FTC-DOJ Hearings
Section 2 of the Sherman Act and single-firm dominant behavior

Eduardo Pérez Motta

Introduction and some definitions

Unilateral conduct is generally defined in terms of predatory or exclusionary conduct. In Mexico, these concepts are contained within the definition of relative monopolistic practices, which group predatory or exclusionary conducts with vertical restraints and even exclusionary group boycotts. Relative practices are distinguished from absolute practices in that they are subject to a rule of reason analysis, whereas the latter are illegal *per se*. The analysis of these practices, set out in the law and discussed in more detail here, includes a number of elements that Mexico's competition agency considers when determining whether evidence uncovered during an investigation would lead to a probable violation of the law.

1. The Constitutional framework for unilateral conduct in Mexico

Competition legislation stems from article 28 in the Constitution, which opens with a general prohibition of "*monopolies, monopolistic practices, government monopolies … in the terms and conditions dictated by laws*" and provides broad and general guidance about the acts or conducts that are prohibited in the United Mexican States:

(1) "*all <u>concentration or hoarding</u> in one or a few hands of basic commodities with the object of raising prices*",

(2) "*all <u>agreements</u>, process or combinations undertaken among producers, industrialists, tradesmen or service entrepreneurs, aimed at preventing free market access or competition among themselves and forcing consumers to pay exaggerated prices*", and

(3) "*whatever constitutes an <u>undue exclusive advantage</u> in favor of one or more persons and against the public in general or some social class*".

Unilateral conduct, then, is contained within the last general prohibition, and broadly speaking, it describes exclusionary or predatory practices as opposed to collusive practices, which are contain in the second prohibition listed here.

1.1. The general prohibition

Although the opening paragraph in Article 28 of the Constitution typifies all monopolies as illegal, a clarifying statement notes that this should be analyzed "*in the terms and conditions dictated by laws*". In fact, further reading of the same constitutional article qualifies this prohibition:

"[*T*]*he functions exercised exclusively by the State in the following strategic areas shall not constitute monopolies: postal service, telegraphy and radiotelegraphy; petroleum and other hydrocarbons, basic petrochemicals, radioactive minerals and nuclear energy generation; electricity and those activities expressly mentioned in the laws signed by Congress. Satellite communications and railways are priority areas for national development … through the granting of concessions or permits, the State will maintain or* *establish the ownership of communication networks in accordance with the laws…The functions exercised by the state in an exclusive manner, through the central bank in the strategic areas of coin minting and the printing of bills shall not constitute monopolies.*"

Also exempted are "[*w*]*orkers' associations, created to protect their own interests and cooperative production associations or societies whose aim is to defend their interests or the general interest, who sell directly to foreign markets national or industrial products that represent the main source of wealth in a region or that are not basic commodities, as long as the federal government or the states oversees or protects them, and have prior authorization from the respective legislatures.*" In addition, the Constitutional article notes that "[*t*]*he privileges granted for a period of time to authors and artists for the production of their* <u>*art*</u> *and those granted to inventors and* <u>*improvers*</u> *for the exclusive use of their inventions, are also not considered monopolies.*"

Underlying the text are the constituencies that are the object of the constitutional protection: consumers in general; population whose livelihood stems from the consumption of basic or essential commodities; organized labor that is officially recognized by federal or state governments; and inventors and artists who contribute to innovation and culture and are thus granted a monopoly for a predetermined period of time. Included as exemptions from the constitutional prohibition are overarching national interests, as reflected in the list of strategic sectors.

2. The Federal Law of Economic Competition (LFCE or law)

The competition law repeats and clarifies the general prohibition in article 28 of the Constitution. Its object is to protect the process of competition by eliminating monopolies, monopolistic practices *and other restrictions to the efficient functioning of markets* (article 2). All economic agents are subject to the law (article 3), although the State's functions in strategic sectors are not considered monopolies (article 4), nor are workers' associations and export cooperatives, or the privileges granted by the State to authors, artists, inventors and improvers (articles 5 and 6). The law does clarify, however, that conduct outside the areas specifically defined under constitutional article 28, are subject to the LFCE.

