ANTITRUST and REGULATION in the EU and US

Legal and Economic Perspectives

Edited by
FRANÇOIS LÉVÊQUE and HOWARD SHELANSKI

NEW HORIZONS IN COMPETITION LAW AND ECONOMICS

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NEW HORIZONS IN COMPETITION LAW AND ECONOMICS

Series Editors: Steven D. Anderman, *Department of Law, University of Essex, UK* and Rudolph J.R. Peritz, *New York Law School, USA*

This series has been created to provide research based analysis and discussion of the appropriate role for economic thinking in the formulation of competition law and policy. The books in the series will move beyond studies of the traditional role of economics – that of helping to define markets and assess market power – to explore the extent to which economic thinking can play a role in the formulation of legal norms, such as abuse of a dominant position, restriction of competition and substantial impediments to or lessening of competition. This in many ways is the *new horizon* of competition law policy.

US antitrust policy, influenced in its formative years by the Chicago School, has already experienced an expansion of the role of economic thinking in its competition rules. Now the EU is committed to a greater role for economic thinking in its Block Exemption Regulations and Modernisation package as well as possibly in its reform of Article 82. Yet these developments still raise the issue of the *extent* to which economics should be adopted in defining the public interest in competition policy and what role economists should play in legal argument. The series will provide a forum for research perspectives that are critical of an unduly-expanded role for economics as well as those that support its greater use.

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Introduction: balancing antitrust and regulation

François Lévêque and Howard Shelanski

For most of the past century there has been a dichotomy across industrial sectors between those industries governed primarily by general competition policy – antitrust – and those governed primarily by sector-specific rules – regulation. In several sectors of the economy, notably telecommunications and energy but in some cases also including transportation, agriculture, and health care, regulation has been dominant, even if not always exclusive of general antitrust enforcement. The telecommunications sector in the United States is an example: AT&T's private monopoly was governed principally by a network of regulations imposed by individual state public utility commissions and by the Federal Communications Commission (FCC); but AT&T's monopoly was not immune from prosecution under the US antitrust laws for anticompetitive conduct. Indeed, it was antitrust prosecution that ultimately led to the break-up of AT&T in 1984. Over the past 20 years, several traditionally regulated economic sectors have been moving, to varying degrees, to competition. The past decade, for example, has seen substantial liberalization in both telecommunications and electricity generation. As this transition toward competition has progressed, the traditional balance of regulation versus antitrust comes into question. To what extent is sector-specific regulation still warranted as monopoly power erodes? Is antitrust law in a given jurisdiction up to the task of protecting consumers and promoting competition?

The chapters in this volume address various aspects of the evolving balance between antitrust and regulation in the European Union and the United States. They were originally presented at a conference jointly organized by CERNA and the Berkeley Center for Law and Technology entitled "Balancing Antitrust and Regulation in Network Industries: Evolving Approaches in Europe and the United States," held in January 2006 at the Ecole Nationale Superieure des Mines in Paris. The chapters span a range of related topics, some focusing on general observations about the relationship between antitrust and regulation in the respective jurisdictions and others tying those observations to particular industrial sectors.

In Chapter 1, Chief Judge Douglas H. Ginsburg of the United States Court of Appeals for the DC Circuit explains how in recent years new regulatory regimes have emerged in the United States designed to foster competition in industries previously dominated by government-sanctioned monopolies. Rather than generate the authentic competition associated with free markets, however, such regimes engender what Judge Ginsburg terms "synthetic competition." The overriding goal of the regulator promoting synthetic competition is not allocative efficiency or consumer welfare; rather, the aim is to ensure the continued success of multiple "competing" providers regardless of whether fewer firms, or even a monopoly, would be more efficient. Because the synthetic competition induced by regulators may bear little resemblance to competition in an unregulated market, Judge Ginsburg argues that, in reviewing the efforts of regulators to structure competition, a court should not demand the rigorous economic theory and evidence necessary to prove an antitrust case. Rather, the court should limit itself to policing the regulatory agency's adherence to prescribed procedures and insisting the agency provide a reasoned justification for its action.

