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This essay discusses the role of a consumer harm test in competition policy. First we consider whether consumer surplus is a better standard than total welfare. Second we consider the relationship between competition and consumer harm. Finally we offer concluding remarks.

Consumer Surplus Versus Total Welfare

Most competition authorities pursue a consumer standard – they seek to deliver an improvement in consumer surplus (i.e. the difference between what consumers are *willing to pay* and what they *actually pay*, aggregated across all consumers who purchase the good in question). Under this standard, if improving consumer surplus reduces profits, those lost profits are not taken into account.

What do economists think about this? Microeconomic textbooks would imply that we should focus on total welfare, i.e. the sum of consumer surplus *and* profits. The standard argument here is that shareholders are ultimately consumers and so there is no reason to prefer consumer surplus to profits.

An interesting response to this argument is that pursuing a consumer standard may actually be better for *total welfare*.[1] The basic idea is that where firms have a choice of *many* profitable

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[1] This draws on the insight of Bruce R. Lyons, *Could Politicians be More Right than Economists? A Theory of Merger Standards*, (May 15, 2002) (working paper for Centre for Competition & Regulation) *available at* http://www.ccp.uea.ac.uk/publicfiles/workingpapers/ccr02-1revised.pdf (arguing that a consumer surplus standard in mergers might be a better way to achieve improvements in total welfare).

strategies, a consumer standard may constrain firms to choose the strategies that are better for total welfare. To see why, consider the following intuition.

Under a consumer standard, firms pursue profitable strategies up to the point where consumers are not harmed. If overall profits rise, while consumer surplus does not fall, total welfare must *increase*.[2]

Under a total welfare standard, firms can go past this point – they may find that the most profitable *permissible* strategies are those that harm consumers a lot (i.e. the very high profits just offset the loss to consumers). In this case, overall total welfare may hardly increase at all.

So, paradoxical as it may sound, the consumer standard may deliver higher *total welfare* than the total welfare standard. In theory, therefore, it is not clear that we should prefer one standard over the other on *a priori* grounds. This means that the practical application of each standard is an important consideration. A consumer standard is easier to administer than a total welfare standard. That is to say, while measuring *whether* consumers have been harmed is by no means easy, measuring consumer harm *accurately* and then trading off gains in profits is even harder. So, on balance, the consumer standard is probably better.

Competition, Consumer Harm, and Their Implications For Each Other

Our next question is: assuming that the consumer standard is the right one to pursue, how does this relate to the pursuit of greater competition? To shed some light on the answer, consider the following propositions:

- Competition is generally good for consumers.
- Restrictions in competition may benefit consumers.
- Just because consumers are harmed by the behavior of one or more firms, does not mean that there is a lack of competition.

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[2] Total profits will not necessarily rise. One firm's pursuit of higher profits may lead to another firm's loss of profits.

Competition and Consumer Welfare

The first proposition is, at face value, intuitive. If firms are striving to win customers from their rivals, this benefits consumers because winning sales from rivals requires offering lower prices or better products. This intuition carries over (more or less) to the analysis of unilateral effects. If two firms cease to compete as a result of a merger, and if that lost competition is material, it is reasonable to presume that consumers are harmed from the merger (absent very large efficiency gains). Further, among economists and policy makers there seems to be (nearly) a consensus as regards the appropriate empirical and theoretical analyses of: (a) closeness of competition; (b) barriers to entry and expansion; and (c) strategic responses by buyers. Therefore, competition authorities are well placed to protect *consumers* by focusing on the question of whether the merger substantially lessens *competition*.[3]

However, the same cannot be said for the analysis of exclusionary effects. A particularly difficult area is exclusionary pricing. Competition policy seeks to protect competition and thereby, *inter alia*, to deliver lower prices to consumers. However, sometimes lower prices lead to harmful exclusionary outcomes where, for example, they deliver a very good deal to (a certain group of) consumers in the short term as a means to substantially reducing competition in the long term.

