract that assigned to Aco much of the risk associated with the level of business generated by Bco and the bypass of Aco by Bco. It assigned to Bco all of the risk that the spot market price of interconnection access might fall more quickly than expected, and also the risk that new pricing regimes such as off-peak discounting might become important in the market. In terms of its contract with Aco, Bco bears this risk whether it is Aco or a third party provider that adopts the new pricing regime. Over the long period of the contract, both assignments of risk seem counter intuitive, since Bco should be best placed to assume some risk associated with its volume growth, and since Aco should be best able to bear at least some of the risk of the emergence of new pricing strategies (especially those that it develops itself). Nonetheless, the economist presumes that these allocations of risk were recognised at the time that the contract was written.

C. Interpreting the contract as a whole

We have seen that the final allocation of risk between Aco and Bco under the contract is complex. Moreover, the allocation of risk in the contract as a whole is influenced by a number of different features and provisions of the contract. Consequently, contracts must be considered and interpreted as a whole.

Contracts are the outcome of a negotiated acceptance of a bundle of obligations. To set aside any aspect of the bundle without the agreement of both parties would affect the willingness of parties to accept the residual components of the contract and the benefit of the contract to them. We illustrate this with two aspects of the contract. The importance of this conclusion lies in the effect on future contracts. If it becomes accepted that provisions of a contract can be set aside, contracts will be designed to allow for this contingency. If relevant parts can be identified *ex ante*, contracts may be written that approximate the collection of a set of almost self-contained subcontracts. This would reduce efficiency by reducing possible contractual trade-offs and thereby the set of available contracts. The reduced set of acceptable contracts may in fact reduce the incentive to enter contracts and thereby influence investment.

The first example of the importance of treating the contract as a whole applies to the settlement of past disputes included in the contract. Aco and Bco have simultaneously agreed on a settlement of outstanding issues relating to their past business interactions and terms governing aspects of their future relationship. The settlement must therefore be viewed as an integral part of the contract. This is true because if the terms of the settlement were more generous to either Aco or Bco, then that party would be prepared to accept less favourable terms in respect of the contract for their future relationship.

Decisions at time T will be affected by expectations of the future. For example, the settlement may differ according to whether or not there is to be a contract. Given that there is a contract, the settlement will have been affected by the terms of the forward-looking contract, even if the contract does not incorporate transfers between parties explicitly relating to the relationship before T (i.e. it does not explicitly incorporate aspects of the settlement). The effect of expectations about the future on the settlement may simply occur via their effect on the bargaining position of each party. This will generally differ according to whether the agreement at T is "one-shot" (i.e. marks a termination) or part of a "repeated game" (e.g. one agreement in a series of agreements/activities associated with a relationship running into the indefinite future).[16] To set aside or interpret only the settlement or the agreement relating to ongoing business is to attempt to interpret only part of the contract.

The second example of the importance of treating the contract in its totality concerns the allocation of risk bearing that is fixed in the contract. Recall that under the contract, Aco bears much of the risk associated with the level of business and bypass. Bco carried the risk that the spot market price of interconnection might fall more quickly than expected, and of the evolution of new pricing regimes by any market participant. This outcome resulted from the parties' assessments of the future and their willingness to carry risk as embodied in the contracting process. To set aside the payment of the usage charge, even for a period of time, is to quite alter the allocation of risk between the two parties. The expectation of this possibility of *ex post* re-allocation of risk by treating contracts provision by provision must raise the transactions costs of any contract.

In sum, setting aside some provisions of a contract may alter the balance of rights, obligations, risk and expected return that was negotiated in the contract as a whole. In this case it would be inefficient to enforce the residual of any contract having set aside any part of it.

IV. The Interplay of Contract and Competition Law

A. Breach of contract

No matter how much the parties to a contract invest in *ex ante* consideration of implications of contractual terms in future (uncertain) states of the world, there exists the possibility that one party will wish to be relieved of certain of the obligations set out in the contract.[17] In these circumstances a party will have at least four options:

1. Absorb the losses resulting from the fulfilment of the contract.
2. Negotiate with the other party to obtain satisfactory terms on which they may be relieved of the obligations set out in the contract.
3. Unilaterally breach provisions of the contract, accepting any penalties for

[16] There is a growing literature in which game theory is used to analyse the implications for contracts of opportunism (K.M. Schmidt, *Contract Renegotiation and Option Contracts*, in *The New Palgrave Dictionary of Economics and The Law*, see note 6 above, at 432) in repeated relationships (B. Salanié, *The Economics of Contracts: A Primer*, MIT Press, Cambridge, Mass, at ch.7).

[17] Re-negotiation is typically required to yield *ex post* efficient outcomes in any state of the world. But it reduces the protection of specific investments, and thereby dynamic efficiency.

breach of contract that might be set out in liquidated damages clauses in the contract or that might be applied by the court.

4. Unilateral breach and seek legal means of having relevant provisions invalidated, such as claims that they breach competition law.

Options (1) and (2) are probably most common in practice. If the term of the contract is relatively short, the costs of re-negotiation during the term of the contract may be greater than the losses associated with fulfilment of the contract. If the contract is longer term, then the costs of contract fulfilment may be large enough to make re-negotiation appropriate. The party that has benefited from the state of the world may re-negotiate for several reasons. First, default on the contract may be costly for both parties (as where both parties have made contract-specific investments), and the party that has benefited from the changed circumstances may benefit more from the re-negotiation than from compensation payable on default. This will especially be the case where compensation is not forward-looking. Second, the contract may represent part of a longer term or wider business relationship. In both cases the party that has benefited from the outcome of the states of the world may have incentives to make concessions in re-negotiation rather than enforce the contract.

If, however, re-negotiation is not mutually advantageous, the disadvantaged party will be prepared to bear the costs of breaching provisions of the contract whenever this is cheaper than completing the contract. Further, the disadvantaged firm will be willing to invest in legal means of having the provisions invalidated, including appeals to competition law, up to the point of expected costs of liquidated damages and/or court-imposed costs for breach of contract. In this case, one of options (3) and (4) will be adopted. Because firms will assess and choose between these two options based on the expected payoff each provides, the two options are (from the perspective of economics) closely linked.

The treatment of a contract by any firm may have implications for future potential transactions other than simply those relating to parties of current contracts. The reputation that a firm establishes for opportunistic behaviour in its contracts will very likely affect that firm's ability to enter contracts, and terms and conditions of any contract, with other parties. This reputation effect is particularly relevant where other asset-specific contracts are contemplated. It is a cost that should enter the calculus of whether or not to breach, and we expect that Bco would have assessed it. Bco may bear reputational costs *ex post* irrespective of the ultimate outcome of the court's determination, given that Bco had full information about the price regimen at the time the contract was signed. The reputational costs will also be affected by the dominant position of Aco in the market at the time the contract was established. Given that the balance of these factors is difficult to assess *a priori*, we do not include any assessment of reputational factors in what follows.

B. BREACH OF CONTRACT OR APPEAL TO COMPETITION LAW

The factors affecting the choice between options (3) and (4) are summarised in the following representation.[18] The disaffected party to the contract will choose the lowest cost option of either:

Unilateral Breach (B) or Breach and invoke Competition Law (C)

The costs associated with these two options are:

$$\{E.Legal_B + E.Comp.\} \text{ or } \{E.Legal_C + (1 - pr).(E.Comp. + E.Legal_B) - pr.E.Award\}$$

The cost of a unilateral breach is the expected (*E*) compensation plus the legal costs ($Legal_B$) of obtaining it. The expected gain from appealing to competition law depends upon the probability of winning under competition law (*pr*). It consists of the legal costs of the competition law action ($Legal_C$) plus payment of compensation should it fail less any possible award should it win, both adjusted for the probability of winning. Note that it is the costs of the disaffected party that enter the calculation; no other agent's costs are included. Note also, that if future relationships are not affected, any award or compensation will simply be transfer payments: they only influence resource use, and hence economic efficiency to the extent that they affect decisions taken in the future. The resource costs are the legal costs. The total of these will include that of the party being breached against as well as that of the court system; and all these would have to be assessed to evaluate the economic efficiency of the choice of the disaffected party.

The party will choose competition law if:

$$E.Legal_C < pr.(E.Compensation + E.Legal_B + E.Award)$$

which illustrates that there can exist a very strong incentive to apply competition law even if the case is weak: that is, even if the probability of success is low. For any level of legal costs, the higher is the expected compensation and anticipated award the lower will be the probability of success that will make it worthwhile for a party to a contract to challenge it under competition law. This finding is enhanced by the fact that the determination of undesirable situations/behaviours under competition law is very inexact. The complexity of assessments of efficiency increase the potential for "type 2" errors to be made;[19] that is, to find a breach of competition law when in fact there is no departure from the public interest.

This way of thinking about the payoff to alternative feasible actions where breach of contract is desired by one party also indicates that parties to a contract may have

[18] We recognise that anticipated future costs and benefits (as well as the likelihood) of an ongoing relationship between the parties will also affect the decision. We abstract from this problematic issue by presuming that the possibility of, and the nature of, any future relationship will be unaffected by the choice between the different approaches to breaching the contract. We have also assumed that a direct breach of the contract draws compensation payments.

[19] For any given "type 1" error probability.

stronger incentives to challenge the provisions of the contract than do outside parties. Private third parties may challenge a contract where they are disadvantaged by a breach of competition law. If the court finds that a breach of competition law has occurred, the third party may be awarded damages and will in addition benefit from the absence of the anti-competitive behaviour in that market in the future. Parties to a contract who challenge it under competition law may also obtain the benefits of damages and altered market circumstances in the future. In addition, however, if the party to the contract has been disadvantaged by exogenous events during the term of the contract, this party will also benefit from the removal of the costs associated with continuing to meet the terms of the contract.

C. Impact of competition law on contract design

There is no unambiguous definition of contractual provisions that are in breach of the Commerce Act. In most cases, it is a time consuming and expensive process to ascertain whether the Commerce Act has in fact been violated. The ambiguity and expense of ascertaining compliance with competition law is increased by the particular words used in the New Zealand Commerce Act.

Section 27 (1) of the Commerce Act states that:

> "No person shall enter into a contract or arrangement, or arrive at an understanding, containing a provision that has the purpose, or has *or is likely to have* the effect, of substantially lessening competition in a market."

The emphasised phrase also appears in sections 27(2) and 27(4) of the Act. This phrase lowers the standard, and alters the nature, of proof. It appears to provide for the possibility that a provision of a contract that is likely to have the effect of substantially lessening competition at some time during the term of the contract represents a breach of the Act. Goddard[20] suggests that contracts that facilitate long term vertical or horizontal relationships should be treated as merger decisions: thus, if a contract is acceptable under competition statutes at the time it is written then these statutes should have no future application to the contract. This argument also follows from the view that no aspect of the realisation of exogenous events during the contract should be viewed as relevant to the interpretation of the competitive implications of the contract. Thus, to suggest that the Commerce Act could be breached by provisions of the contract that may substantially lessen competition given some realisation of events that were uncertain at the time that the contract was signed is not consistent with economic efficiency. It would be extremely costly for parties to consider whether the different provisions in the contract might be regarded as a breach of the Commerce Act under future strategies and future states of the world. This would, in turn, significantly

[20] D. Goddard, *Long-Term Contracts: A Law and Economics Perspective*, (1997) New Zealand Law Review Pt IV, at 457.

increase the costs of signing long-term contracts, and might result in parties being unwilling to sign efficient long-term contractual agreements.

One effect of the words used in Section 27(1), (2) and (4) of the Commerce Act is to provide parties to a contract with an option exercisable during the term of the contract. This option to claim that provisions of a contract breach the Commerce Act could be exercised in the event that either party viewed the realisation of outcomes from the contract to be disadvantageous. It is at least plausible that at the time that Aco and Bco signed their contract they both recognised that contract provisions may be breached through an appeal to competition law. What would be the implications for efficiency if we assumed that Aco's and Bco's advisers had studied the Commerce Act and recognised this potential at the time that the contract was signed?

Opportunities to claim violations of the Commerce Act are not symmetrical between the two parties to the contract that we have described. It is less credible for a dominant firm to claim that a contract reflects the exercise of market power by a small entrant than vice versa. We would expect this asymmetry to be reflected in the provisions of the contract.

The ability of Bco to use the Commerce Act to breach the contract will, *ceteris paribus*, reduce the extent to which Bco invests in information relating to the contract. This will reduce the efficiency of the contract, since efficiency is enhanced by increases in the information available to either party to the contract. It will also mean that Bco will be willing to sign a contract for a longer period, even though its reduced investment in information would normally suggest a shorter contractual period. The option to use competition law as a means of breach provides Bco with protection from outcomes that might make a long-term contract disadvantageous to it. This will have implications for the design of the contract. In particular, we would expect the terms of the contract to provide Aco with some compensation for the ability of Bco to limit its downside risk in this way.

If only Bco may credibly use a claimed violation of the Commerce Act as a means of breaching a contract provision whose *ex post* realisation is disadvantageous for it, Aco will respond in several ways. First, it is likely that Aco will make a larger specific investment in information relating to the outcome of the contract. In the absence of an option to breach provisions of the contract, it will be in Aco's interests to investigate the range and probability associated with outcomes that it would regard as disadvantageous.

Second, Aco's optimal response to Bco's option for breach will include shortening the length of contract. A shorter contract restricts the period over which there will be uncertainty about the realisation of contingent events. As compared to longer contracts, changes in market circumstances can be managed at contract renewal rather than within the parameters of an established contract. A short term will limit both the value and the credibility of attempts to use competition law to resile from the contract. It will reduce the magnitude of any damages or penalties payable if any provision is deemed to violate the Commerce Act, and reduce the magnitude of any losses suffered from honouring it. Thus, a short term will reduce the incentive for Bco to use competition law to breach the contract. In general, this is likely to have the effect of inhibiting dynamic efficiency by reducing the period of commitment required for investment in specific assets.

Third, Aco's preference for a short-term contract, its specific investment in information relating to provisions of the contract, and its lack of an option to breach a provision all suggest that Aco will require a higher expected return to sign a given contract. That is, the terms of the contract will have to be more favourable to Aco to compensate for the option that the Commerce Act provides for Bco to challenge contract provisions once the outcomes are realised.

More generous terms for Aco create a further problem: they increase the likelihood that in evaluating the contract the Commerce Commission or the High Court will take the view that the contract breaches the Commerce Act. These bodies should consider the fact that the option for Bco to claim a breach of the Commerce Act after the contract has been signed makes it more likely that the terms of the contract will look advantageous to Aco. This balance of advantage in the contract will, however, reflect efficient contracting, not the exercise of market power.

Where the courts are willing to rule a provision unenforceable until there is a substantive decision on the case, the incentives for Bco are amplified. A claim of breach of the Commerce Act may result in the plaintiff being able to reduce or suspend payments, making the defendant an involuntary creditor of the plaintiff, and with court delays this situation may persist for a substantial period of time. If the claims of Bco are motivated in part by adverse changes in market circumstances that influence its financial viability, then the Commerce Act option will be particularly attractive.

Our analysis suggests that the option for Bco to utilise the Commerce Act to breach provisions of the contract will result in the two parties having different views about the optimal length of the contract. In particular, Bco will prefer a long-term contract, but without the option to appeal to the Commerce Act a shorter contract allowing for regular renegotiation of terms might be preferred. The option available to Bco will also influence the distribution of expected returns associated with the contract, and provide an asymmetry in the incentives for Aco and Bco to invest in information relevant to the negotiation of the contract. More generally the potential to appeal to the Commerce Act increases the costs associated with writing long-term contracts, and hence reduces dynamic efficiency in the economy as a whole.

V. Means of Addressing the Incentive Problems

We have argued that for Aco and Bco there are asymmetries in both the incentives to appeal to competition law and the credibility of any such appeal. In this section we consider some means by which these asymmetries may be addressed.

1. First, we note that it is not possible for the two parties to agree that the Commerce Act will not apply to their contract: Private contracts cannot

override the Commerce Act. An alternative to contracting out would be for the Commerce Commission to be able to review and authorise contracts as a whole *ex ante*.[21]

2. The Commerce Commission could indicate that it would take action against both parties to a contract if either party succeeded in a private Commerce Act action against the contract.
3. The Commerce Act could be amended so as to be less expansive in its definition of contractual terms that could be held to be a breach of the Act.
4. Recognising the incentives for parties disadvantaged by the outcomes of contracts to make spurious claims of breach of the Commerce Act, the High Court could adopt a strong test for the consideration of such appeals.
5. When there is evidence that the *ex post* realisation of gains in the contract has given the complainant a private interest in resiling from contract provisions, this strong test might include enforcement of the provisions of the contract until there is a decision on the substantive issue.
6. Where any provision is found illegal, the whole contract becomes unenforceable. This will ensure that contracting tradeoffs that determine the balance of parties' interests across provisions are considered more thoroughly in any consideration of a challenge of any specific provision. Section 89(2) of the Commerce Act presents this opportunity to the Court now.

We view all of these courses of action as worthy of consideration in the sense that they have the potential to enhance efficiency by improving incentives, reducing the scope for opportunism, and lowering the costs of writing contracts.

VI. Conclusion

The purpose of competition law is to promote economic efficiency of which a large component is dynamic efficiency. Impediments to efficiency should be addressed by the application of competition law only insofar as these impediments are expected to persist into the future. Because enforceable contracts are critical to dynamic efficiency, it is properly a function of the administration of competition law to bolster the enforceability of contracts.

Parties to contracts in New Zealand have a "Commerce Act option" to claim that provisions of the contract breach competition law. Because it will not normally be credible for a dominant incumbent to claim that an entrant used its market power to insert inefficient provisions into a contract, the Commerce Act option introduces an asymmetry into the contracting process. This asymmetry will increase the transactions costs of contracting. It will also influence the term of the contract that is preferred by the different parties, the distribution of expected returns between the two parties, and

[21] Presently this can only be done for prospective contractual arrangements tested against one or more specific subsections of the Commerce Act.

the willingness of the two parties to make investments in information relevant to the negotiation of the contract. As a consequence, we have argued that the Commerce Act option will reduce the dynamic efficiency in the economy as a whole.

In interpreting any claimed violation, courts should consider that an entrant who is disadvantaged by changes in states of the world will have a strong incentive to claim that provisions in the contract violate the Commerce Act. This will be true even where there is a low probability of a judgment in their favour (that is, where the case is weak). An action brought on this basis has no grounding in economic efficiency. In addition, where both parties anticipate that the entrant has the option of breaching provisions by appealing to the Commerce Act:

- Entrants will rationally make lower sunk investment in information relating to the contract and, despite this low investment, prefer a long-term contract.
- The incentives for the dominant firm are to write a short-term contract and to make a substantial sunk investment in information relevant to the writing of the contract.
- To compensate for the Commerce Act option, the entrant will have been willing to offer and the dominant incumbent will require, a higher expected return over the term of the contract.

The incentives and actions of the plaintiff in the contracting process must be considered in forming a view about the credibility of any claimed breach of the Commerce Act. In cases conforming to the scenario for Aco and Bco analysed in this article, the incentives for the entrant, Bco, to make spurious claims of breach of the Commerce Act are high. Consequently, we consider that pending a substantive decision on the case, the contract provisions should be enforced. These factors suggest to us that a determination that the Commerce Act had been breached should only be made where the breach is plain. Marginal breaches would be too difficult to distinguish from an efficient contract given the incentives created and balance of returns necessary to compensate for the Commerce Act option. We have also suggested that the Commerce Commission should consider taking action against both parties to a contract if either party succeeded in a private Commerce Act action against the contract. Implementation of these suggestions would, in our view, mitigate the efficiency losses that currently result from the potential for appeals under the Commerce Act to be used as a means of breaching efficient contracts.

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Toward Global Competition Policy?

The Expanding Dialogue on Multilateralism

Clifford A. JONES*

In the aftermath of the World Trade Organization's (WTO) turbulent Ministerial Conference in Seattle, there remains increased interest within and without the organization in considering the development of international antitrust rules. The existence of international cartels and their support of, *inter alia*, Nazi Germany once prompted US President Franklin Roosevelt to propose curbing them through the United Nations.[1] The potential role of international antitrust in international trade has been recognized since the original Havana Charter,[2] although the failure to ratify it, usually attributed to failure of the United States to ratify it, caused the International Trade Organization to be stillborn in the late 1940s. The antitrust code included in that agreement was never incorporated into the 1947 General Agreement on Tariffs and Trade (GATT) or its successor under the WTO.

In the post-war period, the United States pressured its European allies such as the United Kingdom[3] as well as Japan[4] and Germany to adopt antitrust laws similar (more or less) to the US Sherman Antitrust Act. Japan (under occupation) was the first to do so, in 1947. In the 1980s and early 1990s, trade disputes prompted the Structural Impediments Initiative, talks between the US and Japan aimed at a relaxation of governmental regulations and a strengthening of antimonopoly policy.

In Europe, when Jean Monnet and Robert Schuman presented the Schuman Plan[5] to US Secretary of State Dean Acheson on 7 May 1950, Acheson's first reaction was the fear that the plan was a clever cover for a "gigantic European cartel".[6] Two days later, Acheson's fears assuaged, the Schuman Declaration heralded what is now considered the birthday of the European Community. Monnet described the antitrust

* J.D. (Okla), M.Phil., Ph.D. (Cantab). Visiting Professor of Law, University of Oklahoma, United States. The author wishes to acknowledge the support of the Center for Global Partnership—The Japan Foundation in the form of a grant to assist in funding this research and the associated conference which took place on 23–24 June 2000.

1 See E. Fox, *Competition Law and the Agenda for the WTO: Forging the Links of Competition and Trade*, (1995) 4 Pac. Rim L. & Pol'y J., 1, 2.

2 *Havana Charter for An International Trade Organization*, U.N. Doc. E/Conf. 2/78 (1948), reprinted in U.N. Doc. ICITO/1/4 (1948).

3 See generally, T. Freyer, *Regulating Big Business: Antitrust in Great Britain and America, 1880–1990*, (Cambridge University Press, Cambridge, 1992) 234–268.

4 J.O. Haley, *Harmonized Rules, Peculiar Laws: Recent Developments in Japanese Law*, in R. Zäch, ed., *Towards WTO Competition Rules*, (Kluwer, The Hague, 1999), 137, 140.

5 For non-Europeans, the "Schuman Plan" proposed the creation of what became the European Coal and Steel Community, prelude to the European Economic Community.

6 D. Acheson, *Present at the Creation: My Years in the State Department*, (Norton, New York, 1969), 383; D. Dinan, *Ever Closer Union?*, (L. Rienner, Boulder, Colorado, 1994), 23. Acheson feared objections by the US Department of Justice's Antitrust Division, which took a dim view of cartels controlling essential war material in the light of the then recent experience with the powerful cartelised German economy.

provisions of the ECSC: "For Europe, they were a fundamental innovation: the extensive anti-trust legislation now applied by the European Community essentially derives from those few lines in the Schuman Treaty."[7]

It is in part the success of the EC's competition rules which gives support to the concept of a broader (global) antitrust regime. If it can be done successfully on a regional basis, why not more widely? The modern history of proposed binding[8] international antitrust rules might be said to start with the "Munich Group" and its 1993 "Draft International Antitrust Code"[9] ("DIAC"). The proposed code was intended to serve as a plurilateral agreement under the WTO Trade Agreement's Annex 4. It has received wide distribution and engendered serious discussion and commentary, which means it has been a success. Among its controversial features are included the creation of an Independent Antitrust Authority to supervise enforcement of domestic competition laws and use of "International Antitrust Panels" to settle intergovernmental disputes under the WTO dispute settlement procedures.[10]

The 1993 DIAC was followed by the European Community's "Group of Experts" report in 1995, the result of a study by three independent experts and six EC officials acting in their personal capacities.[11] The independent experts were Frédéric Jenny and two members of the "Munich Group", Ulrich Immenga and Ernst-Ulrich Petersmann. The "Group of Experts" report also proposed a plurilateral agreement under Annex 4 of the WTO Trade Agreement, but did not consider that an International Antitrust Authority or a worldwide competition code would be realistic. The general EU approach has been to require WTO members subscribing to the plurilateral agreement to adopt domestic competition laws containing "'core principles' that include rules on restrictive business practices and abuse of market power; provide adequate and transparent enforcement; and provide for international cooperation through exchange of non-confidential information, notification, and positive comity provisions".[12]

As a result of the EC's Group of Experts report, the EC commenced an initiative with proposals which helped lead to the creation of a working group in the WTO.