In Chapter 2, John Temple Lang compares and contrasts competition law and regulatory regimes under European Union directives. He also considers some procedural and substantive aspects of the co-existence of national regulatory regimes with European competition policy and competition law rules. Mr Lang's chapter examines the consequences of Regulation 1/2003, the EC competition decentralization regulation, and concludes that while it has important benefits in terms of allowing the Commission to choose its enforcement priorities, the Commission could usefully provide more guidance on national compatibility with EC law and on regulation by member states of sectors not regulated by EC directives.

In Chapter 3, Professor Pierre Larouche follows the above discussions of the United States and European Union by bringing those respective jurisdictions into comparative focus. He argues that the free exchange of economic ideas across the Atlantic often leads to the mistaken idea that, because economic science is meant to be universal in its application, competition regimes should also be similar and in conformity with the prescriptions of economic theory. Professor Larouche observes that EC competition law and sector-specific regulation often tend to be dismissed by economists as inferior, outdated or even-irrational when they fail to conform to the outcomes that would be expected on the basis of economic science. His chapter aims to substantiate doubts about that conclusion by examining whether the universal applicability of economic science might not be limited by legitimate differences between EU and US competition laws and sector-specific regulations. To illustrate his proposition, Professor

Larouche examines three specific issues relating to competition law and telecommunications regulation: (1) the hierarchy in the application of competition law and sector-specific regulation, comparing the US Supreme Court decision in *Trinko* and the European Commission decision on the *Deutsche Telekom* price squeeze case; (2) the principle of technological neutrality and the place of competition law principles in sector-specific regulation, comparing the approach of the FCC under the Communications Act with that of the European Commission under the new electronic communications framework; and (3) the institutional architecture of competition law and regulation in a the EU's multi-level jurisdictional structure.

The focus on telecommunications continues in Chapter 4, in which Professor James B. Speta argues that because telecommunications markets are increasingly, even if imperfectly, competitive, once-dominant public utility regulation is on the way out while competition law and economics is on the way in. He examines the concern that, if freed from utility regulation, concentrated market structures might lead to fragmentation or to significantly higher prices for consumers. Professor Speta discusses whether competition law alone could stop either of these results and how pure antitrust principles and private litigation might be supplemented to improve the use of antitrust as the dominant regulatory mechanism in telecommunications. He studies this question through the lens of the Federal Trade Commission Act, legislation that was expressly designed to supplement antitrust and which outlaws "unfair methods of competition" and "unfair and deceptive trade practices." The chapter examines the FTC's performance under these two standards, and attempts to clarify those standards. To bring the project around to telecommunications in particular, the chapter considers how the "unfair competition" standard might substitute for regulation in addressing the difficult problem of concentrated market structures in telecommunications.

In Chapter 5, Professor Philip J. Weiser argues that the challenge for competition policy in regulated sectors is to design a system where antitrust authorities play the central role in analyzing a merger's competitive effects and regulators play the central role in imposing and enforcing regulatory remedies. He contends that over the last decade, the FCC has vacillated in its approach to merger review. In the worst of cases, Professor Weiser contends, the agency "places harm on one side of the scale and then collects and places any hodgepodge of conditions – no matter how ill-suited to remedying the identified infirmities – on the other side of the scale." In the best of cases, he finds the FCC imposes conditions that address competition policy concerns raised by the merger and enables the antitrust agencies to clear a merger that would otherwise pose potential objections. At present, the US system too often veers towards a "worst case" scenario where federal antitrust authorities – the FTC and DOJ – impose regulatory remedies that overlap with regulatory policy and regulatory agencies perform duplicative merger reviews and impose remedies unrelated to the mergers themselves. In short, there is compelling need for institutional reform. This chapter explains the practice of the FCC in reviewing mergers involved regulated firms, discusses the practice of the DOJ, FTC, and European Union in reviewing mergers of telecommunications companies, and outlines some directions for reforming the US system of merger review and merger remedies in the telecommunications arena.

