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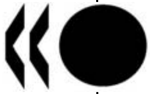

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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
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Global Forum on Competition

CRISIS CARTELS

Contribution from the European Union

-- Session III --

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CRISIS CARTELS

-- European Union --

1. Introduction

1. The Commission considers cartels as hardcore infringement of competition law and is very active in taking enforcement actions against them. In 2010 the Commission adopted seven cartel decisions[1] imposing fines totalling over EUR 3 billion on 70 undertakings. As the fight against cartels continues to be one of its main priorities, the Commission focused on making the process more efficient through the application of the settlement procedure, which was applied in 2010 for the first time in two cases. Moreover, against the background of difficult economic conditions, a number of mainly small and medium-sized enterprises were granted a fine reduction in application of point 35 of the Fines Guidelines[2] (Inability To Pay or ITP).

2. In the context of the current economic downturn, a number of undertakings in various industries across Europe are seeking to justify agreements restricting competition by invoking overcapacity problems or economic crises in their respective sectors.[3] The schemes falling under the notion of "industrial restructuring agreements" (sometimes referred to as "crisis cartels") usually involve scenarios where a significant number of industry players get together to find a joint solution to their common difficulties in times of crisis. This may be achieved by, for example, reducing overcapacity and/or by agreeing on a "fair" price level to avoid that some companies would go bankrupt and leave the market.

3. The Commission therefore considers that there is a need to ensure a coherent application of the EU competition rules in Europe with respect to such industrial restructuring agreements. For this reason, on 30 March 2010 the Commission submitted written observations, under Article 15, paragraph 3, of Regulation No 1/2003[4], in an Irish case concerning an industrial restructuring agreement in the meat processing industry in Ireland.

4. This paper reflects the substance of the legal submission lodged by the Commission in the context of the *Irish beef* proceedings in Ireland. The paper describes the approach for reviewing industrial restructuring agreements under Article 101 TFEU, keeping in mind that the conclusion to be drawn will depend on the specific circumstances of each case.

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1 Cases COMP/38511DRAMs, COMP/39092 Bathroom fittings & fixtures, COMP/38344 Pre-stressing steel, COMP/38866 Animal Feed Phosphates, COMP/36212 Carbonless paper (re-adoption for Bolloré), COMP/39258 Airfreight and COMP/39309 LCD.

2 Guidelines on the method of setting fines imposed pursuant to Article 23(2)(a) of Regulation No 1/2003 (OJ C 210, 1.09.2006, p. 2-5).

3 The Commission has itself been dealing with such cases and is aware of similar cases being addressed by national competition authorities.

4 Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty (OJ L 1, 04.01.2003, p.1-25) sets out the enforcement regime for Antitrust in Europe.

2. The economic problem: Structural (and not cyclical) overcapacity

5. The term "crisis cartels" is misleading as it may create expectations that competition authorities might envisage to allow cartels in order to protect industry from an economic crisis in general. However, the discussion of industrial restructuring agreements should not be related to the current, or any other, cyclical economic crisis and the recession induced fall in demand. In a properly functioning market economy it should normally be price that influences the changing relationship between supply and demand, and when demand falls it is likely that price would follow as well. If the consequence of a recession is that some undertakings go bankrupt, it would normally be those least adapted to the crisis for a number of reasons. Hence, it can be generally assumed that competition would correct the problem of overcapacity available in the market and, over time, it would bring the market back to equilibrium. Therefore, until this adjustment takes place prices must not be artificially maintained at a high level by means of a cartel. In line with this fundamental economic law of supply and demand, the case law of the Court of Justice of the European Union ("ECJ") generally concludes that a cyclical overcapacity in principle can not justify the formation of cartels.[5]

6. Irrespective of the existence of a general crisis, however, more long lasting overcapacity problems could exist in industries in decline due to, for example, technological changes in the market, or in industries where firms have been substantially overinvesting for a prolonged period of time. For instance, such difficulties could arise in industries that have been granted state aids for a long time, or where state control prevented the closure of plants because of overriding social or other political factors, such as unemployment. The relevant question to ask in such situations is whether market forces alone would be able to solve the problem or whether some kind of intervention by the affected undertakings in the market concerned is necessary.

7. There may indeed be market situations where the problem of overcapacity may not be remedied by market forces alone, which would imply that overcapacity is of a structural nature. In the past, the Commission explained in its Annual Report on competition policy for 1982 that "*structural overcapacity exists where over a prolonged period all the undertakings concerned have been experiencing a significant reduction in their rates of capacity utilisation and a drop in output accompanied by substantial operating losses and where the information available does not indicate that any lasting improvement can be expected in this situation in the medium-term*"[6].