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[7] J. Monnet, *Memoirs* [R. Mayne trans.] (Doubleday, Garden City, New York, 1978), 352–3. Compare Article 65 ECSC with Article 81 EC. Monnet noted that the drafter of the Treaty provisions, Robert Bowie, was a "young Harvard professor … who was said to be the leading expert on US anti-trust legislation, which the Americans applied as rigorously as morality itself": id.

[8] I am excluding the voluntary OECD *Guidelines for Multinational Enterprises* of 1976 and the United Nations Conference on Trade and Development's, "UNCTAD", *Restrictive Business Practices Code* of 1980, which were not intended as binding. Other earlier efforts are also not addressed here.

[9] The Munich Group, formally the "International Antitrust Code Working Group" was comprised of 12 academics and private practitioners. It may be found on Ulrich Immenga's web page, as of 2 April 2000: <www.unibw-muenchen.de/privat/u.immenga/0010.html>. It is reproduced in *BNA Antitrust and Trade Regulation Report*, vol. 64 Special Supplement No. 1628 of 19 August 1993. It is also published as a book, W. Fikentscher and U. Immenga (eds), *Draft International Antitrust Code*, (Nomos Verlag, Baden-Baden, 1995).

[10] E.U. Petersmann, *Competition-oriented Reforms of the WTO World Trade System—Proposals and Policy Options*, in Zäch, ed., as note 4 above.

[11] Commission, *Competition Policy in the New Trade Order: Strengthening International Cooperation and Rules*, (Office of Official Publications, Luxembourg, 1995).

[12] International Competition Policy Advisory Committee to the Attorney General and Assistant Attorney General for Antitrust, *Final Report* (Washington, D.C., US Supt of Documents, 2000), 265.

The WTO's first Ministerial Conference (Singapore, December 1996) announced the establishment of a working group to examine the interaction between trade and competition policy, including anticompetitive practices, and to identify areas to be considered for inclusion in the WTO framework. Under the able chairmanship of Frédéric Jenny, a member of the EU "Group of Experts", the Working Group commenced its work in 1997 with the original objective of completing its work by the close of 1998. Following the presentation of the Working Group's 1998 Report,[13] the General Council approved a continuation of the "educative" work related to competition policy. Prior to the Third Ministerial Conference in Seattle, the Working Group issued another report concerning its activities in 1999.[14] At the time of writing, the Working Group continues its work under Chairman Jenny, including the formidable task of developing a consensus among the members of the WTO concerning the need for or desirability of a multinational framework for competition rules and the adoption of domestic antitrust laws by those members who do not have them.[15]

While the WTO Working Group may constitute the largest dialogue in the sense of number of speakers, it is far from the only forum seeking to address international antitrust issues. Within a period of a few weeks in the summer of 1999 alone, there were conferences, symposia, and meetings held by the WTO in Geneva, the Cartel Conference in Berlin, UNCTAD in Geneva, an Organization for Economic Cooperation and Development (OECD) conference in Paris,[16] and a seminar at Zurich University,[17] all of which dealt with various aspects of international competition policy and the interface between trade and antitrust. Many of these meetings were held in anticipation of the WTO's Third Ministerial Conference in Seattle.[18]

In July 1999, the Commission of the EU adopted a proposal intended for submission at the Seattle Ministerial Conference to commence negotiations in the projected "Millennium Round" on competition principles and rules, common approaches to anti-competitive practices, international cooperation, and adaptation of the WTO dispute settlement procedures to competition law matters.[19] However, the Seattle Ministerial Conference did not reach agreement on the issues to be addressed in

[13] World Trade Organization, *Report (1998) of the Working Group on the Interaction Between Trade and Competition Policy to the General Council*, (WT/WGTCP/2, 8 December 1998).

[14] World Trade Organization, *Report (1999) of the Working Group on the Interaction Between Trade and Competition Policy to the General Council*, (WT/WGTCP/3, 11 October 1999).

[15] Approximately 70 of the 135 members of the WTO now have domestic competition laws of some kind, although the nature and scope vary widely. However, this represents a very large increase from the time of the original Havana Charter, when only the USA and a handful of other countries had such laws.

[16] J. Klein, *A Reality Check on Antitrust Rules in the World Trade Organization and a Practical Way Forward in International Antitrust*, in Organization for Economic Cooperation and Development, *Trade and Competition Policies: Exploring the Ways Forward*, (OECD, Paris, 1999), 37.

[17] See, R. Zäch, ed., *Towards WTO Competition Rules*, (Kluwer, The Hague, 1999).

[18] See also, H. Ullrich, (ed.), *Comparative Competition Law: Approaching an International System of Antitrust Law* (Nomos Verlag, Baden-Baden, 1998) (Proceedings of College of Europe Workshop, Bruge), and T. Freyer, *Restrictive Trade Practices and Extraterritorial Application of Antitrust Legislation in Japanese–American Trade* (1998) (on file).

[19] Commission, *Communication from the Commission to the Council and to the European Parliament: The EU Approach to the WTO Millennium Round*, 8 July 1999. (COM (1999) 331-C5-0155/1999-1999/2149 (COS)).

the "Millennium Round", and a further Ministerial Conference for the purpose of "re-launching" the Millennium Round has not yet been held.

However, other dialogues on these issues have been under way on the United States side of the Atlantic. In 1997, the United States Attorney General and Assistant Attorney General for Antitrust Joel Klein appointed an International Competition Policy Advisory Committee (ICPAC) to advise on future routes of international antitrust enforcement policy. The ICPAC was only the third such advisory committee since the passage of the Sherman Antitrust Act in 1890 and the first to deal with international antitrust matters. The ICPAC, chaired by Paula Stern and James Rill, was administered by Professor Merit Janow of Columbia University as Executive Director. It held a number of meetings and hearings and issued its report in February 2000.[20]

The ICPAC Report generally takes the view that a unified international antitrust code is unrealistic at the present time, and bilateral cooperation in enforcement, while laudable and to be continued and encouraged, is insufficient. The ICPAC majority report considers that the WTO is not the appropriate forum, except for education and consultation, to develop competition rules. It is thought that the trade-competition interface, while important, is underinclusive in regard to the universe of international competition law problems. Instead, the ICPAC Report urges the creation of a "Global Competition Initiative" outside the umbrella of the WTO. In a minority statement, ICPAC member Eleanor Fox argues that a necessary role exists for the WTO which is larger than that envisaged by the majority report.[21]

One approach to introducing competition law into the world trade system is the development of a network of bilateral international cooperation agreements. The United States has entered into such agreements with Japan, the European Union, Germany, Australia, and Canada. The official US view has been to concentrate on developing networks of bilateral antitrust cooperation agreements, some unilateral extraterritorial enforcement, and consultations and technical assistance to other countries. It remains to be seen to what extent the ICPAC report will influence US policy. At the moment, it appears that the United States will not agree to commencement of multilateral antitrust negotiations in the Millennium Round, assuming there is one, but the US position is that such negotiations are premature, not that they are out of the question in the longer run.

In general, it seems that the EU approach is supported by Japan, Canada, and Australia,[22] although the United States Trade Representative has indicated that the EU is virtually alone in its desire to commence negotiations on competition rules in the

[20] International Competition Policy Advisory Committee to the Attorney General and Assistant Attorney General for Antitrust, *Final Report* (Washington, D.C., US Supt of Documents, 2000). The report is available in electronic form from the ICPAC page of the US Department of Justice website: <http://www.usdoj.gov/atr/icpac/icpac.htm>.

[21] See also, E.M. Fox, *Toward World Antitrust and Market Access*, (1997) 91 Am. J. Int'l L., 1.

[22] International Competition Policy Advisory Committee to the Attorney General and Assistant Attorney General for Antitrust, *Final Report* (Washington, D.C., US Supt of Documents, 2000), at 265.

proposed Millennium Round.[23] It is not clear from the Seattle conference what the official views of all of the member governments are, but there is little doubt that international antitrust rules will remain on or near the table.

The importance of antitrust policy to world trade development partly lies in the adverse effect of private restrictive practices on the opening of competitive markets. The GATT, now WTO, system has resulted in the opening up of national markets over a period of decades by dismantling or lowering government barriers to trade, such as tariffs and quantitative restrictions (quotas), requiring nondiscrimination in the form of national and "most favored nation" treatment of foreign products, and in promoting transparency.

In general, private restrictive practices are not directly eliminated by reductions in governmental trade barriers, and those which have the effect of blocking or restricting access to markets by foreign traders may either substitute private trade barriers for governmental ones or prevent the elimination of governmental barriers from having the desired effect. The effectiveness of antitrust laws and their enforcement, which seek to eliminate private barriers to competition, is therefore potentially of great significance to the world trading system. It seems probable that international or multinational antitrust law and policy will eventually be introduced into the international trading system, but how and to what extent remains to be determined. The recent international disagreements over the Boeing/McDonnell-Douglas merger and the Kodak/Fuji market access case emphasise the continuing importance of these issues.[24]

The dialogue concerning multinational antitrust rules is not diminishing, but is in fact increasing. It seems likely that the current US approach, reliance on bilateral cooperation agreements, is incomplete and likely insufficient. However, one of the reasons current bilateral agreements limit themselves to cooperation and "positive comity" is that there remain substantial differences in governmental views regarding the proper goals of and scope of substantive antitrust rules which ought to be applied internationally. It is my thesis that until we can work out what is feasible and successful on a bilateral basis, we will not have a sound basis to adopt competition rules at the WTO or other multilateral level. Even the proposals which limit the multilateral rules to requirements concerning adoption and enforcement of domestic competition laws must at some point address the substantive content of the laws to be adopted. If we can't make it work for two countries, how do we expect to make something work for 135 countries? If bilateral cooperation is insufficient, how do we go forward? The ultimate answers to these questions are not yet known.

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[23] Id., at 271.

[24] Some recent works in this area include E.M. Graham and J.D. Richardson, *Global Competition Policy* (Int. Inst. Economics, Washington, D.C., 1997); G.B. Doern and S. Wilks, eds, *Comparative Competition Policy* (Clarendon, Oxford, 1996); J. Haley and H. Iyori, eds, *Antitrust: A New International Trade Remedy?* (Seattle, Washington: Pacific Rim Law & Policy Association, 1995).

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Law and Policy Towards Vertical Restraints of Trade

The Case of Brazil

Leonardo ROCHA E SILVA*

I. INTRODUCTION

Vertical restraints can be defined as limitations imposed by the upstream firm in the production chain on the downstream firm[1] or vice versa.[2] For the sake of ease of analysis, vertical restraints are commonly divided into categories, as they may occur in a variety of forms. Although other sets of categories have been proposed, many commentators would agree that there exist two broad categories of vertical restraints. There are restraints that foreclose a competitor from selling its product (*foreclosure* or *interbrand restraints*)[3] and there exist restraints that limit a reseller's freedom to sell the product[4] (*intrabrand restraints*).[5] Tying arrangements, where the seller conditions the selling of a good to the buying of a second good, are an example of *foreclosure* or an *interbrand restraint*.

Intrabrand restraints, in turn, can be further treated as either *price* or *nonprice* restraints.[6] The first group would comprise those that directly affect the price of goods charged by the downstream firm, such as resale price maintenance (RPM) and price discrimination. The second group would include the restraints that impact on the method and extent of distribution of products, such as exclusive purchasing or dealing

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* LLB (1994), LLM in International Economic Law (1999, University of Warwick, UK). A member of the litigation department of the Brazilian law firm Pinheiro Neto—Advogados, he practices competition law and assists clients in merger and monopoly investigations before the Brazilian competition authorities. This article deals with Brazilian competition law and policy towards vertical restraints of trade, i.e. towards limitations imposed by the upstream firm in the production chain on the downstream firm or vice versa. This article presents an analysis of the treatment developed by the primary Brazilian competition authority, the Administrative Council of Economic Defence (*Conselho Administrativo de Defesa Econômica*—CADE), on resale price maintenance, exclusivity agreements, territorial and customer restrictions, refusals to deal, tying arrangements and price discrimination. The conclusion is that CADE is aware of the main economic issues related to vertical restraints and has recently attempted to establish an original approach to some restrictions, despite the influence of US and EC enforcers. This article therefore suggests that while CADE should draw upon the international experience in the competition field, it should refrain from transplanting alien decisions without careful examination.

[1] As noted by Wegener, "[t]he term 'vertical restraints' is relatively new. The concept of vertical arrangements in an antitrust case did not appear until *White Motor Co. v. United States*, 372 U.S. 253, 261 (1963). The term itself did not appear until three years later. *Ford Motor Co. v. Webster's Auto Sales, Inc.*, 361 F.2d 874, 881 (1st Cir. 1966)": Richard J. Wegener, *Nonprice Vertical Restraints: the good, the bad, and the undecided*, (1999) SD62 ALI-ABA 63, at 67.

[2] Over the years economists have tended to view vertical restraints as responses to supply and distribution problems of the upstream firm. More recently, however, some theorists have considered powerful retailers as instigators of vertical restraints. See Paul Dobson and Michael Waterson, *Vertical Restraints and Competition Policy*, Office of Fair Trading, London, Research Paper 12, (1996), at 7.

[3] Mainly affecting competition between brands.

[4] See E. Thomas Sullivan and Jeffrey L. Harrison, *Understanding Antitrust and its Economic Implications*, 2nd edition, Mathew Bender, New York, (1994), at 149; and Warren Grimes, *Brand Marketing, Intrabrand Competition and the Multibrand Retailer: The antitrust law of vertical restraints*, (1998) 64 Antitrust L.J. 83, at 136.

[5] Primarily affecting competition among resellers of the same brand.

[6] Wegener, as note 1 above, at 67.

agreements, exclusive dealership or distribution agreements, territorial and customer restrictions and refusals to deal.

Such business practices have attracted the attention of courts and competition authorities not only in the United States but also within the European Community, where intense debates on the appropriate treatment of vertical restraints have taken place within the last three decades. In the United States, for instance, a commentator has stated that "probably the most controversial debate over antitrust doctrine today concerns vertical restraints".[7]

In Brazil, however, the debate on the treatment of vertical restraints has not been as intense. Some reasons can be pinpointed. Until the beginning of this decade, competition policy had been relegated to a secondary role. The first Brazilian competition law[8] was enacted in 1962 but "survived" in an environment where government intervention, protectionism and regulation of private industry were very strong. In a period of high inflation rates, price control mechanisms were used on a large scale, impeding the flourishing of competition policy. After the enactment of a new constitution in 1988,[9] structural changes such as trade liberalisation; privatisation and deregulation took place.

In 1991, another competition law[10] was enacted in an attempt to create an institutional framework able to enforce the provisions targeting restrictive business practices more efficiently.[11] Later, as a part of a macro-economic stabilisation programme involving the introduction of a new currency and a tighter monetary policy, a more detailed competition law, Law 8884, of 11 June 1994, was introduced, aimed at a greater reliance on competition policy and efficient markets to protect consumer welfare. In fact, antitrust enforcement only became more prevalent in Brazil after the introduction of Law 8884/94 and arguably because of the structural changes leading to price stability. Since then, the primary Brazilian competition authority, the Administrative Council of Economic Defence (*Conselho Administrativo de Defesa Econômica*—CADE), has concentrated efforts on the control of horizontal agreements and mergers.

Although there has not been a strong debate over the approach to be adopted towards vertical restraints of trade, CADE has rendered decisions on a variety of cases involving such practices and has recently taken action to establish procedural rules and evaluation methods designed to enforce effectively the provisions of Law 8884/94, which aim at curbing restrictive practices including certain vertical restraints. This article is therefore concerned with the approach developed by CADE with regards to vertical restraints of trade as well as with the future trends.

Chapter II will explore the substantive provisions of Law 8884/94. This section will be especially important for the discussion, in the following chapter, of the

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7 Stephen Ross, *Principles of Antitrust Law*, The Foundation Press Inc., New York, (1993), at 224.
8 Law 4137, of 10 September 1962.
9 Federal Constitution, of 5 October 1988.
10 Law 8158, of 8 January 1991.
11 Lucia Salgado, *A Economia Politica da Ação Antitruste*, Singular, São Paulo, (1997), at 180.

decisions rendered by CADE regarding some vertical restraints. Chapter III is divided into six sections, dealing with six types of vertical restraint: resale price maintenance, territorial customer restrictions, exclusivity agreements, refusals to deal, tying arrangements and price discrimination. In Chapter IV, the conclusion will sum up the evaluation of the development of CADE's approach to vertical restraints.

II. THE REPRESSION OF RESTRICTIVE PRACTICES: THE SUBSTANTIVE PROVISIONS

A. INTRODUCTION

The Brazilian Federal Constitution of 1988 provides that "the law shall repress the abuse of economic power that is directed toward market control, elimination of competition, and the arbitrary increase of profits".[12] Law 8884/94 was therefore mainly designed to curb "abuse of economic power".[13] In line with competition laws enacted in other countries,[14] Law 8884/94 arguably targets three possible manifestations of abusive economic power: (1) agreements (including vertical ones) among independent companies, (2) acts performed by a single firm (a producer, distributor or retailer), and (3) structural combination of independent enterprises. The first two categories, which are related to vertical and horizontal restraints, are referred to by authorities dealing with Law 8884/94 as "conducts"; while the third category includes the "acts of economic concentration", such as mergers, acquisitions and joint ventures.[15]

As this paper is concerned with the treatment of vertical restraints in Brazil, this chapter will provide an explanation of the main substantive provisions of Law 8884/94 and other regulations that were issued in order to enable the Brazilian competition authorities to control "conducts". This will lead on to a discussion, in the following chapter, of the treatment of vertical restraints by CADE.

B. THE SUBSTANTIVE PROVISIONS: ARTICLES 20 AND 21 OF LAW 8884/94

Law 8884/94 adopts some expressions commonly used in jurisdictions like the European Community and the United States, but also contains peculiar terms. More technically, Law 8884/94 is said to regulate the prevention and punishment of "violations of the economic order".[16] Article 20 defines "violation of the economic order"[17] as any act intended or otherwise able to produce the effects of: "(I) limiting,

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[12] Article 173, Paragraph 3, 1988 Federal Constitution.

[13] In this sense, see, e.g. Neide Malard, *O abuso do poder econômico*, Fundação Getúlio Vargas, (1998).

[14] Michael Wise, *Review of the United States Competition Law and Policy: The role of competition policy in regulatory reform*, (1999) 1 OECD Journal of Competition Law and Policy 10, at 17.

[15] This article deals with CADE's approach towards the repression of some vertical anticompetitive business practices or conducts. Note, however, that Article 54 of Law 8884/94 sets forth a general test that makes compulsory the notification of any act that has anticompetitive impacts on the relevant market. CADE has interpreted this article mainly as the one dealing with notification of mergers, acquisitions and joint ventures. Therefore, few vertical agreements have been notified in order for CADE to exercise a preventive control, under Article 54 of Law 8884/94.

[16] Law 8884/94, Article 1.

[17] Law 8884/94, Article 20.

restraining or injuring open competition or free enterprise; (II) controlling a relevant market of a certain product or service; (III) increasing profits on an arbitrary basis; and (IV) abusing one's dominant position". Article 20 provides a definition of "dominant position",[18] establishing that dominance is presumed when a company or group of companies controls 20 percent of the relevant market. Such percentage however is subject to change by CADE depending on the economic sector involved.[19]

Law 8884/94 however does not define "relevant market". Recently CADE has attempted to do so in the guidelines attached to Resolution 20, of 20 June 1999, which establishes procedural rules and evaluation methods designed to enforce effectively the provisions of Law 8884/94. There it is stated that the "relevant market constitutes the space—in its product and geographical dimensions—in which it is reasonable to envisage the potential abuse of dominant position".[20] Resolution 20/99 further states that "in view of the 'test of the hypothetical monopolist', the relevant market is defined as the smallest group of product (or the smallest geographical area) in which a monopolist could maintain its price over the competitive level for a significant period of time."[21]

Article 21 of Law 8884/94 in the same chapter presents a non-exhaustive list of 24 restrictive practices that may be considered "violations of the economic order". This list contains vertical restraints commonly targeted by competition authorities like "tying arrangements",[22] "refusals to deal"[23] and "resale price maintenance".[24] Interestingly, Article 21 also includes other practices that indeed "seem to be out of place in a competition law"[25] as "to abandon or cause abandonment or destruction of crops or harvests, without good cause"; "to discontinue or greatly reduce production without good cause"; and "to partially or fully discontinue the company's activities, without good cause".

The conclusion that can be drawn is that there will be "violation of the economic order" whenever one or more firms undertake an act or enter into an agreement (listed in Article 21 or not) that may, effectively or potentially, produce any of the effects mentioned above.[26] It would seem clear, therefore, that for an act to constitute a "violation of the economic order", it has to be in breach of Article 20, but it is not necessary that it is also in breach of Article 21. If the act is not listed in Article 21 but is

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[18] Law 8884/94, Article 20, 2nd Paragraph, reads: "a dominant position occurs when a firm or group of firms control substantial part of relevant market as supplier, distributor, buyer or financier of a product, service or technology".

[19] Law 8884/94, Article 20, Paragraph 3.

[20] Resolution 20/99, Annex II.

[21] Resolution 20/99, Annex II.

[22] Law 8884/94, Article 21, Item XXIII.

[23] Id. at item XIII.

[24] Id. at item XI.

[25] See Dallal Stevens, *Competition Law in Brazil*, [1995] 4 ECLR 255, at 259.

[26] As has been pointed out, the legislator had three objectives with such provisions: (a) to give the enforcer of the law the freedom to apply a "rule of reason" when deciding whether the practice was anticompetitive or not; (b) to prevent that the provision that contained the non-exhaustive list was challenged; and (c) to provide for legal certainty by listing the practices likely to be challenged by the authorities: Calixto Salomão, *Direito Concorrencial: As estruturas*, Malheiros, São Paulo, (1997), at 67.

in breach of Article 20, it will still constitute a "violation of the economic order".[27] However, the wording of such provisions is not straightforward and gives rise to different interpretations.

C. Conflicting interpretations of the substantive provisions

According to some commentators, the inclusion of item (II)—"to control the relevant market of a certain good or service"—in Article 20 is unnecessary.[28] They argue that item (IV) of the same Article 20 already declares illegal the abusive exercise of a dominant position; and that Law 8884/94 affirms legal the market control achieved as a result of economic efficiency.[29] One scholar has stated that "in order to achieve the targets, it would suffice to have only item (IV), as it is more technical and better written. It is, therefore, unnecessary to undertake an analysis of item (II) of Article 20."[30]

Other commentators,[31] in turn, advocate that it is item (IV) of Article 20—"to abuse one's dominant position"—that appears to be a mistake committed by the legislator. Two reasons are given to support such argument. First, it is stated that Article 173 of the Federal Constitution of 1988 does not contain such effect.[32] Secondly, it is sustained that "to limit, restrain or injure competition, control a relevant market and arbitrarily increase profits are means of abusively exercising dominant position".[33]

Some scholars also believe that "to increase profits in an arbitrary manner"—item (III) of Article 20—can only be considered illegal when it is a result of the exercise of dominant position, which is targeted in item (IV) of Article 20. They argue that such practice is the consequence of the power held in a market rather than the demonstration of the existence of such power. Such commentators also affirm that the expression—"to arbitrarily increase profits"—was only included in Law 8884/94 to maintain coherence with the constitutional provision.[34]

D. The application of the substantive provisions in practice

The case law developed by CADE so far appears to be of little help to solve the problems with the interpretation of Articles 20 and 21. Under the terms of Law 8884/94,[35] CADE has the duty of adjudicating the administrative proceedings and

[27] For the opposite opinion, see Dallal Stevens, *Framing Competition Law within an Emerging Economy: The case of Brazil*, (1995) 40 Ant. Bull/Winter 929, at 995.
[28] See Stevens, as note 25 above, at 256; and Sergio Bruna, *O poder econômico e a conceituação do seu abuso*, Revista dos Tribunais, São Paulo, (1997), at 112.
[29] Law 8884/94, Article 20, Paragraph 1.
[30] Bruna, as note 28 above, at 113.
[31] See Fabio Coelho, *Direito Antitruste Brasileiro: Comentários à Lei 8.884/94*, Saraiva, São Paulo (1995), at 61; and Jose Ignacio Franceschini, *Introdução ao Direito da Concorrencia*, Malheiros, São Paulo, (1996), at 45.
[32] Coelho, as note 31 above, at 62.
[33] Id.
[34] Salomão, as note 26 above, at 88.
[35] Law 8884/94, Article 39.

preliminary investigations that are filed by the Economic Law Office (*Secretaria de Direito Econômico do Ministério da Justiça*—SDE). In order to file such administrative proceedings and preliminary investigations, SDE has the duty[36] of identifying not only which practices of a firm fall foul of Articles 20 and 21, but also identifying exactly which provisions of those articles are breached, "providing for the facts to be verified thereunder".[37] Instead of doing so, it seems that SDE has only been listing as many items of both Articles as possible, without due reference to the restrictive practices targeted.