Continuing with the theme of mergers but departing from telecommunications, Chapter 6 is a study by Professors Richard Gilbert and David Newbery of the distinct challenges that electricity mergers pose for competition policy. They explain why a merger of electricity suppliers can affect prices in a very large number of relevant antitrust markets corresponding to different points in time and different geographic regions. As the authors discuss, following the approach to antitrust market definition in the DOJ/FTC Horizontal Merger Guidelines, a separate relevant product market exists if a hypothetical monopolist that is the sole supplier of the product would profitably increase its price above the pre-merger level. A region is a separate relevant geographic market if a hypothetical monopolist that is the sole supplier of the product in the region would profitably increase its price above the pre-merger level. Demand for electricity is highly inelastic and electricity is not easily stored, hence separate antitrust product markets can exist even at very close points in time. Furthermore, separate geographic markets can exist at points that are not distant from each other if transmission constraints limit the ability of a consumer to substitute electricity from a different location. For these reasons Professors Gilbert and Newbery explain, the analysis of mergers of electricity suppliers is often a daunting exercise. The authors discuss some of the approaches that may be used to evaluate the risk of price increases from electricity mergers and some shortcuts to simplify the analysis which might improve the effectiveness of antitrust enforcement in this critical industry.

In Chapter 7, Professor Tommaso Valletti takes the topics of market definition and market power explored in the previous chapter and discusses them in the context of the mobile telephony market. He examines how the market for mobile telephone service may have the characteristics of a "two-sided" market, and explains why those characteristics pose special challenges for defining markets and determining market power in the mobile communications market. Professor Valletti concludes that the preliminary step of market definition in the antitrust analysis of this market should not obscure or substitute for a more detailed analysis of the actual competitive effects of conduct by mobile telephone providers. His chapter provides important guidance for how antitrust authorities or regulators should conduct that competitive analysis given the particular economic characteristics of mobile telecommunications.

Taken together, the chapters that comprise this volume provide both a general overview of relevant practices regarding the balance of antitrust and regulation in the United States and the European Union and more specific practices related to the competitive analysis and governance of the telecommunications and electricity sectors. Our goal has not been to be comprehensive, but to assemble a collection of important contributions that will advance the wider debate over how to govern industries in transition from regulated monopoly to competition. It is our hope that the assembled chapters succeed both in furthering the state of discussion and in expanding the debate in a more comparative direction.

Contents

1. Synthetic competition

Douglas H. Ginsburg

In the 1960s academic lawyers and economists began focusing upon economic regulation, that is, regulation by an administrative agency typically limiting market entry, fixing prices, and setting other terms of competition. These scholars asked what turned out to be an embarrassing question for regulators and regulated firms alike: Where did economic regulation come from in the first place? In time, the answer to this question and the insight gleaned from it would lead to the deregulation of some industries and the advent of a regulation-driven form of competition, which I call "synthetic competition", in others. The latter development – a hybrid of New Deal-style economic regulation and orthodox antitrust or competition policy – has challenged many, particularly judges, to reconsider the standards by which agency regulations should be reviewed.

I. NEW DEAL REGULATION

The crucial intellectual event in the creation of the modern regulatory state in the United States was the New Deal experiment with corporatism. Prior to the New Deal, commerce was "regulated" solely on economic grounds almost exclusively through antitrust law, starting with the Sherman Act of 1890[1] and the Federal Trade Commission Act of 1914.[2] Enforced by the Department of Justice and the Federal Trade Commission respectively, these statutes prohibit firms from entering into contracts, combinations, or conspiracies in restraint of trade, and from engaging in anticompetitive behavior and unfair methods of competition;[3] they are not tailored to any specific industry or industries. The New Deal, with its emphasis upon regulation rather than competition and its industry-specific focus, was a radical break from orthodox antitrust policy.

The New Deal reached its zenith with the National Industrial Recovery Act (NIRA).[4] The idea of the NIRA was to organize every industry so as to cooperate with government and labor in hope of arresting the then rampant deflation.[5] That is, competition would be limited and prices increased in order to enhance producer surplus, which could then be used first to raise wages, thereby increasing purchasing power and demand, and then to finance the plant expansion necessary to meet that demand. In 1935, however, the Supreme Court held this scheme unconstitutional in *A.L.A. Schecter Poultry Corp. v. United States*.[6]