The law in Mexico distinguishes between business law, or private law, and competition law, which is a purely administrative legal process. Both investigative and adjudicative powers are concentrated in one single federal government agency in charge of competition law enforcement, the Federal Competition Commission (CFC or Commission), and there is no direct private right of action. The role of the Judicial System is confined to that of an appeals body.

The CFC can bring suit against any economic agent through two procedures. First, through a complaint brought by any person, in the case of absolute monopolistic practices, or parties with an interest, in the case of relative monopolistic practices (Article 32), in which case the Commission would open an investigative procedure on behalf of the economic agent. The second procedure is by investigating ex officio.

2.1. Relative monopolistic practices

The two articles in the LFCE that describe illegal conduct have been roughly characterized as horizontal (absolute monopolistic practices) and vertical (relative monopolistic practices). However, a more detailed analysis reveals that absolute monopolistic practices only include hard core cartel conduct,[1] which has no legal effects and constitutes a *per se* violation of the LFCE. In the case of relative monopolistic practices, these not only include price and nonprice vertical restraints, but also discrimination in price and sales conditions, exclusionary group boycotts and unilateral conduct.

The CFC's mandate is to protect economic competition: to promote and prevent harm to this process, not the parties involved in this process. In the case of relative monopolistic practices, it is the Commission's task to determine whether displacing or excluding an economic agent simply constitutes harm to an individual competitor, supplier or client or whether competition itself has been harmed, in which case it must act against the economic agent undertaking the illegal conduct.[2]

The analytical process that leads to a determination of illegality in relative practices does not begin with the effect of the conduct, but rather with its typification, that is, the Commission must determine whether the practice aligns with the categories set out under article 10 of the law: (I) nonprice vertical restraints, (II) vertical price restraints, (III) tied sales, (IV) exclusive dealings, (V) refusals to deal, (VI) exclusionary group boycotts, (VII) predation, (VIII) loyalty and fidelity discounts and rebates, (IX) cross subsidization, (X) discrimination in price and sales conditions, (XI) raising rivals' costs.

The analysis then proceeds to the motivation (object) or outcome (effect) of this conduct on the process of competition. This step, together with the rule of reason analysis described below, is meant to minimize false positives as these types of conducts can easily arise as part of a healthy competitive process. Hence, article 10 notes that the conducts must (a) unduly exclude economic agents from the market, (b) substantially impede their access, or (c) establish exclusive advantages in favor of one or more persons – an echo of the constitutional text.

2.1.1. Rule of reason analysis

Article 11 in the law requires that economic agents who undertake conducts typified in article 10 must wield substantial market power within a relevant market. This relevant market is defined following the guidelines set out in article 12 of the law and article 9 in the rulings.[3] Among the elements considered are: (1) the substitution possibilities, both on the demand and supply side, as well as the time required for this substitution; (2) the distribution costs of the good itself and its inputs, complements and substitutes, and the time required for this substitution; (3) consumers' opportunity costs in accessing other markets; (4) legal restrictions and barriers that limit access to intermediate and final consumers.

The CFC distinguishes between market power and substantial market power, with the distinction being a matter of degree. Article 13 establishes elements that the Commission will consider in making a determination of substantial market power, among them:

- An agent's market share and its ability to unilaterally set prices or restrict quantity. Depending on data availability, the Commission frequently uses the monetary value of

[1] The definition for hard core cartel conduct is taken from the International Competition Network. 2005. *Defining Hard Core Cartel Conduct, Effective Institutions, Effective Penalties: Building Blocks for Effective Anti-Cartel Regimes*, vol.1. Report prepared by the ICN Working Group on Cartels. ICN 4th Annual Conference. Bonn, Germany.

[2] For a more detailed economic analysis of competition law, refer to González de Cossío, Francisco. 2005. *Competencia Económica: Aspectos Jurídicos y Económicos*. México: Porrúa.

[3] New rulings to the law are currently being drafted.

sales for this calculation. Market share thresholds, have only been defined with respect to merger analysis and are not used for relative monopolistic practices.