The impression is that SDE officials find it very difficult to identify correctly the infractions committed. They therefore tend to list articles of law in an attempt to justify their investigations. SDE has been repeatedly failing to explain which articles and items have been breached and exactly to what extent the practice is considered a "violation of the economic order".[38] Such practice—of arbitrarily listing items and articles of law supposedly violated—has two immediate drawbacks. It harms the rights of the firms to defend them properly and also impacts directly and negatively on the judgement undertaken by CADE.

To illustrate this point at least one case can be cited. In 1996, an administrative proceeding was filed against *Ouro Fino et al.*[39] because SDE understood that some dry cleaning firms were "involved in a cartel" and were violating items (I) and (II) of Article 20 and also items (III), (IV), (V) and (IX) of Article 21. SDE did not point out how the parties could be "injuring open competition"—item (I)—or to what extent the firms were "controlling a relevant market" of services—item (II). Considering that SDE did not conduct a thorough investigation and that it even failed to identify the illicit act supposedly committed by Ouro Fino and other competitors, CADE decided to shelve the case. In an interesting opinion that supported CADE's decision on the matter, CADE's Attorney General Office stated that: "the authority [SDE] did not give to the firms the possibility of knowing in reality what was being investigated."[40]

The confusion with the terms and definitions can be seen in a number of cases, like the one cited above. No effort seems to have been made in such cases in order to clarify the charges and to give the firms the chance for a proper defence. When adjudicating the cases, CADE has so far failed to give proper guidance on the interpretation of Articles 20 and 21. The firms have therefore to adopt the costly strategy of defending themselves against everything that they can possibly think of in an attempt to avoid penalties and fines.[41]

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[36] Law 8884/94, Article 37.

[37] Law 8884/94, Article 32.

[38] In its recently issued 1999 Annual Report, however, SDE has stressed the need for "providing the facts to be verified thereunder" in all investigations, at 46.

[39] Administrative Proceeding (PA) 08000.028266/96-53, Complainant: *SDE ex officio*; Defendants: *Sociedade Ouro Fino de Lavanderia Ltda. et al*; Commissioner in charge: *Ruy Santacruz*; Date: *2 June 1999.*

[40] CADE Attorney General Office's opinion on the matter was cited by the Commissioner in charge of the case, in its report.

[41] For the fines and penalties to be imposed by CADE see Articles 23 to 27 of Law 8884/94.

E. A PROPOSAL FOR THE INTERPRETATION OF THE SUBSTANTIVE PROVISIONS

As a matter of fact, neither the commentators, nor the authorities in charge of enforcing Law 8884/94 have reached a consensus on the interpretation of Articles 20 and 21. Some authors, as seen above, advocate that item (II) of Article 20—"to dominate a relevant market of a certain product or service" is unnecessary. Others understand that it is item (IV)—"to abuse a dominant position"—that should not have been included in Article 20, as a "violation of the economic order". Finally, some believe that item (III)—to arbitrarily increase profits"—is a mere consequence of the abuse of a dominant position and should not be considered an independent illicit activity. On the other hand, both CADE and SDE have failed to give guidance on the interpretation of those provisions. So far they have acted in a way that creates uncertainty to the market players and poses problems to the defences of the companies suspected of carrying out restrictive practices.

It seems plausible to argue that Law 8884/94 targets two general types of restrictive practices: those whose object or effect is "to limit, restrain or injure free competition and free enterprise" (item I), and those that constitute an "abuse of a dominant position" (item IV). According to such interpretation, any commercial practice that falls foul of items (I) or (IV) of Article 20 should be deemed in "violation of the economic order". Only those items should be considered relevant for the Brazilian competition authorities' analysis, since Law 8884/94, based on Article 173 of the 1988 Federal Constitution, is designed to curb the "abuse of economic power".

It follows that item (II)—"to dominate a relevant market of a certain product or service" should not be taken into consideration alone because Law 8884/94 expressly acknowledges that the "achievement of market control as a result of competitive efficiency does not entail an occurrence of the illicit act".[42] Further item (III)—"to arbitrarily increase profits"—should not be considered an independent illicit activity. This is because, as has been pointed out, "large profits may in fact be beneficial in that they attract newcomers to the market; they may be indicative of efficiency rather than market power, or may be needed to enable a company to carry out research and development".[43] It would appear plausible to argue that only when large profits are a result of abusive exploitation of dominant position should the Brazilian competition authorities intervene.

Some may understand that such a proposal—of concentrating the analysis only on items (I) or (IV) of Article 20—represents a violation of Article 173 of the Federal Constitution of 1988, on the grounds that such provision expressly contains the expressions "market control" and "arbitrary increase of profits". This paper argues that this is not the case. Since the Federal Constitution of 1988 is concerned with "the abuse of economic power" the Brazilian competition authorities will be effectively

[42] Law 8884/94, Article 20, Paragraph 2.
[43] Stevens, as note 27 above, at 947.

enforcing Law 8884/94 if they target business practices whose object or effect is the restriction of competition; or that represent an abusive exploitation of a dominant position.

As a matter of fact, CADE's Commissioner Lucia Salgado recently made a statement that seems to support such a line of interpretation. Referring to Article 21, she stressed that "the law mentions restrictive practices as examples, in the assumption that the abuse of a dominant position or attempts to reduce competition can take countless forms in the real world".[44] It seems fair to state that she is also advocating that a commercial practice would only be considered a "violation of the economic order" when it would fall foul of items (I) or (IV) of Article 20, which is the interpretation being proposed in this article.

F. Further comments on the interpretation of the substantive provisions

It seems fair to state that the US courts have been considering some restrictive practices, such as minimum RPM as *per se* illegal. This approach contrasts with the "rule of reason" approach that has been adopted by the US courts in the majority of the cases involving vertical restraints of trade. In cases related to exclusivity agreements and customer and territorial restrictions, for instance, the US courts have been applying a rule of reason approach, which means that they have been inquiring into the purpose and effects of an alleged restraint, before considering it illicit. Although not as intense as it used to be, there is still a great debate over which restraints can be considered *per se* illegal and which should be submitted to a rule of reason approach.

In Brazil, although some authors have argued that it is not absolutely clear that Articles 20 and 21 of Law 8884/94 represent the adoption of a rule of reason approach,[45] such a debate seems to have been overcome. Alongside with the vast majority of scholars and commentators,[46] CADE has stressed in many decisions that Law 8884/94 expressly requires the adoption of a "rule of reason" approach to "violations of the economic order". The reason for this is the wording of Article 20, which determines that only conducts or acts in "any way intended or otherwise able to produce the effects" indicated in items (I), (II), (III) and (IV), can be considered "violations of the economic order". CADE therefore endorses the view that Article 20 does not allow the Brazilian competition authorities to consider any agreement presumably illegal. In every case it is essential to enquire into the purpose and effects of an alleged restraint and the examination of the economic context involved is compulsory.

[44] Lucia Salgado, *Dominant Position*, CADE, *Textos para Discussão*, 1998, available on the Internet at <www.mj.org.br/cade>.

[45] According to Stevens, as note 27 above, at 960, "the Brazilian law does not clarify whether it is applying a *per se* rule to the 'violations of the economic order' listed in article 21". See also Salomão, as note 26 above, at 223.

[46] See, e.g. Carlos Eduardo Carvalho, *A apuração de Práticas Restritivas da Concorrência*, (1995) *Revista Archè Interdisciplinar—Faculdades Integradas Candido Mendes Ipanema*, Ano IV, n. 11 at 73; Malard, as note 13 above, at 8; Coelho, as note 31 above, at 52; Franceschini, as note 31 above, at 38.

In fact, in the recently approved Resolution 20/99, CADE undoubtedly confirms its understanding that Law 8884/94 imposes a thorough investigation into the market impact of every restrictive practice. Resolution 20/99 determines that CADE shall examine the reasonableness of all horizontal or vertical agreements.[47] It also sets forth that "according to the reasonableness principle, the practices whose anticompetitive effects do not overcome potential benefits/efficiencies shall be condemned". Since a thorough analysis is said to be followed by CADE regardless of the practice undertaken, be it a horizontal price-fixing agreement or a tying arrangement, it is argued that CADE has once again affirmed its intention of applying a "rule of reason" approach to competition. However, it is yet to be seen whether CADE will effectively and consistently probe into market impact before deciding on the legality of every restriction.

III. Policy: CADE's Approach to Vertical Restraints of Trade

A. Introduction

As a matter of fact, both Europe and the United States have experienced an intense debate over the treatment of vertical restraints during the last decades. As economic models were developed, different policy approaches were and are still to be implemented towards vertical restraints in such jurisdictions. In Brazil, although the authorities have been largely influenced by their counterparts in the United States and European Community in the field of antitrust enforcement, such a debate can still be considered a novelty. Though CADE was created in 1962, it has not had the opportunity to decide on the legality of many vertical restraints. CADE's announcement that it has examined approximately 736 administrative proceedings and preliminary investigations from 1996 to 1998 should be treated with caution.[48] Lots of those cases were related to excessive pricing and were summarily dismissed due to absence of legal grounds. In a great number of others, CADE could not render proper decisions due to poor and lengthy investigations conducted by SDE,[49] who made it difficult for CADE to verify the accusations. It follows that few decisions can be used in order for one to assess CADE's approach to vertical restraints, especially if one is interested in the approach developed by CADE after the enactment of Law 8884/94.[50]

[47] The wording used in Annex II of Resolution 20/99 is as follows: "The national and international experiences reveal that it is necessary that one takes into account the specific context in which the practice occurs and its economic reasonableness. Therefore, one must consider not only the costs incurred, but also the eventual benefits arising from the practice in order to access the net effects over the market and consumers."

[48] See the 1998/1999 CADE Annual Report, available on the Internet at <www.mj.gov.br/cade>.

[49] Commissioner Lucia Salgado, for example, has pointed out this problem in her recent paper cited in note 45, above.

[50] The great majority of the administrative proceedings examined by CADE in recent years, as the *Kibon*, *Valer*, *Xerox* and *Sharp* cases commented on later in this chapter, were filed under repealed Laws 4137/62 and/or 8158/91. Considering that the main provisions of such laws are contained in Article 20 and 21 of Law 8884/94, no further comments on those statutes seem to be appropriate at this point. This is because the objective of the analysis being made is to assess the main features of the analysis developed by CADE towards the most common vertical restraints.

As this paper is mainly concerned with CADE's recent approach to vertical restraints, this chapter will review some of the most important decisions that CADE was able to render on the matter in the last few years. This chapter will also discuss in more detail the terms of Annex 2 of Resolution 20/99, since CADE is expected to be following the guidelines contained therein in future decisions. As Resolution 20/99 classifies resale price maintenance, territorial and customer restrictions, exclusivity agreements, refusals to deal, tying arrangements and price discrimination, as the most common vertical restraints, this chapter will attempt to present an analysis on CADE's approach towards all of them. In each section, the applicability of Law 8884/94 to each practice will be considered. Thereafter, the effects of Resolution 20/99 and the major CADE decisions (when available) will be dealt with.[51]

B. Resale price maintenance

Resale price maintenance refers to agreements entered into between the upstream and the downstream firms establishing the price (minimum, maximum or fixed) at which the former would be obliged to sell the products or services. Article 21[52] of Law 8884/94 indicates RPM as a suspect category of "violation of the economic order". RPM may be considered illegal under Law 8884/94 whenever it has the purpose or effect of (1) limiting or injuring free competition or free enterprise or (2) abusing a dominant position, as has been discussed in Chapter II.

Through Resolution 20/99,[53] CADE endorses most of the criticism against imposing RPM. CADE stresses that RPM may impair competition by facilitating cartel behaviour amongst producers (as it eases price monitoring) and by foreclosing new and perhaps more aggressive players in the market. CADE also points out what it considers to be "other" negative effects of RPM: the "unilateral" increase in the producer's market power, due to the possibility of creating barriers to entry for new and more competitive downstream firms. Regarding maximum RPM, CADE highlights the potential anticompetitive effects that might be generated by the upstream firm attempting to exclude downstream firms that aggregate substantial value to the product.

The only efficiency gain of RPM referred to by CADE in the specific section of Resolution 20/99 is the possible reduction of transaction costs. However, CADE seems to agree that RPM may give the downstream firms the incentive to promote the goods and provide services that may improve the brand image, benefiting both producer and consumer, as some general comments on this efficiency gain were presented in a introductory section of Resolution 20/99. CADE also appears not to ignore that RPM may help small firms to compete with large ones, normally in

[51] The cases commented on in this chapter have been chosen to illustrate CADE's approach to some restraints because they contain important statements by CADE commissioners.

[52] Law 8884/94, Article 21, item XI.

[53] Resolution 20/99, Annex 1, item 1.

condition to obtain discounts with producers. In the section dedicated to RPM, Resolution 20/99 finally urges the adoption of a thorough analysis where both anti and procompetitive effects of a given RPM case should be investigated.

1. *The* Kibon *Case*[54]

No discussion of CADE's approach to RPM could be regarded as complete without an analysis of the *Kibon* case. In this case, SDE filed an administrative proceeding against ice-cream manufacturer Kibon under the assumption that the price list it used to present to its retailers constituted a "violation of the economic order". After providing rather inaccurate and inappropriate comments on US and EC competition laws,[55] CADE undertook an unusually thorough analysis to reach the conclusion that the price list sent by Kibon to its retailers constituted *suggested retail price* and not *retail price maintenance*. The decision was important because it gave CADE the opportunity to discuss the issue for the first time.

Before ruling that the practice was not a "violation of economic order", Commissioner Leônidas Xausa collected data from the market participants and also examined the market power owned by Kibon, because of his understanding that the adoption of a rule of reason approach was compulsory. CADE found that there was high level of interbrand competition, weak barriers to entry and atomistic supply, which would make the imposition of price lists and abuse of market power by Kibon virtually impossible. However, CADE put a lot of weight on the finding that the terms of the agreements entered into by Kibon revealed that the price lists were suggested rather than imposed. The wording of the opinion rendered by Commissioner Xausa may therefore lead to the conclusion that if the agreement had a clause providing for the imposition of the price list, CADE would have ignored the other indications of fierce competition in the market to rule Kibon's conduct illegal.

Resolution 20/99 suggests that CADE will be more careful in the assessment of the pro and anticompetitive effects of the conduct on the market and will only render RPM conduct illegal after analysing extensively the economic context involved. This would contrast with the approaches being pursued by US and EsC enforcers, who are definitely advocating a blatant opposition at least to fixed and minimum RPM.

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[54] Administrative Proceeding (PA) 148/94, Complainants: *Sindicato das Indústrias de Panificação e Confeitaria de São Paulo and Associação das Indústrias de Panificação e Confeitaria de São Paulo*, Defendant: *Indústrias Alimentícias Gerais S.A.—KIBON*, Commissioner in charge: *Leônidas Xausa*, Date: *5 November 1997*.

[55] Commissioner Leônidas Xausa mentioned, for instance, that "intrabrand competition, for its turn, is absolutely similar to the notion of franchising", and copied in his opinion a part of EC Regulation 4087/88, dated 30 November 1988.

C. Territorial and customer restraints

By imposing territorial and customer restraints the manufacturer limits the distributor's ability to choose the area in which he will trade. An example of a territorial clause is the requirement that the dealer should only sell the product to customers located in a specific area. The customer clause, in turn, demands that the sales be not made to certain types of consumers, as governmental agencies, for instance. Article 21, item XI, of Law 8884/94 considers as a potential "violation of the economic order", "the imposition on distributors, retailers and representatives of a certain product or service retail prices, discounts, payment conditions, minimum or maximum volumes, profit margins, or any other marketing conditions related to their business with third parties". Territorial and customer restrictions are therefore expressly targeted by CADE and considered, in Resolution 20/99, as a common vertical restraint that may need to be examined closely.

Resolution 20/99[56] points out that territorial and customer clauses are likely to restrain competition and bar the entrance of other distributors in different regions. CADE goes further to stress that such clauses facilitate collusive behaviour among producers and/or distributors since it raises the costs of rival firms, which will be tempted to reduce output and raise prices. CADE is also concerned with: (1) the possible "unilateral" increase in the producers' market power, especially in the aftermarkets,[57] (2) the rise in the costs of entry in the geographical market included in the restriction; and (3) the foreclosure of the market to effective competitors interested in potential consumers.

As it calls for the adoption of a balancing test in the analysis of vertical restraints, Resolution 20/99 points out that territorial and consumer restrictions can also lead to economy in transaction costs. The possible increase in interbrand competition and minimisation of the free rider problem seem also to be considered by CADE as positive effects of territorial and consumer restrictions, although not expressly referred to as such in the appropriate section. As CADE has not adjudicated any relevant case involving mainly territorial and consumer restrictions, it is yet to be seen how it will in fact balance the procompetitive justifications for such a restraint against its envisaged negative effects. It is foreseeable, however, that CADE will follow the more lenient approach developed by the US courts towards territorial and customer restraint, as no market integration goal informs Law 8884/94, as it does in EC competition law.

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[56] Resolution 20/99, Annex 1, item 2.

[57] CADE mentions that the monopolist producer may explore the users of post-sales services, in case such consumers face problems in changing suppliers of goods and services and are locked-in because they cannot find other service providers.

D. Exclusivity agreements

The term "exclusivity agreements" may refer to arrangements where the producer is supplying its goods only to one downstream firm in a determined geographical area (exclusive distribution) and to arrangements where the distributor is buying only from one specific upstream firm (exclusive purchasing). Such commercial practices are not included in Article 21 of Law 8884/94 as one of the suspect practices.[58] This does not mean, however, that exclusivity agreements are presumed legal under Law 8884/94. As with other unlisted practices, an exclusivity agreement can still be caught as a "violation of the economic order" provided that it is in breach of any of the items of Article 20 of Law 8884/94, as explained in Chapter II. In fact, through Resolution 20/99, CADE treats exclusivity agreements as "one of the most common vertical restraints", and therefore attempts to set forth guidelines for its analysis.

Resolution 20/99[59] first clarifies that CADE uses the term "exclusivity agreements" for both exclusive purchasing and exclusive distribution agreements.[60] It follows that Resolution 20/99 focuses on the anticompetitive effects of both types of agreements, such as (1) "introduction of a collusive behaviour leading to a cartel in the 'origin' market"; and (2) the increase of the firm imposing the exclusivity's market power, by raising barriers to entry into the market by outsiders. Nevertheless, CADE does not expressly acknowledge, for instance, the fact that exclusive purchasing agreements will never result in foreclosure of the downstream market and that exclusive distribution agreements will never amount to foreclosure of the upstream level, provided that such an agreement is not coupled with exclusive purchase.[61] Further, Resolution 20/99 does not give an indication as to whether the length of the exclusivity agreement would be considered relevant for the analysis[62] or whether CADE agrees that exclusive distribution agreements can only dampen competition downstream when interbrand competition is weak.[63]

Regarding the potential efficiency gains of exclusivity agreements, Resolution 20/99 stresses once again that CADE will be looking at the economy in terms of transaction costs, related to the exclusion of free-riders and diminution of sunk costs. CADE does not, however, mention other commonly listed positive effects of exclusive distribution and exclusive purchasing agreements. CADE fails to give a clear indication

[58] Law 8884/94, Article 21, item VII, however, reads "to require or grant exclusivity in mass media advertisements".

[59] Resolution 20/99, Annex 1, item 3.

[60] Such a distinction can be verified within the EC, where the European Commission issued specific regulations to each of them. In the United States, "exclusive distribution" or "exclusive selling" are treated as "exclusive dealership"; while "exclusive purchasing" is regarded as "exclusive dealing". See Barry Hawk, *United States, Common Market and International Antitrust: A comparative guide, Volume II*, Prentice Hall Law & Business, New York, 1993, Supplement.

[61] Zoltan Biro and Amelia Fletcher, *The E.C. Green Paper on Vertical Restraints: An Economic Comment*, [1998] 3 ECLR 129, at 132.

[62] Posner, e.g., argues that the negative effect of an exclusivity dealing arrangement is conditioned to its duration: Richard Posner, *Antitrust Law*, Chicago Press, Chicago, 1976, at 201.

[63] Biro and Fletcher, as note 61 above, at 131.

that it is aware that exclusive distribution agreements, for instance, allow producers (1) to enter new geographical markets, due to the experience of dealers already established, and to (2) facilitate the promotion of sales of their products while at the same time rationalising distribution.[64] CADE does not clearly indicate whether it agrees that exclusive purchasing agreements "can improve the production and distribution of goods because they enable the parties to plan production and sale with greater precision".[65] It can be argued that benefits alike are included under the broad expression "reduction of transaction costs". However, as Resolution 20/99 is supposed to contain guidelines, more clarity and transparency would have been welcome.

2. *The* Valer *Case*[66]

It seems fair to state that, after the enactment of Law 8884/94, CADE has not had the opportunity to examine any relevant case solely related to exclusivity agreement. Before that, however, CADE scrutinised the landmark *Valer* case, which involved an exclusivity agreement signed between a meal voucher company, Valer, and some supermarkets. Valer agreed to reduce the period for which supermarkets had to wait to get cash for the meal vouchers they received from customers. In turn, supermarkets agreed to accept only Valer meal vouchers. According to CADE, the question was whether such an agreement represented Valer's intention to dominate the meals voucher market and whether such a conduct produced anticompetitive effects in the relevant market. Arguably applying a rule of reason approach to such restraint, CADE found that the meals voucher market was concentrated and that Valer had diminished market share. CADE also found that the barriers to entry were low and that few supermarkets in fact entered into such an agreement with Valer.

In a unanimous decision, CADE dismissed the case, ruling that an exclusivity agreement, such as the one entered into by Valer, can only result in injury to competition when the firm entering into the agreement has market power, and when the agreement affects a substantial part of the relevant market. CADE reasoned that since Valer did not have market power (as market share and barriers to entry were low), it did not have the intention of injuring competition. This reasoning appears to be dangerous. It may lead CADE to presume that a firm enjoying market power has always the intention of injuring competition when it enters into exclusivity agreements. In fact, in the *Valer* case, CADE even mentioned that "Valer's clear intention to injure competition would suffice to condemn it". This decision demonstrates that although CADE is aware of the necessity of a thorough analysis of the anti and procompetitive effects of exclusivity agreements, it seems to have

[64] Doris Hildebrand, *The Role of Economic Analysis in the EC Competition Rules*, Kluwer Law International, London 1998, at 281.

[65] Hildebrand, as note 64 above, at 284.

[66] Administrative Proceeding (PA) 32/92, Complainant: *Economic Law Office "ex officio"*, Defendant: *Valer Alimentacao e Servicos Ltda*, Commissioner in charge: *Neide Malard*, Date: *22 April 1993*.

problems in pursuing such a policy. Resolution 20/99, however, indicates that CADE is keen to adopt a more permissive approach to such restraints, in line with the approaches being developed by US and EC enforcers.

E. Refusals to deal

Refusal to deal is considered a "difficult topic in competition law",[67] since it involves the right of firms to establish the conditions in their agreements and the freedom to contract with any company as they wish. Article 21, item XIII, of Law 8884/94, considers refusals to deal as a potential restrictive practice or "violation of the economic order". As the Brazilian Federal Constitution 1988 guarantees the right of free enterprise, the task of finding that a given practice constitutes an anticompetitive refusal to deal is not easy for the competition authorities. Although this practice is more likely to give rise to competition concerns whether it happens as a manifestation of abuse of a dominant position, Law 8884/94 does not expressly require that a firm holds such a position in order for CADE to rule a refusal to deal illegal. Perhaps more than in other cases, what seems to be important is the intention of the firm imposing the restriction. It is within this context that we shall examine next the terms of Resolution 20/99.