Although the NIRA failed constitutionally, the industry-specific regimes that accompanied it were upheld after the 1937 "switch in time that saved nine",[7] when the Supreme Court began upholding New Deal programs in order to stave off President Roosevelt's infamous court-packing plan. As a result, statutes that might previously have been held unconstitutional were upheld or went unchallenged, including the Agricultural Adjustment Act,[8] the Public Utility Holding Company Act,[9] the Tennessee Valley Authority Act,[10] the Securities Exchange Act,[11] the Glass-Steagall Banking Act,[12] the Civil Aeronautics Act,[13] and the Federal Communications Act,[14] to name but a few. In fact, very substantial portions of the economy – agriculture, finance, transportation, energy, and communications – were subjected to pervasive regulation meant to displace competition by prohibiting or limiting the entry of new firms,[15] regulating prices,[16] and subsidizing certain consumers at the expense of others,[17] all the while co-existing uncontroversially with relatively free markets – e.g., in mining, manufacturing, distribution, and services – in an economy where competition rather than regulation was still presumed to be the norm.

This tolerance for 1930s-style economic regulation persisted into the post-War era, prolonged no doubt by the prosperity of the period. Renewed attention to regulatory economics began only in the late 1960s, as antitrust scholars, both lawyers such as Richard Posner and economists such as George Stigler, schooled to believe that competition is the best "regulator" of markets, entered the field.[18] And competition of course maximizes consumer welfare, not producer surplus.

These scholars observed that many regulated markets were in fact structurally competitive.[19] That is, the regulated markets comprised a large enough number of firms that there was little reason to fear monopoly pricing. In short, there was no obvious economic rationale for their regulation.[20] Such populous but nonetheless regulated industries included: agriculture; airlines; motor carriers; railroads, which although few, faced competition from motor carriers, which were numerous; deposit accounts at financial institutions; stock brokerage; hydroelectric power projects; and, after the technological revolution of microwave and satellite communications, telephone and telecommunications services as well.

Another observation that antitrust scholars made with respect to these regulatory regimes was that private firms are rarely able to sustain cartels or otherwise to collude without the aid of government.[21] In fact, it seemed most plausible to explain economic regulation of structurally competitive industries as merely a device by which government supported industry cartels that otherwise could not survive and would, in any event, violate the antitrust laws. Indeed, historical research revealed that in many instances, industry-specific economic regulatory regimes had been imposed by government at the request of the industry in question![22]

The final irony was that the regulated industries did not typically earn monopoly profits under regulation. Instead, regulated firms were either bankrupted by inept regulators, as were the railroads;[23]or they lived a quiet life, as did the AT&T telephone monopoly; or, most commonly, they found loopholes through which to vent their competitive instincts.[24] So it was that in the 1950s and 60s the airlines featured lavish meals, free drinks, first-run movies, and glamorous stewardesses.[25] By the late 1970s, the regulation of the interest rates that banks could pay to depositors led them instead to attract deposits by giving away everything from toasters to refrigerators.[26]

The New Deal's establishment of industry-specific regulatory regimes presented the federal courts with a dilemma. Courts bore the responsibility of ensuring regulatory agencies complied with applicable laws,[27] yet the courts lacked sufficient industry expertise to determine whether, in a given instance, the agency had adopted a policy or rendered a decision congruent with the aims of the relevant statute(s).[28] In 1946 the Congress enacted the Administrative Procedure Act (APA), the legal framework within which most federal administrative agencies must propose and promulgate regulations.[29] Although agency rulemakings are subject to judicial review under the APA, the courts have a very narrow role to play; they are limited to reviewing agency regulations in order to determine whether they are arbitrary and capricious.[30] In practice, this means the courts will defer to an 1agency's "permissible" interpretation of a statute,[31] and will otherwise approve an agency's course of action unless it is "unreasonable".[32]

II. DEREGULATION

The academic revisionist view of New Deal economic regulation as something that, far from being vaguely protective of the consuming public, was in fact a front for politically powerful industries to shield themselves from competition was distinctly bipartisan in flavor and enormously influential. Thus, statutory reforms encouraged by the Ford Administration became major legislative successes in the Carter Administration, during which airlines and railroads were substantially deregulated.[33]