Recent years have seen the search for the holy grail of exclusionary behavior, i.e. the answer to the question of how to tell pro-competitive from anti-competitive low prices.[4] The easy route out is to say the latter lead to consumer harm, while the former lead to consumer benefits. But at best, that just defers the question to another stage: how do we identify consumer harm? And at worst, it

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[3] In theory, the same is true of mergers that give rise to coordinated effects but in practice it seems easier to rule out the risk of coordinated effects than to demonstrate their likely existence. With non-horizontal mergers the presumption should normally be that the merger is pro-competitive since the merger does not bring together two firms that were competing with each other prior to the merger. However, where one or both firms merging have market power, it is feasible that the merger would give rise to exclusionary effects which lead to consumer harm. Exclusionary behaviour is discussed below.

[4] *See e.g.*, European Commission, DG Competition Discussion Paper On The Application of Article 82 of the Treaty to Exclusionary Abuses (Brussels 2005) *available at* http://ec.europa.eu/comm/competition/antitrust/art82/discpaper 2005.pdf; and the many responses to it.

is unhelpful because it could lead practitioners to claim that exclusionary behavior can be inferred from harm to consumers.[5]

To infer exclusionary behavior from harm to consumers is not the answer. First, often this simply assumes away the problem. For example, if the issue is whether consumers will be harmed *in the future* from a low price set today, we cannot observe harm to consumers and so the "test" has no power. Second, as we discuss below, harm to consumers need not be caused by competition problems and so is not sufficient to invoke intervention under competition law.

A more satisfactory answer is (a) to set out a clear and coherent theory of harm to *competition and consumers*; and (b) to adduce evidence which supports that theory to a high standard of proof (notably by demonstrating that the theory of harm is both likely and far more likely than alternative pro-competitive explanations). Of course, this still does not tell us *how* to distinguish between harmful and beneficial low prices, but at least it gives us a little more guidance when developing frameworks for the assessment of exclusionary behavior (in particular screening approaches which rule out foreclosure at an early stage).[6]

Dimensions of Competition

Turning to the fact that there are different dimensions of competition, consider, for example, a case where a vertical agreement restricts price competition in favor of non-price competition. In this scenario, a "consumer harm" perspective is helpful in the sense that we need to ask: (a) which dimension do consumers value most (price or non-price factors) and (b) is the gain in non-price factors sufficient to offset the higher prices? That is to say, the consumer harm approach helps us (in principle) to trade-off opposing effects on competition.

However, in practice, this is not always an easy task – especially when one of the dimensions of competition is innovation. It is well known, for example, that sometimes we need restricted

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[5] For a related debate regarding whether dominance should be inferred from evidence of consumer harm, *see* Adrian Majumdar, *Whither Dominance?*, 27(4) EUR. COMPETITION L. REV., 161, (2006).

[6] *See Fidelity Rebates and Selective Price Cuts, A Report for the Office of Fair Trading by RBB Economics*, July 2005 *available at* http://www.oft.gov.uk/shared_oft/reports/comp_policy/oft804.pdf (establishing both initial screens to rule out foreclosure as well as a framework for addressing the more complex cases where foreclosure cannot be ruled out at an early stage).

price competition to deliver greater competition in innovation. If a firm is considering substantial R&D expenditure, it wants a reasonable expectation before making the investment that it will recover its costs. One way is to provide patent or copyright protection – by allowing a successful innovator to enjoy "monopoly" profits (protected by intellectual property rights), this should provide a strong incentive to develop new ideas in the first place. However, where innovators build on each other's innovations, scope for exclusionary behavior arises because the refusal to release intellectual property may delay or even prevent the rival from developing a new product.