Interestingly, Resolution 20/99[68] refers to refusal to deal where the supplier/buyer or group of such players unilaterally establishes the conditions in which they intend to deal, focusing less on the denial itself. CADE goes further to point out that such practice may block the distribution or supplying channels or increase the barriers to entry in such channels by other firms. CADE also demonstrates its concern that a firm uses this type of practice to extend its power in the aftermarket, i.e. in the market of the post-sale services, acknowledging the fact that refusals to deal are normally associated with RPM and exclusivity agreements. Although CADE stresses that it is specially concerned with the refusal to deal by firms controlling essential facilities, it does not mention in which circumstances it understands the seller may lose its freedom not to sell its products. If one turns to case law, some further guidance can be found, as can be seen in the *Columbia Tristar* case.

3. *The* Columbia Tristar *Case*[69]

In this case, Columbia Tristar, United International Pictures, Fox and Warner Bros., were accused of refusal to supply first-run motion pictures to Rio Grande, an exhibitor with theatres located in the city centre of Natal. This would allegedly benefit

[67] Richard Whish, *Competition Law*, 3rd edition, Butterworths, London, 1993, at 612.

[68] Resolution 20/99, Annex 1, item 4.

[69] Preliminary Investigation No. 080012.007758/97-66, Complainant: *Rio Grande Ltda*, Defendants: *Columbia Tristar Buena Vista Filmes do Brasil Ltda et al*, Commissioner in charge: *Marcelo Calliari,* Date: *10 February 1999.*

its sole competitor, the major Brazilian exhibitor group (Severiano Ribeiro), who had theatres in the biggest shopping mall in Natal. The defendant suppliers alleged that first-run motion pictures were distributed to firms best positioned to offer consumers best facilities and, therefore, to provide best returns. The defendants also contended that the performance of both distributors and exhibitors was directly related to box office revenues and that the increasing number of theatres posed an additional advantage to the very competitive distribution business.

Affirming the decision rendered by SDE, CADE dismissed the case on the grounds that no supplier enjoyed a dominant position, since the market was extremely volatile due to the dependence on the success of the motion pictures released. Citing a decision rendered by the US Supreme Court in 1954,[70] CADE ruled reasonable the option of the suppliers to benefit the best-equipped exhibitor, Severiano Ribeiro, who were in position to attract more consumers and therefore more revenue directly transferred to the suppliers. CADE did not undertake a thorough analysis of the markets involved but could infer, by using the information gathered by SDE from the defendants, that the distribution market was atomistic and that the barriers to entry were extremely low. Most importantly, CADE made it clear that an illegal refusal to deal can only be performed by a firm holding a dominant position, since a refusal to deal does not injure competition when there exist alternative suppliers of the same product. This ruling is in line with the case law developed in the United States and consistent with EC competition law,[71] since both systems, in broad terms, require a showing of market power and the absence of an alternative source of supplies in order to condemn a firm for refusing to deal.

F. Tying arrangements

Tying arrangements take place whenever the seller conditions the sale of a product to the buying of a second product. Such practice is cited in Article 21 of Law 8884/94[72] as a suspect category of "violation of the economic order". Law 8884/94 does not require expressly that the tying arrangement be undertaken by a dominant firm in order for it to be considered illegal. It seems possible therefore to argue that a tying arrangement can be considered a "violation of the economic order" even if the company does not have sufficient market power.[73] Some commentators, however, are of the opinion that Law 8884/94, although unclear, should be interpreted in a way that

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[70] Commissioner Marcelo Calliari cited the case *Enterprises Inc. v. Paramount Film Distribution Co*, (1954) 346 U.S. 537, 74S.Ct. 257.

[71] According to Whish, "unilateral refusals to supply are caught, if at all, under Article 86. That they might constitute an abuse was clearly established by the ECJ in *Commercial Solvents v. Commission*": Whish, as note 67 above, at 614. In the same sense, see D. G. Goyder, *EC Competition Law*, 3rd edition, Clarendon Press, Oxford, 1998, at 258.

[72] Law 8884/94, Article 21, item XXIII.

[73] In this sense, see, e.g., Paula Forgioni, *Os Fundamentos do Antitruste*, Revista dos Tribunais, São Paulo, 1998, at 139.

a tying arrangement will only be considered illegal if the firm is abusing a dominant position.[74]

CADE appears to be embracing the former position. Through Resolution 20/99,[75] CADE has attempted to establish a more economic approach to tying arrangements, focusing on the existence of market power by the firm imposing the restriction. Resolution 20/99 reveals that CADE reckons that tying arrangements can have anticompetitive effects but can also produce efficiencies, such as transaction cost reductions, and economies of scope in the production and technical complementarity. The main concern of CADE is the possibility that the tying arrangement enables a company having a monopoly in one market to obtain a monopoly in a second market, allowing the firm to increase abusively its profits in detriment of the buyers and ultimately the consumers. Resolution 20/99 also acknowledges that tying arrangements can foreclose competitors and raise barriers to entry to potential or actual competitors.[76]

Finally, Resolution 20/99 indicates that tying arrangements can be used by regulated industries to circumvent the limits imposed by regulatory bodies and calls attention to the anticompetitive effects that can be originated by the conduct of a firm providing post-sales services. In fact, it seems fair to state that Resolution 20/99 introduces a substantial change to CADE's approach to tying arrangements. A critical appraisal of three decisions rendered by CADE in the recent past may be able to demonstrate such a change.

1. *The* Xerox *Case*[77]

In the *Xerox* case, CADE examined a complaint filed by one of the companies renting Xerox's photocopying machines. The complainant alleged that Xerox was conditioning the maintenance services it provided to the use of other materials it produced. Under a standard agreement signed with Xerox, the complainant was allegedly obliged to buy developer, photo-receiver and other materials from Xerox, in order for Xerox to provide maintenance services. In its defence, Xerox pointed out that the maintenance services were included in the rental agreement, and could not, therefore, be considered a "second product" to give rise to a tying arrangement charge. Further Xerox argued that the agreement allowed the hirers to purchase products from other manufacturers. Finally, Xerox also alleged that the questioned clause in the standard agreement had the sole objective of "protecting" its property, since the

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[74] Salomão, as note 26 above, at 226.

[75] Resolution 20/99, Annex 1, item 5.

[76] Resolution 20/99 also indicates that tying arrangements can help the firm deviate from the limits of the return taxes and price in regulated industries, provided that the firm is able to increase the total price by the compulsory inclusion of a new product or service in a "package".

[77] Administrative Proceeding (PA) 23/91, Complainants: *Repro Materiais e Equipamentos de Xerografia et al*, Defendant: *Xerox do Brasil S.A.*, Commissioner in charge: *Marcelo Soares*, Date*: 31 March 1993.*

products of other companies were likely to damage the rented photocopying machines.

In its analysis, CADE identified three relevant markets and Xerox's respective market shares. CADE found that Xerox had a share of 77.7 percent, in the photocopying machines market, of 91 percent in the maintenance services market; and from 74.3 percent to 100 percent in the materials (such as toner and developer) market. Based on such figures, CADE concluded that Xerox enjoyed a dominant position in all three relevant markets, but decided that it was the abuse of such a dominant position that was targeted. After examining letters exchanged by Xerox and some hirers, CADE ruled that by imposing the purchase of goods over its hirers, Xerox was restricting competition and abusing its market power. CADE held that Xerox was erecting barriers in order to eliminate its competitors, creating difficulties for the utilisation of its rivals' products by the hirers, without giving sufficient evidence that such products were detrimental to the photocopying machines. Xerox's acts were therefore considered illegal and it was heavily fined. CADE also determined that Xerox performed some alterations to its agreements in order to allow hirers to use other firms' products.

Interestingly, CADE members stressed that their decision was similar to the one taken, in 1975, by the US Federal Trade Commission (FTC) in a case involving Xerox Corporation. In its opinion, Commissioner Marcelo Soares even quoted a part of the consent order issued by FTC in order to support its decision that Xerox conduct was illegal,[78] showing how influential the foreign decision was, despite the probable and ignored differences in the concentration levels of the markets involved. It is also interesting that CADE was only concerned about the characterisation of the conduct, by finding evidence that Xerox was conditioning the buying of the materials to the rendering of the maintenance services. CADE did not undertake a thorough analysis of the effects of such conduct on competition nor of the indications of efficiency gains (reduction of transactions' costs, for instance). CADE basically assumed that such conduct would create barriers to new or potential entrants, was detrimental to competition and therefore illegal. In fact, CADE failed to adopt a "rule of reason" approach, although it was of the opinion that Law 8158/91, in effect at that time, did ask for such an approach, since it set forth that the purpose and effects of every business practice had to be examined.

[78] The piece copied was: "… Xerox shall in addition to instructing its employees in the United States not to comment on the quality of competitive toner or developer, place a notice in a location conspicuous to the key operator on each office copier sold or leased by it in the United States stating the following: Xerox Corporation manufactures and distributes toner and developer for use in this machine. Other suppliers may also provide toner and developer for this machine. It may be necessary to adjust the machine to accommodate toner or developer which is provided by either Xerox or any other supplier" (86 FTC 363, decision of 29th July 1975).

2. *The* Sharp *Case*[79]

In the *Sharp* case, CADE also examined the conduct of a photocopying machine producer, Sharp, which was also allegedly conditioning the rendering of maintenance services to the buying of spare parts and materials it also produced. As it did in the *Xerox* case, CADE analysed in detail the agreements entered into by Sharp, concluding that Sharp's conduct was harmful to competition and therefore illegal, despite the fact that Sharp had only 3.5 percent of the photocopying machine market. Following Commissioner Carlos Eduardo Carvalho's opinion, CADE assumed that Sharp had the power to fix the price of material goods above the competitive level, which would allow it to benefit from arbitrary profits.

It seems clear that CADE again treated the tying arrangement as illegal *per se* as it did not undertake a thorough analysis of the markets involved or of the effects of Sharp's conduct towards the market. CADE has also failed to examine the potential or actual efficiencies of the practice. For CADE, it was irrelevant that Sharp accounted for just 3.5 percent of the relevant market. In its opinion, Commissioner Carvalho stated that tying arrangements are harmful to competition as they limit the consumer's ability to choose the product or service. He did not, however, consider any argument in favour of eventual procompetitive effects of such conduct. He was also of the opinion that competition in the market of the tied product is "inevitably" impaired, with the elimination of actual or potential competitors due to difficulties created for the performance or development of companies in that market. This also reveals that CADE did not adopt a "classic" rule of reason approach, which put its decision more in line with the US court approach to tying arrangements.

3. *The* Vesuvius *Case*[80]

More recently, when examining the agreement by which Vesuvius bought 100 percent of the quotas of Re-Plate, Commissioner Lucia Salgado commented on the treatment of tying arrangements in an opinion concurred by other CADE members. While discussing the definition of the relevant markets involved in the transaction, Commissioner Salgado stressed that tying arrangements "can only occur when there exists market power in one of the markets". In this respect, she mentioned that the evaluation of the market shares would suffice to verify the market power requisite in cases alike. Commissioner Salgado further pointed out that "in order for the tying arrangement to be considered anticompetitive it has to allow the tying firm to extend its market power from one market to another (leverage theory)". She finally proposed the examination of the potential barriers to entry as she manifested her

[79] Administrative Proceeding (PA) 01/9, Complainant: *Interchemical Ind. e Com. Internacional Ltda*, Defendant: *Sharp Ind. e Com. Ltda*, Commissioner in charge: *Carlos Eduardo Carvalho*, Date: *28 May 1993*.

[80] Concentration Act (AC) 08012.007674/98-59, Applicants: *Vesuvius Refratarios Ltda & Re-Plate Equipamentos Metalurgicos*, Commissioner in Charge: *Lucia Salgado*, Date: *12 May 1999*.

understanding that tying arrangements can create significant barriers to entry, by raising capital costs, since new competitors can be forced to enter into two markets as oppose to one due to the tying arrangement.

Endorsing Commissioner Salgado's method of analysis, CADE cleared the transaction and ruled that Vesuvius, though holding a 66 percent share in the tying product market, was not likely to enter into anticompetitive tying arrangements. CADE undertook an analysis of the barriers to entry into and the concentration level of the relevant markets involved in the transaction. It then reached the conclusion that the operation did not put Vesuvius in a position of leverage power in the tying market mainly because Vesuvius' competitors were in position to supply similar products at similar prices and quality. In the *Vesuvius* case, CADE opted to undertake an analysis of other aspects determining market power and definitely conducted a more economic approach towards the transaction in order to assess the likelihood of occurrence of an anticompetitive vertical restriction. It is yet to be seen, however, whether CADE will adopt a "classic" rule of reason approach to tying arrangements, differing from the "modified" *per se* rule approach that has been adopted by US courts recently.

G. Price discrimination

Price discrimination refers to the sale of goods or services at prices not corresponding to differences in the cost of supplying them.[81] Article 21 of Law 8884/94 expressly acknowledges such practice as a suspect category of "violation of the economic order".[82] Law 8884/94 does not make it clear whether a firm without substantial market power could be investigated because of price discrimination, even though some economists sustain that such condition is essential.[83] It seems unquestionable, nevertheless, that Articles 20 and 21 of Law 8884/94 condemn not only agreements but also unilateral action to restrict competition. As Resolution 20/99 attempts to provide guidance on the examination of price discrimination charges, a close analysis of it is deemed necessary.

Through Resolution 20/99[84] CADE gives an indication that it will only pursue a price discrimination investigation if the accused firm holds market power. This is because CADE states that price discrimination occurs whenever "the producer uses its market power in order to fix different prices for the same product/service, discriminating against individuals or groups of purchasers, acquiring consumer surplus and raising its profits". CADE also acknowledges the fact that such a practice is not "intrinsically" anticompetitive and should be examined carefully, as it may not impact consumer welfare and can possibly raise the number of transactions in the market.

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[81] See Scherer and Ross, *Industrial Market Structure and Economic Performance*, 3rd edition, Houghton Mifflin Company, Boston, 1990, at 489.
[82] See Law 8884/94, Article 21, item XII.
[83] Scherer and Ross, as note 81 above, at 488.
[84] Resolution 20/99, Annex 1, item 6.

CADE is aware that, in the public utilities sector, price discrimination may occur more often, due to the existence of consumer categories with extremely different levels of consumption. Further CADE identifies that it may be efficient to charge differently, for the same service, higher-volume consumers or at different times of the day. Finally and arguably in line with modern economic thinking,[85] Resolution 20/99 urges that price discrimination practices be investigated with special care and with a proper appreciation of the economic issues involved. Although less detailed than it possibly could have been regarding this complex issue, particularly because no relevant case involving such practice has been decided recently, Resolution 20/99 at least indicates that CADE is aware that "simple generalisations about their [price discrimination] economic effects are apt to be misleading".[86] CADE's intended rule of reason approach to price discrimination is arguably more lenient than the treatment adopted in the United States,[87] and within the European Community,[88] where price discrimination practices have been facing blatant opposition.

IV. Conclusion

This paper has focused on the Brazilian competition law and policy towards vertical restraints of trade. As seen in Chapter II, Law 8884/94 can be considered a mixture of the main US antitrust statutes with some provisions of the EC Treaty of Rome. The result is a set of "imperfect" provisions that clearly attempted to condense years of antitrust enforcement in the United States and in the European Community. The substantive provisions of Law 8884/94 dealing with the repression of "conducts", or "violation of the economic order", including vertical restraints, are not straightforward and definitely create problems to the interpreters.

This article has therefore argued that the Brazilian competition authorities faced with a claim involving a given commercial practice must analyse whether such a conduct "limits, restrains or injures free competition and free enterprise" (Article 20, item I) or whether it represents an "abuse of one's dominant position" (Article 20, item IV). This analysis would seek to examine the purpose and to balance the pro and anticompetitive effects of any restraint, as Law 8884/94 obliges CADE to undertake a thorough analysis of every practice submitted to its review.

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[85] Scherer and Ross, as note 81 above, at 508.

[86] Scherer and Ross, as note 81 above, also at 508.

[87] Frazer has pointed out that, in the United States, "[a]ny differences in price will give rise to a presumption of discrimination, and any substantial discrimination maintained over a period of time will give rise to a presumption of competitive injury. Discrimination may be justified by the seller, or the purchaser, on the basis that it reflects a savings in costs, or that it was made in good faith to meet the lower price of a competitor; both of these defences involve significant difficulties for the defendant.": Tim Frazer, *Monopoly, Competition and the Law*, Wheatsheaf Books, Sussex, 1988, at 228.

[88] As mentioned by Whish, in "*United Brands Co. v. Commission*, the European Court of Justice held that UBC had abused its dominant position by charging different prices for its bananas according to the Member State of their destination.": Whish, as note 67 above, at 549.

In Chapter III, where CADE's approach to the six most common vertical restraints was examined, it was demonstrated that CADE is aware that vertical restraints have intricate potential pro and anti-competitive effects and that such restraints "cannot be presumed to be anti-competitive simply because they raise rival's costs".[89] CADE has indicated that territorial and customer restrictions, exclusivity agreements, and refusals to deal and price discrimination, will most likely be treated on a case-by-case basis, without generalisations. The decisions rendered by CADE recently, however, have also revealed CADE's concern with minimum and fixed RPM and with tying arrangements. Although it has stressed on various occasions its understanding that Law 8884/94 demands a rule of reason type of approach even in such cases, it is yet to be seen whether such an approach will be carried through consistently in relation to RPM and tying cases.

This article has revealed that CADE has made efforts to follow the main international trends regarding the treatment of vertical restraints of trade and will therefore seek to verify: "(i) signs of market power at the manufacturer and/or retailer level; (ii) the effects on competition; and (iii) indicators of efficiency",[90] when reviewing such practices. Through Resolution 20/99, CADE has established a fairly helpful set of guidelines on the examination of vertical restraints. As seen here, the guidelines seem to be consistent with the provisions of Law 8884/94, but could have been more detailed when dealing, for instance, with exclusivity agreements. While the policy set forth in Resolution 20/99 towards RPM and tying arrangements seems consistent with the provisions of Law 8884/94, it does not necessarily adhere to the approach adopted in other jurisdictions, such as the United States and the European Community. However, it is important that CADE resist the temptation of following alien decisions wholesale in these and other cases without due regard to Brazilian law. Rather, a deep and critical analysis of the international experience will enhance the decision-making process of CADE, ensuring legal certainty, predictability and, most importantly, compliance with Law 8884/94.

[89] This is also the opinion presented by the Joint Group on Trade and Competition of the OECD, *Competition and Trade Effects of Vertical Restraints*, COM/DAFFE/CLP/TD(99)54—26 May 1999, at 10.

[90] As suggested by Dobson and Waterson, as note 2 above, at 52.

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Decentralised Enforcement of EC Competition Law and the New Policy on Cartels

The Commission White Paper of 28th of April 1999

Dr Tim WIßMANN*

I. INTRODUCTION

Reform and decentralisation of enforcement of competition law in the Community have in recent years become the central plank of the academic and political debate in EC antitrust law. In the times of subsidiarity, decentralisation and the incapacity of the Commission to effectively and timely handle the task it is entrusted with by the ageing Regulation 17, it is a pure necessity to engage in a discussion as to the future of competition law enforcement. Despite widespread calls for reforms, the Commission has in the past remained conservative with regard to amendments which question its monopolised jurisdiction on cartels. This, however, is no longer the case.

On 28 April 1999 the Commission issued the by now well known *White Paper on Modernisation of the Rules Implementing Articles 85 and 86 of the EC Treaty*.[1] To the surprise of many, it proposes significant changes to the system of enforcement. With regard to the treatment of cartels as a whole it even seems to amount to a revolution. It is clear from the outset that it does indeed qualify as a quantum leap when the Commission proposes to abolish the authorisation system in favour of a system in which Article 81 EC is directly applicable as a whole, making the "judge in Palermo" competent to determine complex economic assessments the Commission up to now has been so eager to keep for itself. It remains to be seen whether the Commission's quantum leap turns out to be a leap which overshoots the mark.

It shall be the task of this article to evaluate the proposals made by the White Paper in the light of the legal and factual developments of the environment in which EC competition law has operated since the early years of that body of European law. Before the White Paper itself is addressed, the changing scope of the EC competition rules with regard to market integration will be discussed and the status quo of

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[1] Commission, *White Paper on Modernisation of the Rules Implementing Articles 85 and 86 of the EC Treaty,* Commission Programme No. 99/027 of 28.04.1999 (hereinafter: Commission, *White Paper*).

competition law enforcement will be recapitulated. Finally, a presentation of potential alternatives to the proposals made by the White Paper will complete this article.

II. Enforcement of EC Competition Law—New Challenges Ahead

At the time of the enactment of Regulation 17 in 1962[2] and the years thereafter, the predominant objective of then Articles 85 et seq. EC was to overcome any separation of the envisaged common market along the lines of the borders of the Member States.[3] Thus, market integration and the promotion of the common market were the central features which determined not only the goals but also the scope of the Community's antitrust system.[4] Frequently, arguments in favour of market integration have prevailed over the encouragement of efficient production and distribution within the common market.[5] Correspondingly, the range of the competition rules was limited to what was considered vital to the integration imperative. Furthermore, the Community's rules on antitrust generally did not, and still do not, prevent the Member States from pursuing their own competition goals.[6] The effect being a coexistence of different substantive sets of rules which are not necessarily congruent in their objectives as they—at least possibly—envisage a different competition policy. It was the essential role of EC competition law within the general aims of the Treaty of Rome that accorded it with the privilege of being laid down in the Treaty itself.

Former Article 85 EC laid down this principle of limited jurisdiction of EC law.[7] It is reflected in its definition of what is prohibited as incompatible within the common market: only agreements between undertakings which *may affect trade between Member States* and which have as their object or effect the prevention, restriction or distortion of competition *within the common market*. In this context it is worth quoting what the Court stated in this respect in its early judgment in *Walt Wilhelm:*

> "Community and national law on cartels consider cartels from different points of view. Whereas Article 85 regards them in the light of the obstacles which may result for trade between Member States, each body of national legislation proceeds on the basis of the considerations peculiar to it and considers cartels only in that context"[8]

[2] Council Regulation 17/62, [1962] OJ L13/204.

[3] *Cf.* Classic in this respect Joined Cases Nos. 56 and 58/64, *Etablissements Consten SARL and Grundig-Verkaufs-GmbH v. Commission*, [1966] ECR 299 at 340 et seq. See also R. Wesseling, *Subsidiarity in Community Antitrust Law: Setting the Right Agenda*, [1997] 22 European Law Review 35, at 38 et seq; N. Finelly, *EC Competition Law—The Millennium Approaches*, in B. Hawk (ed.) 1998 Fordham Corporate Law Institute 243, at 245, 249 et seq.

[4] R. Wesseling, as note 3 above, at 39.

[5] In *Consten and Grundig* the separation of national markets (here: the French market) alone absolved the Commission from all necessity to take into account any other "possible favourable effects of the agreement in other respects …", *Etablissements Consten SARL and Grundig-Verkaufs-GmbH v. Commission*, as note 3 above, at 342.

[6] However, according to the ECJ, the ultimate general aim of the Treaty has to be respected and the effects of national laws may not impede the operation of the EC competition rules. *Cf.* Case No. 14/68, *Walt Wilhelm v. Bundeskartellamt*, [1969] ECR 1 at 14.

[7] *Cf.* R. Wesseling, as note 3 above, at 39.

[8] *Walt Wilhelm v. Bundeskartellamt*, as note 6 above, at 13.

> "However, if the ultimate general aim of the Treaty is to be respected, this parallel application of the national system can only be allowed in so far as it does not prejudice the uniform application throughout the Common Market of the Community rules on cartels and of the full effect of the measures adopted in implementation of those rules."[9]

The Court thereby acknowledged the coexistence of national and EC competition law, ruling out only those effects of national laws which impede the operation of the latter. However, it has to be recalled that in the early stages of the development of the common market it was only Germany that had its own competition rules and competition authority, the well known *Bundeskartellamt* as the public authority to enforce the rules laid down in the *Gesetz gegen Wettbewerbsbeschränkungen (GWB)* of 1957.[10] Thus, any community-wide decentralised enforcement of competition rules—be it on the basis of national or EC law—necessarily lacked efficiency and coherence.