But the larger story was not in statutory reform, which is politically difficult to obtain, but rather in the administration of existing statutes. For example, the Securities and Exchange Commission deregulated brokerage commissions in 1975.[34] The Interstate Commerce Commission effectively deregulated entry and price for motor carriers.[35] The Comptroller of the Currency even began to allow virtually free entry into banking.[36] The Federal Communications Commission (FCC) allowed intercity telephone competition well before the Antitrust Division of the Department of Justice sought the break up of AT&T.[37] The FCC also deregulated customer premise equipment;[38] threw out its own 1972 regulation of cable television, which had stifled that technological threat to broadcasters;[39] and relaxed regulation of broadcasting itself, especially regarding so-called "public trustee" functions.[40]

The deregulated markets became increasingly competitive, as predicted by the academic proponents of deregulation and as feared by incumbent managements and labor unions. Real prices declined and innovation increased in air travel, trucking, stock brokerage, and other markets – perhaps most dramatically, in telephone customer premise equipment.[41]

As the tide of deregulation swept away many of the economic regulatory regimes established during the New Deal, orthodox competition policy also underwent a significant change. Before the late 1970s the federal courts had not agreed upon any single objective behind the antitrust laws.[42] While some courts had focused upon economic considerations, others had been applying the antitrust laws to further socio-political aims, such as minimizing the "helplessness of the individual"[43] and ensuring the "organization of industry in small units".[44] Even the Supreme Court once made the fate of "small dealers and worthy men"[45] relevant to its interpretation of the Sherman Act. The varied goals endorsed by the Supreme Court were so divisive and contradictory that the famed Judge Learned Hand concluded the Congress had "delegated to the courts the duty of fixing the standard in each case".[46]

The Supreme Court's decision in *Continental T. V., Inc. v. GTE Sylvania, Inc.*,[47] largely ended the confusion. There the Supreme Court made the maximization of consumer welfare, or allocative efficiency,[48] the chief consideration when applying the antitrust laws.[49]

Because *GTE Sylvania* could be viewed only "as a ringing endorsement of the economic approach to antitrust law",[50] courts have since relied heavily upon economic analysis to determine the effect of a practice or proposed transaction on allocative efficiency in the relevant market.[51] With the advent of deregulation, orthodox competition policy, with its focus upon consumer welfare, was applied to industries newly freed from the shackles of New Deal economic regulation.

III. "SYNTHETIC COMPETITION"

Of course, not all sectoral regulation was repealed or even relaxed particularly in network industries such as electric power and local telephony. In those industries the deregulatory revolution took the form of scaling back the regulated functions to the perceived practical minimum, that is, to encompass only functions that, with current technology, are thought still to be so-called "natural monopolies", in which competition would entail duplication of facilities and hence wasteful investment.[52] The result has been what I am calling "synthetic competition",[53] that is, a market subject to a regulatory regime designed to assure there are multiple sellers regardless whether fewer firms, perhaps only one, would be more efficient.[54]

Electric power is one industry in which regulators have attempted to manufacture "competition".[55] Similar to a local telephone monopoly, a single company typically owns all the wires running into consumers' homes and businesses in a defined geographic area.[56] Unable efficiently to replicate these and other critical elements of the incumbent utility's network, potential competitors in the past have been unable to enter wholesale or retail electric markets.

In the 1990s the Federal Energy Regulatory Commission sought to generate competition in the wholesale markets for power by mandating that incumbents lease or otherwise make available to other utilities certain of their physical assets.[57] Retail electric markets, subject to state regulation, have also been re-regulated so as to induce synthetic competition. By 2000 at least 12 states had established regulatory regimes that "included the unbundling of the retail supply of generation services from the supply of distribution and transmission service [thereby] giving retail customers . . . the opportunity to choose their power supplier from among competing retail suppliers".[58] The central aim of both the federal and state initiatives has not been "deregulation" but the entry of additional providers into local markets to "compete" with the incumbent utility.[59]

Similarly, in telephony, the newly competitive long distance business was separated from local service, which remained monopolistic. With the Telecommunications Act of 1996 (Telecom Act) the Congress acted to introduce competition into local service as well. The Act directs the FCC to require the incumbent monopolists to provide equal access to would-be competitors so they may, for a fee, use the incumbent's local distribution network, or such elements of that network as they want to lease rather than build their own facilities.[60]

Regardless of whether these efforts to introduce "competition" are deemed successful – and the interested parties disagree fervently on this – or whether it is still too soon to know,[61] the new competition-inducing