What does the recent CFI judgment on Microsoft say about this trade-off?[7] In clarifying the European case law on refusal to supply information, the CFI appears to lower the threshold for intervention. The released information can be used by a competitor to develop a *differentiated* product rather than a genuinely *new product*. Arguably, therefore, if a complainant demonstrated that access to information was *indispensable* to producing a differentiated imitation of an innovator's product, and if that imitation would *compete effectively* with the innovator's product, then intervention might be permitted. However, if imitation is too easy, this can harm incentives to innovate, particularly if the license fee is set too low. Regulating such fees is difficult and the judgment would appear to offer little clear guidance on this aspect.

Does the consumer harm principle help us here? Yes and no! "Yes" in the high-level sense that it should be flexible enough deal with the problem that intervention to make consumers better today might reduce their welfare (via lower innovation) tomorrow. And "No" in the sense that this trade off is very difficult to assess and the consumer harm principle is too high-level to shed any additional light on the practical realities of making the correct assessment.

Consumer Protection and Competition Policy

There are disadvantages of having a pure "consumer harm" test if that would mean that competition authorities could intervene whenever they observed (or thought they observed) firms engaging in a practice that harms consumers. That would take their remit *beyond* competition policy.

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[7] Case T-201/04, Microsoft Corp. v. Comm'n, 2007 WL 2693858 (Sept. 17 2007).

This is because a bad outcome for consumers does not necessarily reflect a failing of competition. For example, suppose that competition means that a product containing a harmful drug is sold more cheaply than it would have been under monopoly provision thereby leading to greater consumption of the drug. Absent consumers being more informed about the drug (or regulation which restricts the use of that drug), the monopoly may better for consumers because the higher price means they consume less of the harmful drug. So if some form of intervention were merited, the appropriate legislation to use would *not* be competition law.

The preceding point may sound obvious but the distinction between competition policy and consumer protection can become blurred in other scenarios. Consider the following argument: *Where uninformed consumers pay higher prices (because of information problems), they suffer the same harm (i.e. higher prices) as if they were served by a monopolist. Therefore competition authorities have a role to improve consumer information. Indeed, improving information may facilitate greater competition, since consumers make better choices.*

At face value this does not sound unreasonable (although the growing literature on bounded rationality indicates that making some consumers more informed does not always benefit consumer surplus[8]). However, while intervention may be merited to improve consumer awareness – should it proceed under competition law?

For example, the UK Competition Commission is currently investigating payment protection insurance (PPI).[9] One potential concern is that there is a monopoly at the *point of sale* of PPI. That is to say, having sold the consumer a financial product (e.g. a credit card), the seller immediately has the chance to make a follow on sale of an insurance product. In that sense, the consumer is captive. But is that really a monopoly? If it is, then have you been monopolized when the sommelier in a top restaurant recommends that you choose a certain wine to accompany your meal and (feeling slightly pressurized) you agree to take the bottle without asking how much it costs?

In short, even if there is a good reason to intervene, it is unhelpful to pretend that monopolies exist when they do not so as to

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[8] Luke Garrod, *Price Transparency and Consumer Naivety in a Competitive Market* (working paper for Centre for Competition & Regulation) (2007) *to be available at* http://www.ccp.uea.ac.uk/default.asp?id=workingpapers2007.

[9] *See* UK Competition Commission, *at* http://www.competition-commission.org.uk/inquiries/ref2007/ppi/index.htm.

find a remit for intervention, especially if that would set a precedent by which firms are found dominant just because they make follow on sales or sell products that are difficult for consumers fully to comprehend.

Concluding Remarks

We have argued that competition authorities should adopt a consumer surplus as opposed to a total welfare standard. Further, in pursuing that standard, sometimes it will be appropriate to infer consumer harm from restrictions of competition (e.g. as with mergers that give rise to unilateral effects). However, in most other cases, the authorities must consider harm to *competition and consumers* together. This applies in particular for exclusionary behavior, where usually we cannot infer harm to consumers from harm to competition (either because the latter is hard to identify independently of the former or because harm to one dimension of competition benefits rivalry on another). Finally, not all practices that harm consumers harm competition – in these cases authorities should use different legislation to intervene and resist the temptation to reverse engineer a restriction of competition to justify intervention under competition law.