Under those conditions the Commission as the main body entrusted with the task of promoting the establishment of a common market was deemed to be the right body to be the central authority enforcing the competition rules of the Community.[11] Consequently, Regulation 17 created a centralised system of enforcement which was based on the idea that only such a system could guarantee the development of a uniform and coherent competition policy which then would be enforced in an equal manner throughout the envisaged common market.

Yet, a fundamental change has been taking place in the environment in which EC competition law operates.[12] Logically, the realisation of the internal market by the end of 1992 can not have been without effect on the pertinence of the integration motive as the original objective of Articles 85 et seq. (now 81 et seq.) EC. The Treaty has gradually moved towards policies going beyond those directly linked to what has been termed "negative integration".[13] The interpretation of the substantial rules has to now predominantly focus on an economically based assessment of the effects on competition of a specific agreement or practice rather than mere integration arguments.

The Court took a step towards such an interpretation acknowledging the impact of the development of the integrated market on the nature of Community antitrust law as early as 1974. In *Commercial Solvents* it held, *inter alia*, that the degree of influence on the patterns of cross-border trade is irrelevant once it is apparent that the agreement or practice in question may have "*repercussions on the competitive structure within the Common*

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[9] Ibid., at 14.

[10] Law against restraints of competition 1957. *Cf.* Commission, *White Paper*, as note 1 above, at para. 18.

[11] Commission, *White Paper*, as note 1 above, at para. 17.

[12] *Cf.* C.D. Ehlermann, *Implementation of EC Competition Law by National Antitrust Authorities*, [1996] 17 European Competition Law Review 88, at 89; A. Schaub, *EC Competition Law—The Millennium Approaches*, in B. Hawk (ed.) 1998 Fordham Corporate Law Institute, 225 at 225 et seq; R. Wesseling, *The Commission Notices on Decentralisation of EC Antitrust Law: In for a Penny, Not for a Pound*, [1997] 18 European Competition Law Review 94, at 95 et seq.

[13] R. Wesseling, as note 3 above, at 43.

Market".[14] In *Hugin* it further elaborated on the jurisdictional clause and held that it is sufficient that the *structure of competition* within the common market is affected.[15]

As a consequence, emphasis in Community antitrust analysis shifted from integration motives to ensuring that competition in the (already) integrated market remained in a healthy state,[16] i.e. workable competition as such being promoted without regard to a specific cross-border relevance.[17] The initial focus on preventing the partitioning of the Community market into separate national markets progressively faded away in favour of the original idea of any competition rules: the maintenance and promotion of a competitive structure.

The criterion of "effect on trade between Member States" no longer serves as an essential feature of Community action in the field of competition. Rather, enforcement on the EC-level seems to step in only whenever *Community interest* is at stake.[18] This conclusion is underpinned by the Court of First Instance (CFI) judgment in *Automec II*[19] and the 1997 Commission *Notice on the co-operation between national competition authorities and the Commission in handling cases falling within the scope of Articles 85 and 86 EC Treaty*.[20] The policy of the Commission clearly has shifted—by an attempted establishment of an informal decentralisation—towards focusing on cases with a Community interest. This approach is now taken up by the White Paper as it envisages a role of the Commission which is focused on the "most important cases".[21]

These relatively minor legal developments face a much broader and more significant change in the environment of EC competition law and policy than at the beginning of the 1960s. The EC is no longer a homogenous Community of only the original six Member States but has already enlarged to 15 Member States and is committed to further enlargements in the early years of the new millennium.[22] A European Union with possibly about 25 Member States is on the horizon which has to be borne in mind whenever questions of future adaptation of competition law enforcement are discussed. Thus, institutional and procedural laws, which were designed for a much smaller Community, will have to be adjusted in order to be able to cope with such an enlarged environment of competition law enforcement.[23]

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[14] Joined Cases Nos. 6 and 7/73, *Istituto Chemioterapico Italiano SpA and Commercial Solvents Corporation v. Commission,* [1974] ECR 223.

[15] Case No. 22/78, *Hugin v. Commission*, [1979] ECR 1869 at para. 17.

[16] Opinion of AG Trabucchi in Case No. 73/73, *Groupementsdes Fabricants de Papier Peaints de Belgique v. Commission*, [1975] ECR 1491 at 1522 et seq.

[17] *Cf.* R. Wesseling, as note 12 above, at 95.

[18] *Cf.* R. Wesseling, as note 3 above, at 48.

[19] Here, the CFI held that it was legitimate for the Commission to refer to the Community interest in order to determine the degree of priority: Case No. T-64/89, *Automec Srl v. Commission*, [1990] ECR II-2223.

[20] [1997] OJ C 313/3. *Cf.* J.H. Maitland-Walker, *Commission Notice on Co-operation between National Competition Authorities and the Commission in handling cases falling within the scope of Articles 85 and 86 of the EC Treaty,* [1998] 19 European Competition Law Review 124.

[21] Commission, *White Paper*, as note 1 above, at para. 9.

[22] *Cf.* A. Schaub, as note 12 above, at 230; C.D. Ehlermann, as note 12 above, at 89; Commission, *White Paper*, as note 1 above, at para. 7 et seq.

[23] A. Schaub, as note 12 above, at 230.

Factors such as the Economic and Monetary Union, the liberalisation and globalisation of world trade, technological change and continuous market integration will promote trade and thereby intensify competition.[24] This will almost necessarily lead to an ever progressing challenge of workload and raise more questions of objectives and policy of competition regulation.

The need for a coherent system of enforcement throughout the Union is faced with such a wide geographical, administrative and substantial sphere of application that any highly centralised approach, as taken by Regulation 17 over 35 years ago, seems to be untenable from the outset and outdated. Decentralisation appears to be an appropriate alternative as it allows the centre to focus its resources on the essential issues. In this context it has to be noticed that in an integrated market the definition of what is essential cannot merely follow geographical aspects or the aspect of the law applicable: Agreements between undertakings of one Member State can have an affect on the market structure as a whole.[25] On the other hand, not every competition issue which involves effects on trade between Member States is necessarily essential enough that it should be dealt with only by the central body. Be that as it may, it remains obligatory to scrutinise the status quo and address the experiences of the system before further conclusions may be drawn.

III. The Status Quo

It is almost needless to say that the above mentioned future challenges come along with challenges already faced in the past and the present which have questioned and still question the advisability and usefulness of the relevant rules.

It is a well-known fact that the Commission as the central body enforcing the EC rules on competition has for a long time been unable to cope with the increasing workload.[26] This has even been admitted by the Commission itself[27] besides the fact that the latter has—up to now—shown great reluctance to give up its partly monopolised role. The backlog of cases is dramatically exemplified by the fact that the Commission could not manage in the years 1994–1997 to close more than 1–3 percent of the pending cases by formal decision.[28] In retrospect, it is clear that the centralised authorisation system set up by Regulation 17 in 1962 made sense only if the

[24] *Cf.* ibid., at 226; Commission, *White Paper*, as note 1 above, at para. 6.

[25] Commission, *White Paper*, as note 1 above, at para. 20.

[26] See for instance J.H. Maitland-Walker, as note 20 above, at 124; H.P. v. Stoephasius, *Enforcement of EC Competition Law by National Authorities* in Slot and McDonnel (eds) *Procedure and Enforcement in EC and US Competition Law* (London, 1993) at 32 et seq.; A. Riley, *More Radicalism, Please: The Notice on Co-operation between National Courts and the Commission in Applying Articles 85 and 86 of the EEC Treaty*, [1993] 14 European Competition Law Review 91; P.B. Marsden, *Inducing Member State Enforcement of European Competition Law: A Competition Policy Approach to "Antitrust Federalism"*, [1997] 18 European Competition Law Review 234; I. v. Bael and J-F. Bellis, *Competition Law of the European Community*, (3rd Edn, London, 1994) at para. 1306; M. Siragusa, *Rethinking Article 85: Problems and Challenges in the Design and Enforcement of the Competition Rules*, in B. Hawk (ed.) 1998 Fordham Corporate Law Institute, 271 at 280.

[27] See Commission, *White Paper*, as note 1 above, at para. 12.

[28] See tables in Commission, *XXVIIth Report on Competition Policy 1997*, [1998] at 353 et seq.

Commission dealt with a manageable amount of cases. Unless there is a major increase of staff—which is unlikely to happen[29]—the administrative resources of the Commission can only ensure effective enforcement if that involves far less than the current case-load. The very elaborate procedures of Regulation 17—especially the appropriate investigative measures, the need for every formal decision to be announced in advance in all official languages (currently already 11) in the Official Journal, and the consultation of the Advisory Committee on the draft decision[30]—seem appropriate only to large important cases which do not need to be decided quickly.[31]

The centralised character which leads to this workload mainly derives from two features inherent in the authorisation system. First, every agreement or concerted practice which is believed to fall within the scope of the prohibition of Article 81(1) EC has to be notified in order to be granted exemption (Article 81(3) EC; Article 4(1) of Reg. 17). This, and the wide interpretation of Article 81(1) EC—admittedly promoted by the Commission[32]—means that the undertakings concerned practically have to have their agreements or practices *validated* rather than *prohibited*. This has led to a vast number of notifications irrelevant of their actual or potential anti-competitive effect as the agreement could otherwise not benefit from legal security and the possibility to block private action before national courts and national competition authorities.[33]

That the current system of authorisation does not work for the benefit of effective control is exemplified by the fact that in more than 35 years of application of Regulation 17 only nine (!) prohibitive decisions have been made in cases having their origin in notifications, the latter representing about 58 percent of the cases overall (in 1988–98).[34] Directorate General IV (DG IV) of the Commission is thereby forced to deal with many cases that are only of minor or even no relevance to its original task. Second, and even more importantly, is the Commission's *monopoly* to grant exemptions from the prohibition of Article 81 (Article 9(1) of Reg. 17). That this rule factually makes any true decentralisation very difficult if not even impossible will become apparent from the following. However, it may at this point be pointed out that the Commission now believes that the general *reactive* approach taken by Regulation 17 towards enforcing the Community's rules on cartels is one of the main obstacles to an effective enforcement.[35]

[29] *Cf.* C.D. Ehlermann, as note 12 above, at 89; S. Wilks, *Options for Reform of European Competition Policy*, in A. v. Mourik (ed.), *Developments in European Competition Policy* (Maastricht, 1996), 153 at 169.

[30] *Cf.* Commission, *White Paper*, as note 1 above, at para. 24.

[31] J. Temple Lang, *Rapport Générale*, in *FIDE—Application Nationale du Droit Europeen de la Concurrence*, XVIII Congrès 1998 [II], 265 at 268.

[32] *Cf.* V. Korah, *The Future of Vertical Agreements under EC Competition Law*, [1998] 19 European Competition Law Review 506; M. Siragusa, as note 26 above, at 273 et seq.; A. Waller, *Decentralisation of the Enforcement Process of EC Competition Law—The Greater Role of National Courts*, Legal Issues of European Integration [1996/II] 1 at 2.

[33] Commission, *White Paper*, as note 1 above, at para. 6.

[34] Ibid., at para. 44 and *XXIInd Report on Competition Policy*, as note 53 below, at para. 77.

[35] *Cf.* Commission, *White Paper*, as note 1 above, at para. 24.

The Commission has in the last decades tried to overcome the backlog of cases by reducing its workload by introducing different means within the current legal system. One may divide them into two different approaches, one being focused on internal, the other on external means, i.e. decentralised enforcement. They will be discussed in due course.

A. INTERNAL MEANS TO PROMOTE EFFICIENCY

In order to achieve a decrease in the number of individual notifications a so-called *de minimis* rule was introduced by the Commission in 1970[36] which is based on the concept of appreciable effect on competition, allowing any agreement not having such effect to fall outside the prohibition of Article 81(1) EC and, thus, not having to be notified. This concept followed the ruling by the Court in *Völk v. Vervaecke* holding that an agreement escapes the prohibition of Article 81(1) EC when it affects the market only "insignificantly".[37] However, as it is not for the Commission to define the scope of Article 81 EC, the notices cannot have the force of law and the idea of legitimate expectations by the undertakings concerned is limited as the Commission itself is not bound by them.[38] Therefore, the notices may be understood to reflect the current Commission policy,[39] however, this is only of use to those undertakings that fulfil the quantitative test set forth therein. The notices helped to reduce the number of notifications,[40] albeit to a limited extent only.

In an effort to simplify the application of the exemption regime of Article 81(3) EC the Commission, empowered by the Council, adopted a number of regulations[41] by virtue of which certain categories of agreements are generally exempted from the prohibition of Article 81(1) EC.[42] Thereby, the need for separate and time-consuming notifications and individual exemptions is obviated.[43] The block exemption regulations did in fact produce a not insignificant lessening of the number of applications for

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[36] Commission *Notice on agreements of minor importance* of 2.6.1970, [1970] OJ C 64, at 1, as updated in *Notice* of 9.12.1997, [1997] OJ C 372/3, at 13.

[37] Case No. 5/69, *Franz Völk v. SPRL Etablissements J. Vervaecke*, [1969] 295, para. 3.

[38] P. Craig and G. de Búrca, *EU Law—Text, Cases and Materials,* (2nd Edn, Oxford, 1998), at 915 et seq.; M. Furse, *Competition Law of the UK and the EC*, (London, 1999), 142 et seq.

[39] M. Furse, as note 38 above*,* at 143.

[40] Commission, *White Paper*, as note 1 above, at para. 27.

[41] So-called block exemption regulations: Regulations (EEC) 1983/83 of 30.6.1983 OJ L 173; (EEC) 1984/83 of 22.06.1983 OJ L 173; (EEC) 4087/88 of 30.11.1988 OJ L 359; (EC) 1475/95 of 28.06.1995 OJ L 145; (EC) 240/96 of 31.01.1996 OJ L 31 on basis of Council Regulation 19/65/EEC of 6.03.1965 OJ 36 and Regulations (EEC) 417/85 of 19.12.1984 OJ L 53; (EEC) 418/85 of 19.12.1984 OJ L 53 on basis of Council Regulation 2821/71/EEC of 29.12.1971 OJ L 285.

[42] After a proposal of the Commission in late 1998, Regulation 19/65/EEC is now amended such as to empower the Commission to adopt a block exemption covering all vertical agreements (Council Regulation No. 1215/1999 of 10 June 1999, OJ L 148, 15.06.1999, p. 1). It is the intent to further simplify the system of exemption, reduce the costs to industry, provide a greater commercial flexibility and increase legal certainty. Furthermore, notifications will become superfluous in most areas of vertical restraints (see section V.E.3. of this Article, below). *Cf.* A.J. Riley, *Vertical Restraints: A Revolution?* [1998] 19 European Competition Law Review, 483; V. Korah, as note 32 above, at 506; Z. Biro and A. Fletscher, *The EC Green Paper on Vertical Restraints: An Economic Comment*, [1998] 19 European Competition Law Review 129.

[43] P. Craig and G. de Búrca, as note 38 above, at 919.

individual exemptions,[44] however, a toll had to be paid. Due to their systematic and stereotype characteristic they entail a considerable loss of flexibility as the undertakings drawing up their contracts are tempted to follow the regulations rather than their own economically orientated ideas.[45]

No other "solution" to the problem does better exemplify the helplessness of the Commission than its ever increasing tendency[46] to close files on an informal basis, especially through so-called "*comfort letters*". Since the Court's rulings in the "perfume-cases"[47] it is clear that comfort letters may (only) be taken into account by national courts and authorities, however, they produce no binding legal effect and the benefit arising from them may be removed at any time.[48] Indeed, the informal closure of a file with the statement that the agreement in question merits exemption, implies that it does infringe the prohibition of Article 81(1) EC which inherits not only legal uncertainty but creates more discomfort than anything else in front of national courts or authorities. Furthermore, comfort letters do not need to be published. This not only questions legal certainty but also the transparency of the Commission's administrative work.[49]

It may be suggested that these measures did indeed to some, albeit limited, extent decrease the workload of the Commission. Yet, they failed to grasp the underlying reasons which is especially exemplified by the use of comfort letters as a meaningful symbol of the tendency to circumvent the cause by employing informal methods.

B. Decentralised enforcement within the current legal system

The decentralisation of enforcement may be seen as a different approach as it addresses not the overall number of cases as such but rather their allocation. In so far decentralisation is primarily not a means to decrease the workload but share the burden of the enforcement of EC competition law. Still, the Commission's main device in order to ease its own workload is its campaign for decentralisation started in the early 1980s.[50] The Commission first tried to promote greater use of national courts as a means of *private* enforcement of EC competition law, followed by the attempt to

[44] Commission, *White Paper*, as note 1 above, at para. 33.

[45] M. Siragusa, as note 26 above, at 282.

[46] About 95% of pending cases are closed by informal means (especially comfort letters); source: Commission, *XXVIIth Report on Competition Policy 1997*, [1998] 353 et seq.

[47] Joined Cases Nos. 253/78 and 1–3/79, *Procureur de la République and others v. Bruno Giry and Guerlin SA and others*, [1980] ECR 2327 at para. 9–13; Case No. 99/79, *SA Lancôme and Cosparfrance Nederland BV v. Etos BV and Albert Heyn Supermart BV*, [1980] ECR 2511 at para. 7–11.

[48] M. Furse, as note 38 above, 66 et seq.

[49] V. Korah, *Comfort Letters—Reflections on the Perfume Cases*, [1982] 14 European Law Review at 38 et seq.; M. Siragusa, as note 26 above, at 282.

[50] Commission, *XIIIth Report on Competition Policy 1983*, [1984] at para. 217 et seq.; *XVth Report on Competition Policy 1985*, [1986] at para. 38 et seq.; *XVIIth Report on Competition Policy 1987*, [1988] at para. 55 et seq.; *XIXth Report on Competition Policy 1989*, [1990] at para. 109 et seq., *XXIst Report on Competition Policy 1991*, [1992] at para. 69 et seq.; *XXIIIrd Report on Competition Policy 1993*, [1994] at para. 189 et seq.; *XXIVth Report on Competition Policy 1994*, [1995] para. 23 et seq. and 40 et seq.

encourage national *authorities* to play a more significant role in the enforcement process.

1. *Enforcement Through National Courts*

Four main factors are believed to be the underlying assumptions in favour of an enhanced role for the national courts.[51] The Commission expected that, first, the frequent application of EC competition law would increase the awareness of that body of law among EC citizens and thus ensure greater respect for Community law; second, decentralised application would provide a quick and efficient way of enforcement and provide legal security; third, more private actions would ensure that less complicated and less important cases would be dealt with without the complex involvement of the Commission, giving the latter more resources to concentrate on the important cases.[52] Fourth, and finally, the application of EC competition rules as a part of the Community's legal order on the national level was perceived as reflecting the principle of subsidiarity.[53]

It has been clear since the Court's judgment in *BRT v. SABAM* that Articles 81 and 82 EC produce direct effect between individuals which national courts must safeguard.[54] Both European Community courts have in subsequent cases—*Delemitis*[55] and *Automec II*[56]—laid down more specific rules that have not only encouraged this attempt by the Commission to decentralise but also given more guidance as to the principles which govern the relationship between national courts and the Commission in applying EC competition law. However, it remains beyond doubt that the national court is not entitled to fully apply Article 81(3) EC and the conditions laid down in *Delemitis* considerably restrict the national courts' jurisdiction to finally rule on those cases where either the notified agreement in question "clearly" does not even fall within Article 81(1) EC or if it may "on no account be the subject of an exemption decision" of the Commission.[57] Furthermore the Court stressed in this ruling that conflicting decisions must be avoided because they would obviously be contrary to the general principle of legal certainty.[58] Thus, it made the national courts aware of the

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[51] See Commission, *XVth Report on Competition Policy 1985*, [1986] at para. 38 et seq.

[52] *Cf.* also A. Waller, as note 32 above, at 3 et seq.; B. Rodger and S. Wylie, *Taking the Community Interest Line: Decentralisation and Subsidiarity in Competition Law Enforcement*, [1997] 18 European Competition Law Review 485 at 486; J. Meade, *Decentralisation in the Implementation of EEC Competition Law—A Challenge for the Lawyers*, [1986] 37 Northern Ireland Legal Quarterly 101 at 104 et seq.; S. Kon and A. Maxwell, *Enforcement in National Courts of the EC and New UK Competition Rules: Obstacles to Effective Enforcement*, [1998] 19 European Competition Law Review 443.

[53] Commission, *XXIInd Report on Competition Policy 1992*, [1993] at para. 299.

[54] Case No. 127/73, *Belgische Radio en Televisie and Société Belge des Auteurs, Compositeurs et Editeurs v. SV SABAM and NV Fonior*, [1974] ECR 51 at para. 16 et seq. *Cf.* A. Waller, as note 32 above, at 4; B. Rodger and S. Wylie, as note 52 above, 486; Commission, *White Paper*, as note 1 above, at para. 37.

[55] Case No. C-234/89, *Stergio Delemitis v. Henninger Bräu AG*, [1991] ECR I-935.

[56] Case No. T-64/89, *Automec Srl v. Commission*, [1990] ECR II-2223.

[57] *Stergio Delemitis v. Henninger Bräu AG*, as note 55 above, at para. 50 et seq.

[58] *Stergio Delemitis v. Henninger Bräu AG*, as note 55 above, at para. 47. *Cf.* A. Waller, as note 32 above, at 13.

possibility[59] to stay proceedings and await a formal decision or seek guidance by the Commission whenever conflicting decisions may arise.[60]

It is obvious and one cannot neglect to mention that there are numerous advantages of bringing actions before national courts, be it as a means of defence or to claim damages.[61] These are particularly the general possibility of damages and restitution which can be awarded,[62] of interim measures and injunctive relief, of the reimbursement of legal costs, and the possibility of combining a claim under Community law with a claim under national law. The Commission pointed out these arguments in order to encourage this form of decentralisation in its *Notice on co-operation between national courts and the Commission in applying Articles 85 and 86 of the EEC Treaty* which was issued following the judgment in *Delemitis*.[63]

However, the disadvantages of private enforcement have prevented the application of EC competition law by national courts from becoming a true alternative within the current system.[64] As the burden of proof generally lies on the party invoking it, the great difficulties in getting hold of evidence constitutes a major obstacle.[65] Another problem which does not—or not to a great extent—arise for undertakings lodging a complaint with the Commission are the high costs involved for private litigants.[66] Furthermore, it has been doubted that courts generally have the knowledge, experience and means to deal with the complexities of EC competition law.[67] The main obstacle, however, appears to be one which lies in the heart of Regulation 17: the restricted jurisdiction of the national courts as they cannot apply Article 81 EC as a whole.[68] Neither the guiding rules of the above mentioned Notice nor any other approach within the current legal status can circumvent the fact that any decentralisation by making use of national courts suffers from the allocation of powers as set forth in Regulation 17. Under these circumstances it is not surprising that the

[59] Even if the Court uses the term "may", it may be suggested that, as the principle of legal certainty reflects a general rule of law, it would like to see the national courts under an *obligation* to stay proceedings in any event where conflicting decisions may arise (*Cf. Stergio Delemitis v. Henninger Bräu AG*, as note 55 above, at paras 47 and 52).

[60] *Stergio Delemitis v. Henninger Bräu AG*, as note 55 above, at para. 52. *Cf.* I. v. Bael, *The Role of the National Courts*, [1994] 15 European Competition Law Review 3 at 4 et seq.

[61] *Cf.* B. Rodger and S. Wylie, as note 52 above, at 486.

[62] However, in many Member States, damages are difficult to obtain or depend on the application of national law. *Cf.* C. Rhone, *From the European Commission to the National Courts: A UK Perspective on Decentralisation of Enforcement of the EC Competition Rules*, [1998] 2 Edinburgh Law Review 345 at 348 et seq.

[63] [1993] OJ C 39/6 at para. 16. *Cf.* R. Whish, *The Enforcement of EC Competition Law in Domestic Courts of Member States*, [1994] 15 European Competition Law Review 61; A. Waller, as note 32 above, at 21 et seq.; S. Kon and A. Maxwell, as note 52 above, at 443 et seq.; J. Shaw, *Decentralization and law enforcement in EC competition law,* [1995] 15 Legal Studies, 128 at 134 et seq.

[64] *Cf.* A. Waller, as note 32 above, at 23 et seq.

[65] A. Riley, as note 26 above, at 22; W-H. Roth, *The Application of Community law in West Germany: 1980–1990*, [1991] 28 Common Market Law Review 137 at 172. *Cf.* also E. Steindorff, *Article 85, para. 3: No case for application by national courts*, [1983] 20 Common Market Law Review 125.