- The existence of barriers to entry and any elements that may foreseeably alter those barriers. Among these barriers entry are: capital requirements, that is, “financial costs or the costs of developing alternative channels”; whether financial markets are efficient, that is, if conditions of “limited access to financing” exists; adjustment costs, “[the] term for recouping the required investment”, and whether costs are effectively sunk, “[the] return for alternative uses of infrastructure and equipment”; fixed costs such as advertising and investments in brands or trademarks as barriers to entry; marketing and business practices, such as exclusive arrangements; normative barriers, including regulation and regulators’ actions, the use of intellectual and industrial property as barriers to entry, and regulation relating to international trade as a special case of barriers to entry.
- The existence of competitors and their relative market power.
- Possibilities of access to inputs by the agent and its competitors.
- The agent’s recent behavior.
- Other criteria set out in the rulings, including: the positioning of the agent’s goods and services, lack of access or high costs of imports, high cost differentials faced by consumers in purchasing the goods or services from other firms, and industry concentration.[4]

<u>2.1.2. Efficiency considerations</u>

Finally, the CFC weighs potential efficiency considerations against the negative effects that the conduct may generate (*rule of reason*). There are obvious difficulties in designing rules for situations where conduct has both beneficial and exclusionary effects, but it is the role of the Commission to give structure to reach a decision that ensures positive net benefits to society, both consumers and producers.

With the reforms to the law, the general guidelines to use efficiencies as a potential defense are:

(1) That the conduct positively influence the process of competition and free market access

(2) That benefits to consumers outweigh anticompetitive effects arising from these practices

In addition, the law now offers examples of potential efficiencies that shall be considered by the CFC: the introduction of new products; the use of production leftovers, or byproducts; reductions in costs that arise from applying new techniques and methods of production; merging of assets; increases in the scale of production and the production of different goods or services with the same factors of production; the introduction of new technological advances that result in new or improved goods or services; improvements in quality, investments and their returns, timeliness and service, whose incidence over the distribution process is favorable; that these do not result in a significant price increase, or a

[4] The CFC issued the methodology for calculating concentration indices and the criteria for their implementation in 1998. It comprises two indices, namely the renowned Herfindahl index and the Dominance index. The latter index takes into account an agent’s ability to displace competitors based on both its absolute size and relative size, as compared to other competitors. High market concentration is not a sufficient condition to conclude that an agent possesses SMP.

significant reduction in the consumer's options, or a similar reduction in the degree of innovation in the relevant market.

2.2 Regulated sectors and declarations on substantial market power

Regulated sectors (mostly former state-owned monopolies) have very much influenced the development of abuse of dominance rules. The reformed article 4 of the LFCE clarifies that conducts by state-monopolies which lie outside the scope of their legal privilege, are subject to the law and can be illegal. They can be characterized as absolute monopolistic practices (article 9) or relative monopolistic practices (article 10, in conjunction with 11, 12 and 13). Additionally, for newly liberalized sectors, Article 24 was amended to establish that the Commission has powers to determine whether effective competition conditions exist, or substantial market power is wielded, and that this determination is to be used for regulation pursuant to other laws and regulations (paragraph V).

Most sectoral regulation requires that the CFC determine the absence of "effective competition conditions" before regulators can impose price, access or other regulation on market participants.[5] In practice, the concept of effective competition has a broader meaning than substantial market power; a determination of effective competition can also occur within a concentrated industry, not necessarily dominated by one agent alone, and can result from structural or behavioral characteristics in the market.

3. Selected case examples[6]

3.1. Alleged relative monopolistic practices by Wal Mart, Mexico (Walmex)

In May 2002, the CFC initiated an ex-officio investigation into large self-service chain stores. The relevant market was defined as the acquisition, distribution, and marketing of goods by self-service stores with a national geographic dimension. One of the principal motivations was a concern that some multiproduct self-service retailers were forcing their suppliers to charge higher resale prices to competing stores under threat of termination. As part of the investigation, the CFC also looked at potentially unlawful behavior, such as discrimination in the terms offered by the stores to upstream suppliers, or unilateral conduct that could arise from increased reliance on a store's private brand.