[66] R. Whish, as note 63 above, at 62.

[67] W-H. Roth, as note 65 above, at 175; S. Kon and A. Maxwell, as note 52 above, at 444; S. Kon, *Art. 85 para. 3: A case for application by national courts*, [1982] 19 Common Market Law Review 541 at 555; M.B. Hutchings and M. Levitt, *Concurrent Jurisdiction*, [1994] 15 European Competition Law Review 119 at 123.

[68] A. Waller, as note 32 above, at 22 et seq.

level of proceedings before national courts has always been low,[69] thus, the Commission having to "regret the slow progress in this respect".[70]

In addition, it may be suggested that any enforcement of competition rules by private litigants before courts may always only serve as a supplemental means of enforcement. Because of its very nature as involving the initiative of private parties it can never appreciably reduce the necessity of authoritative enforcement or even make it superfluous.[71]

2. *Enforcement Through National Authorities*

Before the enactment of Regulation 17 in 1962 national authorities generally had—according to former Article 88 (now 84) EC—the power to enforce the competition provisions.[72] Article 84 EC imposes a duty on the national authorities to apply Article 81 and 82 EC in areas which are not covered by implementing legislation.[73] However, the aforesaid regulation effectively marginalised these powers before any noticeable national policy in this respect could develop.[74] As the main legislation implementing Articles 81 and 82 EC it primarily entrusts the Commission and its DG IV with the task of enforcing the competition policy of the Community. By virtue of Article 9(3) of Regulation 17, national cartel authorities have the capacity to apply Articles 81(1) and 82 EC only so long as the Commission has not initiated any procedure under Articles 2, 3 or 6 of the Regulation. Furthermore, the exclusive right of the Commission to grant exemptions from Article 81(1) EC established a quasi-monopolised system in this respect.[75] Yet, even in the areas which are covered by Regulation 17 or any other provision pursuant to Article 83 EC, Member States are not required by Article 84 EC to apply EC competition rules but they still nevertheless enjoy the power to do so within the limits laid down therein.[76]

In the early years of competition policy within the then just developing common market such a predominantly centralised approach seemed inevitable and necessary in order to ensure a high degree of uniformity.[77] The general legal and factual conditions

[69] *Cf.* the figures shown by A. Waller, as note 32 above, at 19 et seq.

[70] Commission, *White Paper*, as note 1 above at para. 37 with reference to various competition reports of the Commission.

[71] *Cf.* C.D. Ehlermann, as note 12 above, at 89, who even refers to the "traditional social and cultural attitudes" of Europeans as being opposed to recourse to the judiciary.

[72] However, it is almost generally accepted that additional national enabling legislation is needed in order for national competition authorities to be competent to enforce EC competition law; *cf.* Bundeskartellamt, *Praxis und Perspektiven der dezentralen Anwendung des EG-Wettbewerbsrechts—Diskussionspapier*, (Berlin, 1998), at 4 and 10; U. Zinsmeister, *Die dezentrale Anwendung des EG-Wettbewerbsrechts durch die nationalen Kartellbehörden in der Praxis*, [1999] 10 Wirtschaft und Wettbewerb 115 at 119; C.D. Ehlermann, as note 12 above, at 89.

[73] U. Zinsmeister, E. Rikkers and T. Jones, *The Application of Articles 85 and 86 of the EC Treaty by National Competition Authorities*, [1999] 20 European Competition Law Review 275 at 276.

[74] Even the *Bundeskartellamt* took only three exemption decisions between 1958–62 before the enactment of Regulation 17 seriously restricted that power. *Cf.* Bundeskartellamt, as note 72 above, at 8.

[75] *Cf.* C.D. Ehlermann, *The European Administration and the Public Administration of the Member States with regard to Competition Law,* [1995] 16 European Competition Law Review 454.

[76] *Cf.* U. Zinsmeister, E. Rikkers and T. Jones, as note 73 above, at 276.

[77] Commission, *White Paper*, as note 1 above, at paras 4 and 14; C.D. Ehlermann, as note 12 above, at 89.

of the early 1960s, with only Germany and later France having its own competent authority made any effective administrative enforcement on the level of the Member States impossible or at least very fragmentary. However, there have been major changes with regard to the main preconditions of enforcement at national level, i.e. national enabling legislation[78] and the establishment of national competition authorities.

As far as the latter is concerned, it is partly due to the enactment of national anti-trust legislation that as of now all 15 Member States can come up with more or less independent national anti-trust authorities.[79] Whereas the Commission employs approximately 150 full-time professionals dealing with competition issues, the Member States altogether do now have more than 1000.[80] Secondly, the national laws of eight Member States[81] confer express power upon those authorities to apply the rules of Articles 81 et seq. EC.[82] Moreover, the group of seven Member States which still do not grant their competition authorities such power might shrink in the future, and it can be expected that any accession of new Member States will be accompanied by measures ensuring the application of EC rules as fast as possible.[83] As almost all Member States—the exceptions being only Germany and perhaps Luxembourg and Austria—have adopted national legislation very similar to Articles 81–82 EC,[84] a uniform standard of rules which is being applied by the national authorities is in practice even ensured in those Member States lacking express power to apply the EC competition provisions. For example, Belgium, The Netherlands and Italy generally do not apply the EC rules on competition simply because their own rules correspond to the former.[85] This is exemplified by the fact that the Member States have an increasing tendency to interpret their national rules in the light of the case law of the Court of Justice.[86]

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[78] See note 72 above.

[79] C.D. Ehlermann, as note 12 above, at 89; A. Haslam-Jones, *A Comparative Analysis of the Decision-taking Process in Competition Matters in Member States of the European Union, the European Commission and the United States*, [1995] 16 European Competition Law Review 154. See also figure shown by J. Temple Lang, as note 31 above, at 270. However, Austria and Luxembourg have no national competition authority operating independently of the national courts; see U. Zinsmeister, E. Rikkers and T. Jones, as note 73 above, at 279.

[80] See figure in J. Temple Lang, as note 31 above, at 270. However, the figure is merely indicative and has to be treated with caution as there is no common definition in the Member States of what is a "full-time professional or high-level official".

[81] These are Belgium, France, Germany, Greece, Italy, the Netherlands, Portugal, Spain. The United Kingdom is in a unique position as express power is only conferred where the UK is under a duty to apply Articles 81 and 82 EC. See U. Zinsmeister, E. Rikkers and T. Jones, as note 73 above, at 278; N. Green, *Rapport Britannique*, in *FIDE—Application Nationale du Droit Europeen de la Concurrence*, XVIII Congrès 1998 [II], 57 at 67.

[82] U. Zinsmeister, E. Rikkers and T. Jones, as note 73 above, at 277; see figures in J. Temple Lang, as note 31 above, at 270 and at the homepage of DG IV <www.europa.eu.int/comm/dg04/entente/en/tabl.htm>, the latter two with a slightly different result due to the unique position of the UK.

[83] *Cf.* A. Schaub, *EC Competition Law—Proposals for Reform*, Fordham Corporate Law Institute—25th Annual Conference, 22 October 1998, available at <www.europa.eu.int/comm/dg04/speech/eight/en/sp98059.htm>, under I.

[84] U. Zinsmeister, E. Rikkers and T. Jones, as note 73 above, at 277. For a slightly different assessment see figure in J. Temple Lang, as note 31 above, at 270.

[85] U. Zinsmeister, as note 72 above, at 116.

[86] *Cf.* for instance Case No. C-7/97, *Oscar Bronner GmbH & Co. KG v. Mediaprint Zeitungs- und Zeitschriftenverlag GmbH & Co. KG et al.* [1998] ECR I-7791 (see Frensh, *Recuil de la Jurisprudence*, [1999] 4 CMLR 112), where an Austrian Court effectively used the reference procedure of Article 234 EC in order to interpret national (!) competition law.

Still, the debate about a better use of national competition administrations did not begin before the early 1990s. The underlying motive of the Commission to encourage an increased involvement at the national level was seemingly born out of the need for the former to compensate for its lack of resources rather than any purely altruistic ideas. It was in this vein that the Commission issued no earlier than 1997 the *Notice on the co-operation between national competition authorities and the Commission in handling cases falling within the scope of Articles 85 and 86 EC Treaty*.[87] The notice tries to set out guidelines for the allocation of cases between national authorities and the Commission by establishing its own priorities on cases which are of particular Community interest.[88]

Yet, the establishment of such an informal decentralisation may be criticised as an attempt to cut costs and to free up resources with a minimum amount of effort, by changing the system without changing the rules. This is exemplified by the—until the White Paper—remaining reluctance of the Commission to even discuss a reduction or reform of its own powers.[89] A study undertaken by the *Association Européenne des Avocats* on the application of Articles 81 and 86 EC by national competition authorities shows that the monopoly of the Commission to grant exemptions from Article 81(1) EC and the uncertainties left by the above notice are reasons for the remaining unwillingness of the national authorities to make use of the EC competition rules.[90]

3. *The Limits of the Current System*

The most obvious contradiction in any attempt to promote decentralisation within the current legal system lies in the fact that no one other than the Commission may apply Article 81(3) EC and grant exemptions to the general prohibition of cartels.[91] Furthermore, Article 9 of Regulation 17 leads to the dilemma that national authorities lose their competence to deal with cases as soon as the agreement is notified, and national courts are put in an awkward position of a "semi-assessment" of the requirements laid down in Article 81(3) EC.[92] Undertakings have taken advantage of this by using the centralised authorisation system in order to block private action or authoritative enforcement at national level.[93]

The availability of exemptions is indispensable for the current system to function as it was designed. However, as the Commission is by far not able to fulfil the task as envisaged by the centralised authorisation system, any underlying idea of legal certainty

[87] [1997] OJ C 313/3. See for a critical discussion of the notice J.H. Maitland-Walker, as note 20 above, at 124; R. Lane, *Current Developments: EC Law, III. Competition*, [1998] 47 International and Comparative Law Quarterly 713 at 716; B. Rodger and S. Wylie, as note 52 above at 487.

[88] J.H. Maitland-Walker, as note 20 above, at 125.

[89] C.D. Ehlermann, as note 75 above, at 454; J.H. Maitland-Walker, as note 20 above at 125; M. Cini and L. McGowan, *Competition Policy in the European Union*, (London, 1998), at 189 et seq.; A. Schaub, as note 12 above, at 237.

[90] U. Zinsmeister, as note 72 above, at 118 et seq. For a report of the study see also U. Zinsmeister, E. Rikkers and T. Jones, as note 73 above, at 275. The study itself is not yet published.

[91] *Cf.* Bundeskartellamt, as note 72 above, at 11.

[92] *Cf. Stergio Delemitis v. Henninger Bräu AG*, as note 55 above. See also A. Waller, as note 32 above, at 23.

[93] Commission, *White Paper*, as note 1 above, at para. 39. See also H.P. v. Stoephasius, as note 26 above, at 34.

and uniformity becomes an absurd reasoning. An obvious structural discordance exists between the asserted jurisdictional power of the Commission and its factual administrative capacity to deliver the legal certainty for which its underlying theory creates a need.[94] The vast number of notifications is consistent with and inherent in the logic of the system, but also contributes to its unworkability.[95]

Seemingly, the Commission was well aware of the drawbacks of the current system. Yet, at the same time jealously anxious not to question its own central and monopolised role.[96] However, all attempts by the Commission to improve the system—chiefly by informal means—have not been very successful: group exemption regulations inhere a loss of flexibility, comfort letters lack legal certainty, and attempts to further integrate national courts and authorities as a means of decentralisation have been ineffective due to the limited jurisdiction granted to them.[97]

IV. The Objectives of Reform and Decentralisation

The aim of a reform of the current system must of course be to overcome the drawbacks and deficiencies which were outlined above. There can be no doubt that the primary objective has to be the maximisation of efficiency in the implementation of the Community competition rules.[98] At the same time a balance has to be maintained between the need of sufficient legal certainty on the part of the undertakings concerned, the possibility of a wide-spread enforcement of the competition policy, and an ease of the administrative constraints.[99] Furthermore, a reform must do justice to the need for transparent decision-making which reflects a comprehensible and uniform competition policy. Since national competition authorities are better acquainted with local markets and the undertakings concerned, decentralised enforcement is also seen to reflect the principle of subsidiarity.[100]

It is apparent that any simplification of the substantive and procedural rules easily leads to a less stringent supervision. The inability of the Commission to cope with its workload—provided that it does its best under the current circumstances[101]—may be seen from two perspectives: either the rules are too burdensome and create an

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[94] *Cf.* I. Forrester, *Competition Structures for the 21st Century*, in B. Hawk (ed.) 1994 Fordham Corporate Law Institute, 445.

[95] M. Siragusa, as note 26 above, at 280 et seq. *Cf.* I. Forrester and C. Norall, *The Laicization of Community Law: Self-Help and the Rule of Reason: How Competition Law Is and Could Be Applied*, [1984] 21 Common Market Law Review 11; Commission, *White Paper*, as note 1 above, at para. 39.

[96] P-V. Bos, *Towards a Clear Distribution of Competence between EC and National Competition Authorities*, [1995] 16 European Competition Law Review 410.

[97] M. Siragusa, as note 26 above, at 281.

[98] C.D. Ehlermann, as note 12 above, at 90.

[99] See Commission, *White Paper*, as note 1 above, at para. 42.

[100] R. Wesseling, as note 3 above, at 37; P-V. Bos, as note 96 above; M. Cini and L. McGowan, as note 89 above, at 190; Bundeskartellamt, as note 72 above, at 2.

[101] This, however, is now overtly doubted by D. Wolf, President of the *Bundeskartellamt*, see D. Wolf, *Perspektiven des europäischen Kartellrechts*, Policy document on the occasion of the panel discussion at the Frankfurter Institut—Stiftung Marktwirtschaft und Politik on 8 July 1999, available at <www.bundeskartellamt.de/perspektiven.html>.

unnecessary consumption of resources, or the Commission is simply not entrusted with the necessary number of staff. As an increase of human resources on the part of the Commission seems very unlikely in the current situation, it might be dangerously tempting to grasp the problem of an overwhelming workload simply by reducing the standard of supervision.

A further utilisation of the resources at national level can only be achieved by means of a true decentralisation. It has been shown by the foregoing that national authorities can only be encouraged to apply EC competition rules to a larger extent if they are given more responsibility as to their jurisdiction.[102] In order for a decentralised system to be workable and effective, four main prerequisites have to be met:[103] the authorities of all Member States have to have the power to enforce the EC Competition rules; they have to be given the appropriate material resources to do so; there have to be instruments which ensure coherence and a high level of uniformity in the application; and finally, criteria for the allocation of cases between the Commission and national authorities have to be found in order to avoid a duplication of procedures.[104]

V. Switching to a Directly Applicable System—The White Paper's Proposals

In the light of the conservative and sometimes somewhat defensive attitude, the Commission now takes a remarkably frank stand with regard to its own factual and legal situation. Indeed, it has been suggested by the President of the *Bundeskartellamt*—not without some malicious joy—that the White Paper must be seen as a declaration of capitulation by the Commission.[105] Furthermore, the latter suddenly seems to be at the forefront of reform, proposing far-reaching changes within the system of the European law on cartels which have not—or at least not noticeably—been seriously discussed so far.

The most significant proposition made in the White Paper concerns the core of the EC rules on cartels: The current authorisation system is to be changed into a directly applicable exception system.[106] The Commission prefers this approach over any other option apparently being anxious to dramatically decrease the overall workload which is in its opinion almost necessarily inherent in any authorisation system.[107] Despite the decentralising effect of such a new system the Commission wants to maintain a key position by solely setting forth the overall policy, concentrating on the most important cases and cases involving general interest.[108]

[102] *Cf.* U. Zinsmeister, as note 72 above, at 119.
[103] *Cf.* J. Temple Lang, as note 31 above, at 268 et seq.; A. Schaub, as note 83 above, under IV. C.; C.D. Ehlermann, as note 12 above, at 90.
[104] Bundeskartellamt, as note 72 above, at 19 et seq.; P-V. Bos, as note 96 above.
[105] D. Wolf, as note 101 above.
[106] Commission, *White Paper*, as note 1 above, at paras 69 and 76 et seq.
[107] Ibid., at para. 52 et seq.
[108] Ibid., at paras 84, 87 and 88.

Moreover, the White Paper aims at a shift from the current *ex ante* control of restrictive practices to a system which addresses them from an entirely *ex post* perspective.[109]

The next section will assess whether the new proposals of the Commission actually grasp the problems in the right way, and to what extent legal difficulties arise in the context of the amendments proposed.

A. The changed face of Article 81 EC

The drafters of the Treaty of Rome were confronted with a fundamental choice when they wanted to set up a system under which restrictive practices are prohibited: the adoption of an authorisation system or one of directly applicable exception.[110] These two options are fundamental especially with regard to the legal effects of the prohibition and the character of enforcement.

An authorisation system is based on the idea that the general prohibition of restrictive practices as now set forth in Article 81(1) EC can be lifted only by an act of a competent public authority. Thus, the agreement or practice which falls within the prohibition is void by virtue of law until it is validated by an authoritative declaration, the latter being constitutive in nature.[111] In this respect it is without consequence whether the decision granting exemption from the prohibition has an effect *ex tunc* or *ex nunc*. Logic then dictates *prima facie* invalidity of any allegedly anti-competitive agreement and an enforcement which is focused on *ex-ante* control.

By way of contrast, in a directly applicable exception system, the abolition of the prohibition of a restrictive practice stems from the law itself, without the need of any prior authoritative decision. As in such a system the exception is an exception by virtue of law, any decision taken can only confirm the state of law which makes it merely declaratory in nature.[112] Consequently, there exists—at least from a legal point of view—no *prima facie* invalidity of a restrictive practice as no authoritative decision is in the position to change the self-executed state of law which exists from the beginning. Because no prior authorisation is needed if the undertakings concerned believe their practices fulfil the criteria of exception, no notification or the like is necessary either. This focuses enforcement on *ex post* control.

The Commission proceeds on the assumption that the switch to a directly applicable exception system, which would make Article 81 EC a unitary norm applicable as a whole,[113] can be achieved within the framework of the prohibition system as set forth by Article 81 EC. A Council Regulation based on the powers of Article 83 EC would stipulate the direct applicability of the prohibition (Article 81(1)

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[109] Ibid., at paras 75 and 108 et seq.
[110] *Cf.* W.P.J. Wils, *Notification, Clearance and Exemption in EC Competition Law: An Economic Analysis*, [1999] 24 European Law Review 139 at 154 et seq. Commission, *White Paper*, as note 1 above, at para. 53.
[111] Commission, *White Paper*, as note 1 above, at para. 53.
[112] Ibid., at para. 53.
[113] Ibid., at para. 69.

EC) as well as the exception (Article 81(3) EC). Apparently the Commission does not believe an amendment of Article 81 EC itself as being necessary. However, it is at least questionable whether the current wording of Article 81(3) EC allows the change to a self-executing system by mere secondary legislation. The provision states that the prohibition laid down in paragraph 1 of that Article "may, however, be *declared* inapplicable".[114] The need for an additional "declaration" suggests that the exception does not have effect by virtue of law, i.e. the Treaty, but rather by virtue of the authoritative act. Thus, meaning that it is not Article 81(3) EC but the authoritative act granting exemption from the rule of prohibition which is constitutive.

The Commission clearly does not envisage a system which is in need for any prior decision before Article 81(3) EC can take effect. Rather, the restrictive practice is deemed to be lawful as from the time it was concluded.[115] This, for instance, rules out the possibility that it is in fact a widely applicable block exemption or the like by which means the direct applicability is achieved.[116]

Before the enactment of Regulation 17 in 1962 which clearly chose the option of an authorisation system,[117] it had indeed been strongly argued that former Article 85 EEC, itself already unalterable, had laid down a system of authorisation.[118] Thus, ruling out any other alternative without amendment of what is now Article 81 EC. However, the legislative history suggests a neutral character of Article 81 EC in this respect: in the course of the negotiations of the Treaty of Rome it was the French delegation which favoured a system of "*exception légale*" under which Article 85(1) EEC would be directly applicable together with Article 85(3) EEC. Germany, however, sought an authorisation procedure as set forth in its national law. As no agreement could be reached, the current negative wording was finally chosen.[119] By opting for the negative approach, the issue whether to choose an authorisation system or a directly applicable exception system was believed to be left to secondary implementing legislation.[120]

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[114] Emphasis added by author.

[115] Commission, *White Paper*, as note 1 above, at para. 69.

[116] Such an approach would follow the Commission's recently introduced policy with regard to vertical restraints (see note 42 above). However, in a directly applicable system the issuance of exemptions as constitutive decisions runs counter to the self-executing character of the exception. The White Paper's suggestion to continue the use of "block exemptions" (see for instance at paras. 71, 78, 85) is confusing in this respect. For further evaluation on this topic see at V.B.1 of this Article, below.

[117] W.P.J. Wils, as note 110 above, at 155.

[118] G. Grabitz and H. Hilf (eds), *Kommentar zur Europäischen Union* (München, 1994), at Art. 85 para. 154; E.-J. Mestmäcker, *Versuch einer kartellpolitischen Wende in der EU*, [1999] 10 Europäische Zeitschrift für Wirtschaftsrecht 523 at 525 et seq. The same opinion is taken by the President of the Bundeskartellamt with regard to the White Paper's proposals, see D. Wolf, *Aktuelle Entwicklungen im Recht der Vertikalbeschränkungen*, lecture on the occasion of the 6th St Gallen International Forum on Competition Law, 23 April 1999, available at <www.bundeskartellamt.de>.

[119] At first, the phrase "restrictive agreements may be declared valid" was chosen. At the request of the French delegation the version "The provisions of paragraph 1 may, however, be declared inapplicable to …" was included into the final text of the Treaty. *Cf.* A. Deringer, *The Competition Law of the European Economic Community*, (Chicago, 1968) at 126.

[120] A. Deringer, as note 119 above. See also W.P.J. Wils, as note 110 above, at 155 (note. 36); Commission, *White Paper*, as note 1 above, at para. 12. However, this interpretation of Article 85 EEC was heavily disputed, see E.-J. Mestmäcker, as note 118 above, at 524 et seq.

Yet, leaving the legislative history aside, there are other reasons inherent in Article 81 EC which argue in favour of the necessity of an amendment of the Treaty. With a directly applicable system there would be no *prima facie* presumption that restrictive practices are void under Article 81 EC.[121] Rather, as far as enforcement is concerned, any agreement or practice even in the sphere of horizontal restraints is practically deemed to be valid until an authority or court has found otherwise. Thus, the principle of general rule (prohibition of cartels) and exception (exemption granted if positive effects outweigh the disadvantages) inherent in the structure of Article 81 EC is turned upside down. The effect would be that enforcement is almost entirely focused on the "abuse" of a generally acknowledged freedom of contract of undertakings. This *de facto* control of abusive behaviour makes the control of cartels very similar to the control of monopolies. Hence, the structural difference between Articles 81 and 82 EC, the former addressing the *existence* of an agreement or a practice and the latter addressing the *behaviour* only, is eliminated.[122] It may be submitted that such a structural change of the enforcement rules concerning the law on cartels also changes the substantive foundations as set forth in Article 81 EC to such an extent that an amendment of the Treaty would be required.[123]

Furthermore, Article 81(3) EC only allows for exemptions with regard to an "agreement or category of agreements". The interpretation of that provision as being directly applicable, however, would lead to a *general* exemption of all agreements until *a posteriori* a prohibitive decision is taken.[124] It was only with regard to the first paragraph of Article 81 EC that the Court of Justice held, it could by its very nature produce direct effect and be directly applicable.[125] According to the rules laid down by the Court in *van Gend & Loos*[126] only those provisions which are clear, unambiguous, unconditional and not dependent on further action may be directly applicable. Yet, whether an agreement falls under Article 81(3) EC necessarily entails complex economic assessments,[127] and, implies wide discretionary power.[128] Consequently, it may be doubted whether the Court of Justice would be willing to interpret current Article 81 EC directly effective as a whole. Needless to say that a regulation as mere secondary legislation is not in a position to do so.[129]

The Commission stresses in its White Paper that the objective of the reform proposed is to be achieved by alteration of the procedural rules only. This fails to acknowledge that the proposals in fact change the competition policy with regard to

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121 Commission, *White Paper*, as note 1 above at para. 78.