The investigation was closed in early 2003 without a discovery of violation, notwithstanding the fact that the Commission determined that Walmex possessed substantial market power in the relevant market. Specifically, the CFC found no evidence to sustain the claim that Walmex had terminated suppliers because they had sold goods at a lower price to its competitors. In spite of this finding, Walmex agreed to issue an internal communication informing its purchasing agents that price negotiations with suppliers should focus exclusively on prices charged to Walmex without any reference to prices charged to competitors.

3.1.1. The CFC's analysis

The relevant market was defined as the acquisition, distribution, and marketing of goods by self-service stores, following the definition and elements set out under article 13 of the

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[5] In telecommunications, the sectoral legislation requires that the CFC find an economic agent with substantial market power to impose additional regulations on that specific agent.

[6] The case examples are based on Mexico's recent contribution to Working Party 3 of the OECD's Competition Committee. 2006. *Roundtable discussion on techniques and evidentiary issues in proving dominance/monopoly power -- Mexico*. DAF/COMP/WP3/WD(2006)28.

LFCE, the Commission's analysis considered as one of the key factors Walmex's high market share and its ability to set prices or restrict supply in the relevant market. The data on the value of sales consistently showed that Walmex was the leader of multiproduct self-service retailers with a market share of 35.9%, more than twice that of each of its main competitors' market share. This leadership was reinforced by a global trend that showed a growing importance and use of self-service chain stores.

The CFC also found that for 8 of its 16 main product suppliers, Walmex was their most important distribution channel, representing at least 40% of their sales. In contrast, none of Walmex's suppliers represented more than 10% of Walmex's sales. It was evident from these facts that an asymmetry existed between Walmex and its individual supplier, and this asymmetry coupled with the "one-stop shopping" phenomenon, an intrinsic characteristic of self-service retailers, gave Walmex the capacity to unilaterally set prices or restrict supply.

Among the entry barriers identified were the existence of economies of scope in the distribution and marketing of goods, advertising expenses, and brand recognition. In evaluating the existence of competitors, the Commission took into account Walmex's size relative to its closest competitors and determined that other agents would be unable to offset its ability to undertake monopolistic practices. In assessing access to input sources the Commission considered testimony by its main competitors stating that Walmex had used its power to get exclusive products and special conditions. All these factors led to a determination that Walmex was an agent with substantial power in the relevant market.

In its defense, however, Walmex argued that it had developed important efficiencies and economies of scope due to improvements in its distribution system. These efficiencies were transferred to its customers as low prices, and to its suppliers as shorter payment periods. The CFC also noted that Walmex had exhibited accelerated growth following its 2000 strategy of "low prices everyday", and that this growth had continued amid a slowdown in private spending.

3.2. Determination of Telmex's market power in 5 relevant markets

Telecommunications was the first infrastructure sector to be liberalized in Mexico, a process which preceded the LFCE and the involvement of the Commission in its design. The concession title granted the privatized telephony firm, Teléfonos de México, SA de CV (Telmex), a six-year exclusivity or monopoly period for long distance telephony in order to maximize government revenues, rebalance tariffs and increase network deployment. Moreover, the exclusivity period granted to Telmex gave it a first-mover advantage in telephony, thus increasing barriers to new entrants who were unable to gain critical mass in order to recover their investments. These measures have resulted in Mexico consistently being ranked among the most expensive OECD countries with the lowest penetration rates in telephony markets.

In 1997, the Commission determined that Telmex possessed substantial market power in five telephony markets. A brief description of these markets follows, together with some of the key elements analyzed to reach this determination.

3.2.1. Local service

In this market, Telmex's market share was almost 100%, being the sole holder of a concession to operate a Public Switched Telecommunications Network (PSTN) that provided local telephony in Mexico. It had the capacity to unilaterally set prices because it significantly increased local service fees in 1997 in order to eliminate cross-subsidies, and was the only provider of dedicated lines. Investments required to establish a local public network was the main barrier to entry, although large advertising outlays required to establish a trademark were also considered another important barrier. Even though there were no explicit regulatory barriers, the lack of a specific regulatory framework for these services significantly discouraged entry into the market, and a concession title was needed in order to provide local services. In addition, the availability of spectrum to provide local wireless services was also considered normative barriers. Finally, there were no competitors offering local services.