122 *Cf.* E.-J. Mestmäcker, as note 118 above, at 528.

123 Similar D. Wolf, as note 118 above; E.-J. Mestmäcker, as note 118 above, at 525 et seq.

124 E.-J. Mestmäcker, as note 118 above, at 525 et seq.

125 Case No. 127/73, *Belgische Radio en Televisie and Société Belge des Auteurs, Compositeurs et Editeurs v. SV SABAM and NV Fonior*, [1974] ECR 51 at para. 16. *Cf.* J. Goh, *Enforcing EC Competition Law in Member States*, [1993] 14 European Competition Law Review 114.

126 Case No. 26/62, *van Gend & Loos*, [1963] ECR 1.

127 *Stergio Delemitis v. Henninger Bräu AG*, as note 55 above, at para. 44.

128 Joined Cases Nos. 56 and 58/64, *Etablissements Consten SARL and Grundig-Verkaufs-GmbH v. Commission*, [1966] ECR 299.

129 E.-J. Mestmäcker, as note 118 above, at 526.

cartels as a whole. The White Paper lacks any evaluation with regard to the shift of policy as to the enforcement of the prohibition of horizontal restraints and fails to address the impact on the underlying Treaty provision, Article 81 EC, as the substantive cornerstone.

B. A NEW ALLOCATION OF RESPONSIBILITIES

The current state of law is based on a centralised application of Article 81(3) EC. Article 9(1) of Regulation 17 stipulates that it is the Commission only which has the power to exempt restrictive practices from the general prohibition laid down in Article 8(1) EC. In a directly applicable system, however, this allocation of jurisdiction automatically changes as the former monopoly of execution dissolves into the self-executing character of the exception.

1. *The Role of the Commission*

The White Paper's leading principle underlying any suggestion for reform is undoubtedly the will to decrease the overall workload and lighten the administrative burden.[130] By doing so, the Commission hopes to get into a position which enables it to concentrate on the most important cases, these being cases which involve especially serious restrictions of the competitive structure or which raise new issues of law.[131] Apparently, the principle of cause and responsibility is applied rigorously: the large amount of notifications makes enforcement ineffective as it consumes resources needed to focus on the important tasks;[132] notifications are inherent in any form of authorisation system;[133] thus, the latter system is to be abolished as it is responsible for the current deplorable state of competition law enforcement.

The Commission primarily employs two means. The introduction of a directly applicable system makes notifications superfluous, thus decreasing the overall administrative workload. The utilisation of the resources of the Member States in a network of competition authorities will help to share the burden of the remaining work.

The White Paper is eager to emphasise that the Commission in such a new division of responsibilities remains the sole body to determine the competition policy at Community level.[134] Apparently the Commission is willing to give up its monopoly with regard to Article 81(3) EC, however, not at the cost of any decrease as to its overall power. It wants to maintain the exclusive right to propose legislation implementing the policy in order to ensure consistency and uniformity in the

[130] See for instance Commission, *White Paper*, as note 1 above at para. 77.
[131] Ibid., at para. 87.
[132] *Cf.* ibid., at para. 76 et seq.
[133] *Cf.* ibid., at para. 52 et seq.
[134] Ibid., at para. 83 et seq.

application of the competition rules.[135] It is interesting to notice that the use of block exemptions—besides notices, guidelines and individual prohibition decisions—is to continue in the new directly applicable system.[136] It is hardly consistent with a system where the "exemption" derives from Article 81(3) EC itself and not from a prior decision, how—seemingly constitutive—additional decisions can be part of such a scheme.[137] The proposal itself clearly refers to the criteria of Article 81(3) EC which themselves provide for the prohibition to be lifted *ex tunc* and as a matter of law.[138] Thus, there is no scope for a further decision which "exempts"—be it an individual exemption or a block exemption.

The inconsistency of the proposal in this respect is underlined by the subsequent idea that as a "logical consequence" national authorities would be able to withdraw the benefit of such a block exemption.[139] Again, as the "benefit" derives from Article 81(3) EC, there is no benefit of the block exemption to withdraw. Furthermore, neither the Commission nor any other authority can, under a directly applicable system, be empowered to disregard an exemption granted by the Treaty itself. Article 83(2) EC gives legislative powers only in so far as this is to *define* the scope of the exception, however, there is no jurisdiction to *alter* it. Yet, secondary legislation pursuant to Article 82(2) EC may be used to detail more clearly the scope of application of Article 81 EC which is evidently the objective now envisaged by the so-called "block exemptions".

A shift in the policy of EC competition law which is a primary result of the direct applicability of Article 81(3) EC has to be seen in the transformation to an *ex post* control of restrictive practices. The reactive stance, in conjunction with the large number of notifications in the current legal situation, is seen as the main obstacle to effective enforcement. Therefore, the Commission believes that it should be able to be proactive, and to pursue only own-initiative procedures and procedures following complaints, in order to be able to focus its resources on restrictive practices which seriously restrict competition or threaten market integration.[140] It is clear that the system as it is now proposed eases the administrative burden to a large extent. Especially since notifications would no longer form part of practically compulsory procedures and any action on the part of the Commission would be based on its own assessment of necessity and priority. However, whether these advantages outweigh the disadvantages remains to be discussed.[141]

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135 Ibid., at para. 84 et seq.

136 Ibid., at paras 71, 78, 85.

137 E.-J. Mestmäcker, as note 118 above, at 526, rightly observes that, if Article 81(3) EC applies by virtue of direct effect, there is no scope for separate authoritative proceedings.

138 Commission, *White Paper*, as note 1 above, at para. 69.

139 Ibid., at para. 95. This possibility has already been envisaged by the Commission with regard to vertical restraints (OJ C 365, 26.11.1998, p. 3). However, this was still under the current authorisation system.

140 Commission, *White Paper*, as note 1 above, at para. 45 and 108 et seq.

141 See section V.E.5. et seq of this Article below.

2. *The Situation of National Authorities*

The sole power of the Commission to grant exemptions from Article 81(1) EC has always been recognised as being a major obstacle to effective and workable decentralisation.[142] Thus, a system in which the competition authorities of the Member States would also have this power has been strongly advocated for a considerable time.[143] If the proposal is put into effect, the obstacle is not removed by merely including the national competition authorities into Article 9(1) of Regulation 17 but—taking even a step further—by the direct applicability of Article 81(3) EC itself. In such a system logic dictates that national authorities with the power to enforce the EC competition rules would themselves be fully empowered to assess whether or not a restrictive practice meets the requirements for exception as laid down in the Treaty.[144]

In order to set up a true "network of authorities" it is necessary, however, that certain conditions are fulfilled at national level. First, it is necessary that the national authorities are legally[145] as well as factually equipped with sufficient means to effectively enforce the competition rules. In this respect nothing would be gained by recreating the current deplorable state of affairs at national level. The requirement of sufficient staff in the national cartel offices is self-explanatory but must not be taken for granted. The *Bundeskartellamt*—probably the earliest and strongest promoter of decentralisation[146]—as well as other offices might see themselves as having been well-prepared for a long time. Yet this is doubtful with regard to some Member States, and especially with regard to new accessions.[147] This might explain the fact that several Member States have been, and still seem to be, in favour of the *status quo*.[148] It may be suggested, however, that an increase of power will work as an incentive for the Member States and encourage them to legally and personally equip their competition authorities with the necessary means.[149] The argument, that national administrative authorities are generally not well suited to decide on political questions of a Community dimension[150], must be

[142] Bundeskartellamt, as note 72 above, at 11; with regard to national courts see A. Waller, as note 32 above, at 32.

[143] For instance M. Cini and L. McGowan, as note 89 above, at 191; U. Zinsmeister, as note 72 above, at 120; S. Wilks, as note 29 above, at 167; H.P. v. Stoephasius, as note 26 above, at 36 et seq.; D. Wolf, *Zum Verhältnis von europäischem und deutschem Wettbewerbsrecht*, [1995] 5 Europäische Zeitschrift für Wirtschaftsrecht 233 at 235; Bundeskartellamt, as note 72 above, at 15 et seq. A. Waller, as note 32 above, at 33. For critical comments see C.D. Ehlermann, as note 12 above, at 93 et seq.

[144] *Cf.* Commission, *White Paper*, as note 1 above, at para. 93.

[145] It has to be noted that the authorities of seven Member States are still not empowered to enforce the EC rules on competition. Thus, before any decentralisation can work effectively, national legislation has to provide for the necessary jurisdiction. *Cf.* Commission, *White Paper*, as note 1 above, at para. 94.

[146] C.D. Ehlermann, as note 12 above, at 93; Bundeskartellamt, as note 72 above, at 15 et seq.

[147] J. Temple Lang, as note 31 above, at 274: the Austrian, Finnish, French and UK reports say that their national cartel offices are currently seriously short-staffed.

[148] *Cf.* C.D. Ehlermann, as note 12 above, at 93; J. Temple Lang, as note 31 above, at 278.

[149] Bundeskartellamt, as note 72 above, at 11; U. Zinsmeister, as note 72 above, at 119.

[150] See B. Doherty, *Community Exemptions in national law*, [1994] 15 European Competition Law Review 315 at 318.

rejected at the outset: competition policy must not be influenced by overall political considerations but has to maintain and to promote effective competition and market integration following an assessment of the conditions laid down by the EC competition rules.

Secondly, a decentralised network requires a workable scheme of exchange of information and evidence. Currently, Article 20 of Regulation 17—according to the *Spanish Banks* principle[151]—prevents national competition authorities from using as evidence information supplied by the Commission[152] and several national laws do not allow the forwarding of confidential information to any other body.[153] Thus, a harmonisation of the national and Community legislation concerned is needed in order to make satisfactory co-operation possible, at the same time safeguarding the necessary confidentiality of business secrets.

Thirdly, the *status quo* also raises questions with regard to the territorial limitation of national authorities as to their investigative powers[154] as well as the legal effects of their decisions taken pursuant to Articles 81 et seq. EC.[155] It is suggested that, in order to build the necessary enforcement bridges, multilateral agreements between the Member States—under the guidance of the Commission—could provide for a system which not only allows but also makes co-operation compulsory in respect of any cases involving more than the investigating Member State.[156] However, it seems more appropriate to include all aspects with regard to the powers of the national authorities when enforcing Article 81 EC, into the new Regulation 17 itself.[157] Such an amendment could then ensure the Community-wide recognition of national decisions and provide for compulsory terms of preceding co-operation.

3. *Enforcement Before National Courts*

The White Paper envisages an "enhanced role" for the national courts in the application of the competition rules under the new directly applicable system.[158] It has previously been stated[159] that the absence of jurisdiction of national courts over Article 81(3) EC creates major difficulties when private enforcement is sought. This obstacle would be removed by the new system as any national judge would not only have the power but the duty to fully assess the conditions for exception. Furthermore, any judgment which has become *res iudicata* would have to be recognised by the courts of

[151] Case No. C-67/91, *Dirección General de Defensa de la Competencia v. Asociación Española de Banca Privada and others*, [1992] ECR I-4785 at para. 35 et seq.

[152] This problem is also addressed by the White Paper (Commission, *White Paper*, as note 1 above, at para. 96).

[153] *Cf.* J. Temple Lang, as note 31 above, at 277; C.S. Kerse, *E.C. Antitrust Procedure*, (3rd Edn, London, 1994) at 176 et seq.

[154] P-V. Bos, as note 96 above, at 413.

[155] Bundeskartellamt, as note 72 above, at 28; P.B. Marsden, as note 26 above, at 239 et seq.

[156] P.B. Marsden, as note 26 above, at 240.

[157] Yet, it is questionable whether Article 83 EC provides for the power to enact such Community legislation, see Bundeskartellamt, as note 72 above, at 30.

[158] Commission, *White Paper*, as note 1 above, at para. 99 et seq.

[159] See section III. B.1 of this Article, above.

all Member States under the *Brussels*[160] and *Lugano*[161] Conventions. However, as the other disadvantages of private enforcement—such as the high costs for the parties and the difficulties in getting hold of evidence[162]—remain, it may be doubted that national courts will ever play a role of significantly increased importance.[163]

In addition, serious problems might arise with regard to coherence of the application of Article 81(3) EC. In contrast to the involvement of national authorities it is hardly consistent with the independence of courts to include them into a system of compulsory co-operation with bodies outside the judiciary. Under the new scheme, the direct effect of Article 81 EC as a whole would empower the national court to judge on the complex and wide scope of Article 81(3) EC. The inherent discretion could undoubtedly lead to conflicting decisions. References to the Court of Justice are compulsory for the final instance only and merely include questions of interpretation of the Treaty rather than any assessment of the economic facts involved in the case at issue.

4. *The Situation of Undertakings*

The current authorisation system requires the undertakings to notify their agreements in order to benefit from an exemption pursuant to Article 81(3) EC. This imposes a significant administrative burden on both the Commission and the undertakings. In the new system without authorisation and notification this deficit is—at least at first glance—no longer an issue. Furthermore, undertakings lose their ability to block procedures before national authorities by notifying their restrictive practices.[164]

Yet, this only seemingly puts the undertakings in a more comfortable position. What the Commission with some euphemism describes as the "added responsibility"[165] of the economic operators may turn out to be a disguised repetition of the pre-reform state of affairs: the current system results in the vast majority of cases being "settled" by informal means, especially comfort letters. This leads to great legal uncertainty on the part of the undertakings. In the new system of *ex post* control the undertakings would have to make their own assessment of the compatibility of their restrictive practices.[166] This not only maintains the necessity of costly legal advice,[167] but also leaves the undertakings with great legal uncertainty with regard to the enforceability of the concluded agreements. Thus, it may be suggested that from this perspective not much is to be gained by the undertakings with the introduction of the new system.

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[160] *Brussels Convention on jurisdiction and enforcement of judgments in civil and commercial matters*, OJ L 304, 30.10.1978, p. 36, as amended by the *1997 Accession Convention*, OJ C 15, 15.01.1997, p. 1.

[161] *Lugano Convention on jurisdiction and enforcement of judgments in civil and commercial matters*, concluded on September 16 1988, OJ L 319, 25.11.1988, p. 9.

[162] See section III. B.1 of this Article, above.

[163] With doubts in this respect see also D. Wolf, as note 105 above.

[164] *Cf.* Commission, *White Paper*, as note 1 above, at para. 6.

[165] Ibid., at para. 77.

[166] *Cf.* ibid., at para. 77.

[167] *Cf.* D. Wolf, as note 105 above.

C. Allocation of cases

The new regime not only promotes decentralised application by the fact that national authorities are able to grant exemptions. Rather, provided that national law entrusts them with the necessary power of enforcement, national authorities enforce Article 81 EC as a unitary provision by virtue of direct applicability. Thus, the question of allocation of cases between the Commission and the national cartel offices is in principle raised in any case to which the EC competition rules are applicable. Yet, it has to be noticed in this respect, that the cessation of notifications in favour of pure *ex post* enforcement makes it an issue for the authorities rather than the undertakings concerned.[168]

The White Paper addresses this issue only incidentally. However, it is easily noticeable that it is the Commission's objective under the new system to focus its resources on the most serious restrictions and cases raising general questions of competition policy and new issues of law.[169] It appears that the Commission thereby envisages national authorities playing a much more vital role as they should be the bodies which in principle deal with *all* cases *unless* practical (e.g. the case requires investigations in several Member States),[170] or legal reasons (e.g. the case is important as a precedent),[171] require action of the Commission. However, the Commission seeks to maintain a position of *Kompetenz-Kompetenz* which in any event allows it to take a case out of the jurisdiction of the national competition authorities.[172] Thus, the question whether the case has a "Community dimension" is decided on a case by case basis rather than any strictly applicable quantitative criteria as set forth in the Merger Regulation[173] and the EEA Agreement.[174] It may be suggested that this flexible approach does not create great legal certainty as far as the jurisdiction is concerned. Hence, the new scheme would require a system which ensures both the continuous exchange of information[175] and a co-ordinating body similar to the present Advisory Committee on Restrictive Practices and Dominant Positions.[176]

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[168] Different mechanisms have been suggested in order to draw a line between the competence of the Commission and the national cartel offices. These were in particular quantitative threshold and qualitative criteria ("*Schwerpunkttheorie*"). Yet, these are designed for an authoritative system with a continuous need of the competition authorities to deal with notifications as a means of *ex ante* control. In such a system legal certainty for the undertakings requires a clearer jurisdictional divide. For the different proposals see for instance Bundeskartellamt, as note 72 above, at 19 et seq.; R. Wesseling, as note 12 above, at 97; R. Wesseling, as note 3 above, at 47 et seq.; P-V. Bos, as note 96 above; H.P. v. Stoephasius, as note 26 above, at 37.

[169] Commission, *White Paper*, as note 1 above, at para. 83 et seq.

[170] See ibid., at para. 96.

[171] See ibid., at para. 87.

[172] Ibid., at para. 105.

[173] Council Regulation 4064/89, [1990] OJ L 257/13 (as amended).

[174] Art. 56 of the Agreement on the European Economic Area [1994] OJ L 1/1.

[175] Note, Section 50.3 of the German *Gesetz gegen Wettbewerbsbeschränkungen—GWB* now provides that the Commission is to be informed of cases of application of Community Law so as to enable it to state a view.

[176] The Commission likes to see the Advisory Committee as a full scale forum in which important cases are discussed irrespective of the competition authority dealing with them. However, it seems not to be envisaged as a body which makes final decisions as to the jurisdiction; *cf.* Commission, *White Paper*, as note 1 above, at para. 106.

D. UNIFORM ENFORCEMENT AND CONSISTENCY

Ideally, it should not matter whether a case involving the application of EC antitrust rules is dealt with by the Commission or a national authority, the result should be the same.[177] If a system is set up which also ensures the decisions taken to be enforceable in each Member State, even the question of territoriality should not arise. However, the current state of affairs is far from this ideal and it cannot be substantially adjusted by merely changing the legal environment. The switch from a scheme that was characterised by a partial monopoly of the Commission to that of full-scale concurrent jurisdiction inevitably puts the consistency and uniformity of enforcement at a greater risk.[178] However, it may be reasoned that a sporadic divergence in the application of the EC rules on cartels would just reflect the direct effect of these rules and is by no means as harmful as the current deplorable state of affairs.[179] Furthermore, from a legal point of view, there is nothing which suggests that a decision taken by the Commission is more correct than that of a judge in Palermo. Inconsistency is to some extent the inevitable price of effective decentralisation and the division of power.

It is clear that, with regard to national courts, any other authority has to recognise judgments of courts which have become *res iudicata* as binding. Thus, no other decision may be taken with respect to the legal position of the parties. Accordingly, even the Commission loses jurisdiction in those cases. Preceding co-operation mechanisms and the possibility of the Commission intervening as *amicus curiae* in pending cases[180] cannot prevent the national judge from taking a position contrary to that of the former. However, it remains to be seen whether this in effect puts consistency at an appreciable risk as such cases may prove to remain rare.

According to the early decision in *Walt Wilhelm*, the principle of the primacy of the EC rules on competition prevents the application of the respective national laws from undermining the full and uniform application of Articles 81 and 82 EC and the effectiveness of measures implementing these provisions.[181] However, in any other circumstances the remaining divergence of national and EC rules on cartels, and possible conflicting policies, give rise to further inconsistency.[182] It may be suggested that in the medium-term only the existence of one uniform set of substantive competition rules can ensure the necessary clarity for all the parties involved. The increase of jurisdiction at national level might act as an incentive for further harmonisation of EC and national competition laws, lessening the difficulties arising out of the current system of double control. Yet, in any event a system which involves different levels and different bodies needs mechanisms which not only ensure a clear

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177 *Cf.* J. Temple Lang, as note 31 above, at 281.

178 *Cf.* P.B. Marsden, as note 26 above, at 235.

179 M. Furse, as note 38 above, at 142.

180 This is suggested by the White Paper. Commission, *White Paper*, as note 1 above, at para. 107.

181 *Walt Wilhelm v. Bundeskartellamt*, as note 8 above, at 14. *Cf.* Commission, *White Paper*, as note 1 above, at para. 101.

182 A. Schaub, as note 83 above, under IV. C. 2.

division of powers, but which also precisely decide which body has in any event the last word. The White Paper does not address this question to a satisfying extent, arguably because it feels that the political landscape is not yet prepared for the establishment of a hierarchical administrative structure with the Commission or a European Cartel Office[183] on top.[184]

E. Criticism and alternatives

Besides the critical remarks already made, there are other aspects of the new scheme envisaged by the Commission which give rise to objections and make it necessary to discuss other options of reform.

1. *Further Critical Remarks*

As pointed out above[185] a directly applicable system focuses enforcement of the prohibition laid down in Article 81(1) EC solely on *ex post* control, in contrast to the current state of the law where any alleged restrictive practice is under the presumption of being *prima facie* invalid. The latter system thus allows for an extensive pre-screening of restrictive agreements and practices, putting the undertakings under the pressure to forward the necessary information. Furthermore, in the areas which are not covered by block exemptions, i.e. especially horizontal agreements, there is a lower risk that the damaging effects of a restrictive practice on the market structure have already occurred until any authoritative action is taken.

Consequently, as the White Paper itself admits, the new system requires an "intensified *ex post* control".[186] As notifications no longer form part of it, the investigating authorities have to exclusively rely on their own investigative resources and on complaints. It has to be noted in this respect that these means currently make up less than 45 percent of the cases before the Commission.[187] Albeit on the surface proposing only an amendment of the procedural rules as laid down in Regulation 17, the envisaged changes *de facto* alter the substantial rules to an order that, similar to Article 82 EC, focuses on the "abuse" rather than the mere existence of restrictive agreements or practices.[188] It is clear that the renunciation of any pre-screening also abandons the "close" contact between undertakings and anti-trust authorities which necessarily forms part of an authorisation system with notifications. The economic operators have to rely on a self-assessment of their practices and agreements. This not only still requires costly legal advice, but also

[183] *Cf.* M. Dreher, *Do We Need a European Competition Agency?*, in W. Geoffrey and R. Rogowski (eds), *Challenges to European Legal Scholarship: Anglo-German Legal Essays* (London, 1996) at 95 et seq.

[184] *Cf.* C.D. Ehlermann, as note 12 above, at 94.

[185] See section V.A. of this Article, above.

[186] See Commission, *White Paper*, as note 1 above, at para. 108 et seq.

[187] Ibid., at para. 44.

[188] See section V.A. of this Article, above.

eliminates the possibility of *ex ante* co-operation between them and the authorities. The latter form of informal co-operation, however, has proven to be useful in order to prevent restrictive agreements taking effect in those cases in which the undertakings are indeed willing to co-operate with the competition authorities.[189]

Moreover, the transition to a mere *ex post* control also in the sphere of horizontal agreements decreases the level of protection against such restrictive practices, which are *per se* deemed to be much more harmful to the competitive structure of the markets than vertical restraints which often have a predominant pro-competitive effect.[190] Practically, the directly applicable system requires every such case to be discovered rather than being uncovered by the undertakings themselves. It is at least questionable whether own-initiative investigations and complaints will indeed provide the necessary information.[191] In addition, the new policy behind the approach taken by the White Paper sends a message to operators of horizontal agreements which is in contrast to the view taken by just recently reformed national laws on cartels that recognise the qualitative difference of horizontal and vertical restraints:[192] even such agreements are *de facto* operable until any contrary decision is taken.[193]

Furthermore, the shift of general policy, which does not prohibit any agreement *per se*, must necessarily take increased account of the principle of good faith of undertakings when assessing the legal validity of their agreements on their own. If, after such an assessment, the undertakings concerned acting in good faith come to the conclusion that their restrictive practice does comply with Article 81 EC, it may be doubted whether fines may still be imposed to more than a limited extent or at all.[194] This also has the regrettable result of decreasing the deterrent effect of fines overall.

2. *The Options of Reform Discussed by the White Paper*

The White Paper does indeed discuss other options available for reforming the system of control of restrictive practices.[195] It becomes clear from the outset that it is the Commission's prime objective to reduce its overall caseload, thus freeing resources to focus its work on the "most serious restrictions".

Before turning to the directly applicable exception system, the Commission refers to four other options within the current authorisation system, yet discusses them only briefly. These are, a more restricted application of Article 81(1) EC by including a test

[189] D. Wolf, as note 118, above.

[190] M. Furse, as note 38 above, at 125.