3.2.2 Access to local networks

IN this market, Telmex's market share was almost 100%, being the sole provider of both switched and leased services. In addition, there was evidence that Telmex charged unauthorized tariffs for switched interconnection services, openly disregarding the regulated tariff, and in 1996, it increased fees for certain leased lines not subject to regulation by more than 900%. The Commission therefore determined that it had the capacity to unilaterally set prices. Telmex also had the capacity to restrict supply by delaying the provision of leased lines to its competitors. In terms of barriers to entry, an almost insurmountable barrier consisted in huge monetary outlays required to duplicate Telmex's local wire network, which provides access to final users (i.e. local loop). The CFC also determined that normative barriers existed as concessions were required to provide access services and to use the spectrum for microwave links.

3.2.3. National long distance

Telmex's market share was over 70% in this market and comprised 60 cities that had opened to competition. Herfindahl and Dominance indices showed a high degree of market concentration. As an indication of its capacity to set prices over relevant inputs, the CFC used Telmex's announcement to increase the fee for leased lines by 900%. Barriers to entry included very high economic and financial cost of building a network, the time required to build it and to generate marketable products (a sunk cost); and advertising expenses for new entrants. Telmex's competitors were deemed to have a very low market share and no market power, since they relied on Telmex for interconnection to local networks. In addition, Telmex's vertical integration allowed it to control access to an essential facility, the local loop, for the provision of long distance services.

3.2.4. Inter-urban transport

In this market, Telmex had a market share of 83%, measured in terms of installed capacity. Telmex's vertical integration conferred it a significant advantage because it was the only agent able to sell a package of services that included both inter-urban transport and interconnection. It also gave it incentives to use its market power to harm competitors in downstream markets that were open to competition by charging, for example, the same price in retail and wholesale markets. A key barrier to entry were the high economic and financial costs of building an optic fiber network, as well as the time required for building this network. Nevertheless, the Commission considered that this barrier was likely surmountable over the medium term, as long distance operators would be able to install microwave lines and expand their wire networks with expected technological developments. Although several providers were identified in the market for inter-urban transport, this fact was considered insufficient to dilute the incumbent's substantial market power.

3.2.5. International long distance

This market was open to competition shortly after the investigation began so that information on international traffic volumes was not available. The CFC therefore estimated Telmex's market share based on the number of registered subscribers (74%) and in terms of its capacity to offer international port services (85% but expected to fall to 65%). The incumbent was found to have the capacity to set prices because tariff rules appointed Telmex as the operator in charge of negotiating liquidation tariffs in international agreements, thus granting it privileged information with respect to other domestic operators. Telmex also had the ability to restrict the capacity of other providers to offer the service by delaying the provision of leased lines.

In its assessment of barriers to entry the CFC considered that, to provide this service, concession holders required local and international interconnection services and a network (owned or leased) that was connected with the local loop. Regulatory barriers restricted entry to international ports, since only long distance service providers could request authorization to operate international ports; requiring, among other things, that long distance concession holders prove that they had connected cities located in at least three states using their own infrastructure; and that they had undertaken at least one interconnection agreement with a foreign operator, authorized by the regulator. The ten operators who were able to serve any route had low market shares and depended on Telmex to provide interconnection and to determine liquidation tariffs. Finally, access to inputs were restricted as a consequence of Telmex's vertical integration since it was able to control the supply and price of cross-border leased lines and to provide integrated packages including local and long distance services.

Through different legal means, Telmex has been successful in delaying the enforcement of the CFC's declaration of substantial market power that would trigger specific regulations to control its dominant position in these five relevant markets. In August 2004, the CFC issued a new resolution satisfying a Circuit Court's rulings, but it has been challenged before the judiciary and a final resolution is still pending. In all subsequent decisions, the CFC has been able to support its initial conclusions without Telmex being able to reverse them in the Courts.