[191] D. Wolf, as note 118 above.

[192] *Cf*. the new competition laws of The Netherlands and Germany. In the UK under the Restrictive Trades Practices Act 1976, many vertical agreements were exempted from the Act's application by virtue of section 9.3, and the DTI indicated early in the preparation of the 1998 Competition Act that it was intended to remove most vertical agreements from the scope of the Chapter I prohibition of that act. *Cf*. M. Furse, as note 38 above, at 175 et seq.

[193] The President of the Bundeskartellamt describes this as a general shift to an "*in dubio*"—validity of cartels. See D. Wolf, as note 105 above.

[194] D. Wolf, as note 118 above.

[195] Commission, *White Paper*, as note 1 above, at para. 55 et seq.

of the pro- and anti-competitive elements of an agreement ("rule of reason") into the provision;[196] enabling the national authorities to grant exemptions;[197] extending further the exception to the notification requirement;[198] and finally, simplifying the complex procedural rules required for formal decisions.[199] It may be said at the outset that it is regrettable that the Commission does not even consider combining certain aspects of these options. By doing so, it unnecessarily restricts itself to an "all or nothing" approach.

The first alternative would decrease the number of cases in need of an evaluation of the conditions laid down in 81(3) EC, thus, decrease the number of cases overall as a full competitive balance would be already made in the context of Article 81(1) EC.[200] However, a restriction of the scope of Article 81 EC could only be achieved by a Treaty amendment,[201] as it is not for the Commission to interpret the Treaty differently from the current case-law of the Court, and the power to amend the Treaty lies solely with the Member States.[202] Moreover, the latter may not enforce a sudden shift of the Community's policy as to restrictive practices by gradually "adjusting" the Treaty to comply with that policy. Even if the Court of Justice would be prepared to do so, it would take many years until such a disguised amendment of Article 81(1) EC would be accomplished. Furthermore, as the Commission rightly states, it is to some extent at least paradoxical to cast aside Article 81(3) EC when that provision in fact contains the elements of a "rule of reason".[203] The backlog of cases, however, is not primarily due to the broad application of Article 81 EC as such, but due to the limitation of authorities who may apply Article 81(3) EC.

The second option, i.e. granting national cartel offices the jurisdiction to apply Article 81(3) EC and to adopt constitutive exemption decisions, has especially been promoted by the *Bundeskartellamt*, most recently in one of its working papers.[204] The White Paper rightly points out that this option does not itself reduce the total number of notifications, but merely redistributes the cases between the Commission and the national cartel offices.[205] Consequently, such allocation of powers would only be a

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[196] Ibid., at para. 56 et seq.
[197] Ibid., at para. 58 et seq.
[198] Ibid., at para. 63 et seq.
[199] Ibid., at para. 66 et seq.
[200] *Cf.* A. Schaub, as note 83 above, under IV. D. 2. 2.1.
[201] The necessity of an amendment of the Treaty is denied by M. Siragusa who states that Article 81 EC "is drafted broadly enough to allow the Commission and the Court of Justice to bring about important changes in the current application of EC competition law", see M. Siragusa, as note 26 above, at 284. Yet, this statement drastically neglects the attribution of powers as set forth in the Treaty and the principle of the division of powers. *Cf.* A. Schaub, as note 83 above, under IV. D. 2. 2.1.
[202] The Court of Justice has already endorsed an approach which allows a limited assessment of the pro- and anti-competitive aspects of some restrictive practices under Article 81(1) EC. However, there are no signs that the Court is prepared to include a full-scale rule of reason into Article 81(1) EC. *Cf.* Case No. 258/78, *LC Nungesser KG and Kurt Eisele v. Commission*, [1982] ECR 2015; Case No. 161/84, *Pronuptia Paris GmbH v. Pronuptia de Paris Irmgard Schillgalis*, [1986] ECR 353.
[203] Commission, *White Paper*, as note 1 above, at para. 57.
[204] Bundeskartellamt, as note 72 above, at 15 et seq. See also C.D. Ehlermann, as note 12 above, at 93; U. Zinsmeister, as note 72 above, at 120; A. Schaub, as note 83 above, under IV. D. 2. 2.1.
[205] Commission, *White Paper*, as note 1 above, at para. 60.

means to further promote decentralisation as such, leaving the question of notifications and overall workload aside. However, this cannot lead to the conclusion that this approach may not be one part of a reform as long as the latter issue is dealt with by other means. Furthermore, it seems somewhat inconsistent to reject this approach on the grounds that the question of the allocation of cases may not easily be solved[206] and that it could particularly prove to be difficult for the new Member States' authorities to introduce notification systems.[207] These questions do not just arise by opting for this option but are general issues of decentralisation which also have to be faced with the directly applicable exception scheme.

Thirdly, the White Paper discusses whether a reduction in the number of notifications by broadening the scope of Article 4(2) of Regulation 17 would be a sound method to simplify administration.[208] A further extension of the exception to the notification requirement would prevent agreements falling within the prohibition of Article 81(1) EC which have not been notified from being automatically void. Even in the event of late notification, the Commission could adopt an exemption decision that would still be effective *ex tunc*, i.e. the date on which the agreement was concluded.[209] Surprisingly, this approach is rejected solely on the grounds that the Commission's maintained monopoly to grant exemptions would pose an obstacle to decentralisation.[210] Surprising, because the current monopoly of the Commission as set forth in Article 9(1) of Regulation 17 is an entirely independent issue, and there are no reasons apparent why a lessening of the notification requirement may not come along with a decentralised jurisdiction as to Article 81(3) EC.

The fourth option brought up by the White Paper—the simplification of procedural rules[211]—blatantly reveals the Commission's reservations against notifications as such and any pre-screening of restrictive agreements. As it states, simplifications would have the "perverse effect in that all notifications would be dealt with by decision, and undertakings would therefore be encouraged to notify".[212] Again, it is not discussed whether a simplification of procedural rules *in combination* with other reforms as to the obligation to notify and decentralised decision-making could indeed foster effective supervision and create a true alternative to the system of direct applicability.

206 Ibid., at para. 61.
207 Ibid., at para. 62.
208 See also A. Schaub, as note 83 above, under IV. A. 1. 1.2. b.
209 Commission, *White Paper*, as note 1 above, at para. 64.
210 Ibid., at para. 65.
211 See also M. Siragusa, as note 26 above, at 287 et seq.
212 Commission, *White Paper*, as note 1 above, at para. 66.

3. *An Alternative—Combination of Decentralisation with a Reform of the Authorisation System*

It has undoubtedly become apparent from the foregoing that the current system is in need of reforms which adjust the legal environment to the challenges of an effective supervision of restrictive practices within the common market. However, it may be doubted whether such a far-reaching approach as taken by the White Paper is indeed necessary. It is suggested that reform should be such as to give competition authorities the possibility of focusing their resources in the sphere of vertical restraints to a higher degree on *ex post* control, whilst at the same time maintaining the advantages of pre-screening in the sphere of hard-core vertical and especially horizontal restraints. The utilisation of national cartel offices may then serve as a further means to decrease the Commission's workload and to promote a more widespread application of the EC competition rules.

About half a year prior to the publication of the White Paper, on 30 September 1998, the Commission adopted a Communication on the application of the EC competition rules to vertical restraints and issued proposals for amendment of Regulations 19/65 EEC and Regulation 17[213] following its Green Paper on the same issue.[214] These proposals have now been put into effect.[215] The underlying idea is that a more economic effects-based system covering virtually all sectors of distribution would provide greater commercial flexibility and increase legal certainty. A single block exemption regulation pursuant to the amended Regulation 19/62 would then apply to virtually all economic sectors concerning vertical restraints, and free the economic operators from the need to have their agreements validated if they fulfil the criteria laid down therein. A market share threshold[216] is envisaged to serve as a means to distinguish those agreements which are presumed to be legal—i.e. the block exemption applies—from those that may require individual exemption—i.e. the agreement falls outside the scope of the regulation. Moreover, the "safe haven" created by the block exemption would be contemplated by so-called black lists of certain *per se* prohibited behaviour, defining rather what is not exempted instead of defining what is exempted.[217] In addition, the amendments include a relaxation of the notification procedure, in so far as vertical agreements are

[213] COM(1998) 546 final.

[214] Green Paper on vertical restraints in EC Competition Policy, COM(1996) 721 final. *Cf.* A.J. Riley, as note 42 above, at 483; V. Korah, as note 32 above, at 506; Z. Biro and A. Fletscher, as note 42 above, at 129; J. Nazerali and D. Cowan, *The Commission's Draft Communication on Distribution Agreements—Market Shares are Predictably Back on the Table!* [1998] 19 European Competition Law Review 409.

[215] Council Regulation No. 1215/1999 of 10 June 1999 (amending Regulation 19/65) and Council Regulation No. 1216/1999 of 10 June 1999 (amending Regulation 17/62), OJ L 148, 15.06.1999, pp. 1 and 5 respectively.

[216] With regard to the use of the market share caps, the Commission had in its policy paper left open the option for a system which is based on one (20% and 40%) or two thresholds (between 25% and 35%). However, currently a one threshold system (30%) seems to be on the table; *cf.* D. Wolf, as note 118 above.

[217] *Cf.* A. Schaub, as note 83 above, under IV. A. 1. 1.1.

now exempted from the notification requirement laid down in Article 4(1) of Regulation 17.[218]

It is clear that the Commission would be liberated from a large part of its current work on individual exemptions as the majority of notifications received by the Commission are concerned with vertical agreements.[219] This would free resources for *ex post* control in the sphere of vertical restraints and would filter out cases that appear *a priori* to be less harmful to competition by exempting them from prior notification. At the same time a *pre-screening* of those constraints which are *a priori* believed to be more harmful, i.e. hard-core vertical restraints and horizontal agreements, would generally be maintained. The greater flexibility of block exemptions which could always be adjusted to new economic developments would be another advantage in contrast to the decision of a "once-and-forever" taken by the direct applicability of Article 81 EC as a whole.

In order to distribute the remaining work, the cartel offices could not just be entrusted with the competence to withdraw the benefit of a block exemption,[220] but also with the general power to apply Article 81(3) EC and to make individual decisions concerning restrictive practices which are outside the sphere of the block exemption. As far as coherence is concerned, the issues raised by this "restricted" decentralisation are the same as with a system of direct applicability. The allocation of cases, as notifications would still form part of such a scheme, would have to be dealt with in a more precise manner in order to give the undertakings concerned legal certainty with regard to jurisdiction in their particular case. However, as any form of decentralisation requires a sophisticated network of information, co-operation and decision-making, the allocation of the remaining number of notifications should not impose a heavy obstacle.

It is suggested that the results of the proposals made by the Green Paper should be left to make their course as to the impact they have on the overall work-load before any more drastic and irrevocable measures are taken. Moreover, the simplification of the administrative procedures and a general decentralisation should support the Commission to an extent which puts it into a less burdensome position without endangering effective enforcement of the competition rules.

VI. Conclusion

Much has been said about the difficulties and challenges EC competition law faces at the beginning of the new millennium. Key terms such as globalisation and

[218] Point 2 of Article 4(2) of Regulation 17 is now replaced by the following wording:
"(2) the agreements or concerted practices relate to the supply or purchase, or both, of goods for resale or processing, or to the marketing of services, and the agreements or concerted practices are between two or more undertakings each operating at a different stage of the economic process; …"

[219] D. Wolf, as note 118 above; A. Schaub, as note 83 above, under IV. A. 1. 1.1.

[220] This is envisaged by the proposals of the Commission concerning vertical restraints but also mentioned in the White Paper; see Commission, *White Paper*, as note 1 above, at para. 95.

technological change alone seem to be a justification for the need of reform. Apparently, the Commission has now somewhat hastily decided to put itself at the forefront of reformatory efforts by proposing significant changes to the current system of EC competition law enforcement. In contrast to what the White Paper makes us believe, these proposals do not only address the structure of the procedural rules but radically alter the Commission's policy towards cartels as a whole.

As much as the attempt to decentralise the enforcement must be welcomed; the renunciation of pre-screening with regard to horizontal and hard-core vertical restraints overshoots the mark. There is nothing which suggests that globalisation and the integration of markets lessens the danger of cartels. Indeed, rather the opposite is the case. These cartels, however, would profit from the factual *prima facie* validity inherent in the system just as any other, in most cases far less harmful, vertical restraint. Yet, with regard to the administrative difficulties the Commission faces in the current system, especially the large number of notifications, such a far-reaching reform does not seem to be necessary as the new policy towards vertical restraints already introduced by the Commission undoubtedly will already significantly decrease the overall workload.

With regard to decentralisation, it has to be noted that much will have to be done until the necessary common competition culture has developed. Inevitably, difficulties will arise especially with regard to new Member States. However, only true reforms may foster a new allocation of responsibilities and provide for the necessary incentives to build a coherent network of cartel offices throughout the European market.

The White Paper surely is a step in the right direction as it opens grounds for the indispensable debate about future reforms. Yet, many legal issues remain unclear and the proposals will undoubtedly raise heavy criticism as to the new policy on cartels. If, after all, the White Paper turns out to be a millennium bug, remains to be seen.

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BOOK REVIEWS

Book Review Co-ordinator: Professor Valentine KORAH

Valentine Korah

Faull & Nikpay eds.: *The EC Law of Competition*, (Oxford University Press, 1999), cxviii + 961 pp. including index, £125

Michel Waelbroeck and Aldo Frignani, *European Competition Law* (Transnational Publishers Inc., 1999), translated by Françoise Gamet-Pol, lxii + 1040 pp. including index and chronological tables of cases, $185

Lennart Ritter, W. David Braun and Francis Rawlinson, *European Competition Law: A Practitioner's Guide*, (2nd edition, Kluwer Law International, The Hague, 2000), xcix + 1377 pp. including index and 383 pp. of appendices, £102

Faull & Nikpay is written entirely by officials working for the European Commission Competition Department and competition experts have bought copies to discover more about their thinking. The book is much better than that. Many using the book tell me how happy they are with it. In chapter after chapter the best articles in English are cited and more awareness of economic analysis is demonstrated than in the European Commission's decisions. The development of the law is lucidly explained. This is the best book of the three for students to consult. Not only are the rules and case law described, the reasons for the rules are explained. This feature should help practitioners to understand their likely future development.

The first chapter is devoted to economics: the static analysis by Luc Peeperkorn and the dynamic analysis by Kirti Mehta. The economic analysis by each seems to a lawyer to be sophisticated and accurate, but I wonder for whom the static analysis is intended. It assumes that the reader understands terms widely used in the economic literature, such as "the hold up problem". Those who have read the literature will not need the chapter. The dynamic analysis is much easier for a non-economist to understand although it is highly abstract and requires concentration. Both sections resemble a succinct summary for readers familiar with economic works.

The following chapters provide clear and thoughtful analyses of the law. The link made in the chapter on Article 81 between agreements that "by their very nature" restrain competition, and the "object of restraining competition" makes the Commission's rigid view on the *per se* nature of the prohibition of even vertical price fixing and market allocation more understandable. There is a tendency to cite Commission decisions, when an outsider might cite more judgments of the Court of First Instance (CFI) and European Court of Justice (ECJ).

Chapter III on Article 82 also cites many of the best articles in English and is supplemented by a chapter on State measures under Article 86 (ex Article 90). The part of the chapter on horizontal agreements relating to joint ventures is the best piece I have read on the subject. The section on vertical agreements explains in simple and readable fashion, the Commission's early determination to regulate by finding many restrictions, especially those appearing to divide the common market, contrary to Article 81(1) and providing specific group exemptions. This chapter has been overtaken by the adoption of the Regulation on Vertical Restraints.[1]

There are also chapters on the special sectors of financial services, communications (telecoms, media, internet) and transport. The chapter on energy is particularly good. There is no chapter on the Commission's procedure, but the books by Kerse and Ortiz Blanco[2] cover the gap.

Citations in the notes are to case number and *European Court Reports* (ECR) or to *Official Journal of the European Communities* (OJ). Usually the relevant paragraphs are specified in the notes. The table of cases includes also the *Common Market Law Review* (CMLR), but not the CCH series widely used in the US Regulations, and notices are cited only from the OJ. I wonder why the table of legislation should list every point where Article 81 or 82 is mentioned, with no entries distinguished as more important.

The book by Waelbroeck and Frignani was published in French and Italian in 1997. It is a classic. Much careful thought has been devoted by both authors over several decades to the analysis of difficult, controversial issues, taking all the original language versions of the Treaty into account and with extensive citation of the literature also in many languages. Complex analysis is pithily expressed. The explanations are lucid and the criticisms cogent. The translation into English by a French lawyer working in New York and familiar with the subject matter is good and the book reads as if originally drafted in English.

Those practising before the courts or needing deep, perceptive analysis consult the work all the time with the help of the detailed table of contents and learn to find their way around it. The notes frequently specify the paragraph of a judgment that is relevant.

Unfortunately, the publishers decided to delay publication in English to enable the other language versions to sell. The result is that now we have an English version, the work is sadly out of date. The last court case listed was in July 1998 and the last Commission case in March of that year. The delay has destroyed much of the work's value to many practitioners. The experts will already be using one of the older versions and the new English one has little additional material.

Moreover, an erudite work by prestigious academics with huge experience in practice has been marred by inadequate editing. It is user-hostile because the busy authors had no time to edit. In many notes, where one would expect a citation, the only indication is "supra" without any indication of where. The tables list cases chronologically, not by name, and the index is quite inadequate. Busy practitioners

[1] Regulation 2790/1999, O.J. 1999, L336/21, [2000] 4 C.M.L.R. 398, [2000] E.C.L.R.

[2] C.S. Kerse, *E.C. Antitrust Procedure* (4th edition, Sweet and Maxwell, London, 1998); L. Ortiz Blanco, *E.C. Competition Procedure* (Oxford University Press, Oxford, 1996). Reviewed in 22 W.Comp. 4.

wanting snap answers will not use this book. Those needing more thoughtful analysis may use little else.

The second edition of Ritter, Braun and Rawlinson is also welcome. The text is more complex and detailed than that of Faull and Nipkay as is appropriate to a practitioners' guide,[3] but the reasons for the development of the law are less clearly explained than in the other two books reviewed here. In some sections, such as that on refusals to supply, the historical development of the topic is less clearly indicated.

I turned at once to the problems of mergers leading to collective dominance and was rewarded by a good and very thorough discussion of the judgment of the CFI in *Gencor* in the light of several decisions of the Commission and E.C.J. Checklists of structural and economic links with reference to decisions are included with economic reasons for their relevance.

A novel feature is that the book is being updated on the World Wide Web and, already, there is an analysis of the new group exemption for vertical distribution agreements.

The work is thorough with lists of cases to describe the various concepts and criteria analysed and is user-friendly, with paragraph numbers inserted in the notes after citations. Citations in the text are to OJ or ECR with the date and in the table of cases the CMLR and CCH series are included. The citations in the notes are more helpful than those in the tables in that appeals, etc. are listed. Careful editing has made a detailed work readable and user-friendly.

All three books will be widely used. They are complementary. It is easier to be up-to-date in 2000 despite the mass of case law and new initiatives from the Commission. This has been a rich year for new large works on EC competition law. A new edition of Bellamy and Child is expected early in the autumn.

Valentine Korah
University College London

Review of Loose Leaf Works

Continuing with the editorial policy of this journal to review categories of competition law books and to compare the titles in them, this issue of *World Competition* looks at the merits of some of the more reputed loose leaf works aimed at practitioners. All the loose leafs covered are reliable and regularly updated.

[3] If the appendices are ignored the work has much the same number of pages as Faull and Nikpay, but the print is smaller and there are far more notes.

Benoît Keane

Valentine Korah, General ed., *Competition Law of the European Community* (Matthew Bender), 2 volumes, loose leaf

This loose leaf work is undergoing a transformation under its new General Editor. The contributors no longer work for a single firm, but are senior experts from the European Commission, CFI or law offices, most of them in Brussels. Consequently, time is available for each contributors to devote care to their chapter or special sector. The policy is to distribute one release per year covering several areas of competition law. Those chapters will not usually be touched again for two or three years, when the whole contribution will be revised. The work is like a series of monographs, held together in loose leaf folders. Loose leaf works are seldom updated systematically, so there is not much loss of timeliness. With the release expected next November, most of the chapters will have been revised, save for procedure, which is expected in 2001, technology transfer (which has not altered much since last revised) and further special sectors. The primary and secondary legislation is appended. There is an elaborate table of cases with five items of information where available, a table of legislation and an index.

The latest release has three rather general chapters by the General Editor, a short chapter on international aspects by John Parisi who helped to set up and implement the collaboration between the Commission and the US agencies, a chapter on special sectors on financial services by Luc Gyselen who was head of the relevant unit in Competition Directorate-General (DG IV) at the time and a chapter on agriculture by Lambros Papadias, who had worked on the sector at the CFI.

The release for 2000 will include a short chapter on state aids by Paul Lasok QC, and more complete analyses of mergers by Nicholas Levy of Cleary Gottlieb, on joint ventures by Izzet Sinal of Morgan Lewis and Bockius, on cartels by Morton Kofmann of Bech-Bruun & Trolle, on distribution by a partner from Coudert, on more special sectors by Dirk Van Liedekerke of Oswang and and Lambros Papadias, now working for the Competition Directorate-General. A section on proceedure will be released in 2001 by Marc Van der Woude of Nauta Dutilh and more special sectors by the same contributors as this year.

P. Freeman and R. Whish (eds.), *Butterworths Competition Law*, (Butterworths) 5 volumes, loose leaf

Butterworths Competition Law is an accurate and perceptive guide that extensively covers EC and UK competition law. In 13 divisions, this publication addresses all facets of competition law with a detailed treatment of the substantive issues arising in areas such as horizontal agreements, distribution agreements, merger control, dominant firms and State aids. In addition, this publication also examines the regulatory regimes that affect specific sectors such as agriculture, transport, financial services, water, electricity and telecommunications. In each of these divisions, an invaluable collection of extracts of the relevant legislation is provided with in-depth commentary and analysis of the relevant EC and UK case law. This loose leaf is written by a team of leading competition law experts in a pragmatic style geared towards the practitioner, with a great deal of the text covering certain types of commercial agreements or practice. All in all, this loose leaf is an invaluable guide that would be of daily use to the practising competition lawyer.

M. Van Empel (ed.) *Competition Law in Western Europe and the USA* (Kluwer Law International, Deventer, 1997), 24 volumes, loose leaf

This strength of this loose leaf is that it contains the legislation relating to competition law in the EC and under the various national jurisdictions. In this respect this work provides substantial extracts of the relevant legislation with excellent critical commentaries throughout. This loose leaf also reprints many of the decisions by the European Court of Justice and the European Commission as well as the Commission's Annual Reports. Again, a very practical guide useful for practitioners in the field.

Ivo Van Bael and Jean Francois Bellis, *EC Competition Law Reporter* (CCH Europe), looseleaf

The *EC Competition Law Reporter* is one of the most reliable loose leaf works for practitioners seeking information and comment. The work provides a comprehensive and up-to-date analysis of EC competition law. This publication covers the legislation on EC competition law, decisions of the European Commission and European Court of Justice. This publication addresses the principles of EC Competition law and the manner and procedure in which these principles are applied to commercial agreements and practices. The loose leaf in this regard covers co-operation agreements, intellectual property rights, horizontal agreements, competition issues arising for dominant firms, mergers and acquisitions as well as State aids. The loose leaf is written in a practical style aimed at the practitioner. Insightful legal analysis and commentary is provided throughtout, making this edition an invaluable resource for practitioners.

All these loose leaf works have excellent reputations. Much is expected from the forthcoming work to be published by Bender in November 2000 especially given that its new team consists of highly respected competition practitioners and commentators. In this regard it should become a standard reference for practitioners. Van Bael and Bellis is perhaps is one of the most highly regarded loose leaf works on EC competition law currently used by practitioners and is particularly useful for the immense amount of case law that it cites and summarises. Its commentaries are practical and aimed at the practitioner. It is a fundamental part of any competition practitioner's library. The real value of Butterworth's loose leaf is that it covers a far greater range of topics than the other loose leafs and it is a valuable reference point for examination of EC and UK competition in specific sectors. There are, however, some questions over the timeliness of the updates of some sections. For UK lawyers it has the real advantage of devoting a lot of coverage to UK legislation.

Benoît Keane
Hammond Suddards