8. There are economic reasons explaining why in situations of overcapacity the problems cannot always be remedied by the free interplay of market forces and the mechanisms of competition alone. This can be best explained by the notion of "*war of attrition*". This refers to a situation where the object of firms is to induce the rivals to give up and, consequently, they would wait and suffer economic losses for a while until their rivals would effectively exit the market. In such a context, firms try to avoid closing plants and giving up market shares as thereby they would increase their costs. This situation is especially likely to occur in industries characterised by increasing returns to scale and/or high fixed or sunk costs (and thereby high costs of exit and entry).

9. The undertakings involved in a "war of attrition" expect that sooner or later some firms will leave the market and, therefore, they may not want to close their unused capacity as they would hope to be able to utilise it for production in the future. The persistence of such a situation can be illustrated with the

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5 See Case T-16/99 Lögstör Rör v Commission [2002] ECR II-1633, paragraphs 319-320; Joined Cases T-236/01, T-239/01, T-244/01 à T-246/01, T-251/01 et T-252/01 Tokai Carbon e.a./Commission [2004] ECR II-1181, paragraph 345; and Case T-30/05 William Prym GmbH & Co. KG and Prym Consumer GmbH & Co. KG v Commission [2007] ECR II-107, paragraphs 207-208.

6 See Twelfth Report on Competition Policy, point 38.

theory of a public good, where more production and corresponding investment in capacity than would be socially optimal takes place because of a *"free riding"* problem. In such situations, even though unilateral or coordinated reduction of overcapacity would be beneficial for everyone in the industry, firms would prefer not to make the first move of reducing their own capacity. Instead, it is possible that they would prefer to wait for other competitors to reduce capacity in order to benefit from the overall fall in capacity in the sector concerned, without incurring the costs of reducing it themselves.

10. However, this situation, which in game theory is referred to as a "*prisoner's dilemma*", is generally considered to be sustained in very specific circumstances, such as stable, transparent and symmetric market structures. This is because if it is expected that one firm will suffer more than its competitors from the persistence of overcapacity problems, its incentives to reduce capacity would be higher and it would be more likely to reduce capacity first. Moreover, where there is no symmetry in size and competitiveness, the weaker firms could foresee that they will have to exit first (as soon as they empty their pockets) and therefore it is unlikely that they remain in the wasteful "war". Thereby, in heterogeneous market structures with firms of different sizes and cost structures the problem of overcapacity would normally not persist.[7]

11. The waste of economic resources caused by the "*war of attrition*" may significantly impair the industry's competitiveness which could ultimately result in consumer harm. In this very rare type of situation, and assuming all conditions of Article 101(3) are met (see below) such industrial restructuring agreement could possibly be exempted.

3. Framework for assessment of industrial restructuring agreements under Article 101 TFEU

3.1 Restriction of competition by object (Article 101(1) TFEU)

12. As is evident from the recent case law of the ECJ in *Irish Beef*[8], industrial restructuring agreements will in principle constitute a restriction of competition by object within the meaning of Article 101(1) TFEU. Restrictions of competition *by object* are those that by their very nature have the potential of restricting competition.[9] It is not necessary to examine the actual or potential effects of an agreement on the market once its anti-competitive object has been established.[10]

13. The *Irish Beef* case concerned a joint scheme by the ten principal Irish beef processors by which they intended to reduce the total capacity of the industry by 25% within one year. These ten producers represented about 90% of the Irish beef market in terms of sales. The aim of the scheme was to reduce the number of players on the market whereby those companies staying on the market would compensate those leaving the market.

14. The proposed scheme had been devised by McKinsey, a management consultancy. The Irish competition authority, however, objected to it and brought the case before the Irish courts, which, in turn,

[7] Note that a limited degree of uncertainty in the industry could compensate for a limited amount of asymmetry in this context.

[8] Case C-209/07, Competition Authority v Beef Industry Development Society Ltd and Barry Brothers (Carrigmore) Meats Ltd (hereinafter "BIDS"), [2008] ECR I-8637.

[9] See, for example, Case C-209/07, BIDS, [2008] ECR I-8637, paragraph 17.

[10] See, e.g., Joined Cases C-506 P et al, GlaxoSmithKline, [2009] ECR I – 09291, paragraph 55; Case C-209/07, BIDS, [2008] ECR I-8637, paragraph 16; Case C-8/08, T-Mobile Netherlands, [2009] ECR I-4529, paragraph 29 et seq.

referred it to the ECJ by way of an application for a preliminary ruling on the application of Article 101(1) TFEU (then: Article 81(1) EC).

15. The ECJ held that the proposed agreement to reduce capacity constituted a restriction of competition by object within the meaning of Article 101(1) TFEU. In reaching this conclusion, the ECJ relied on several factors:

- The ECJ stressed that it is irrelevant that the parties to an agreement acted without any subjective intention of restricting competition, but with the object of remedying the effects of a crisis in their sector. An agreement may be regarded as having a restrictive object even if it does not have the restriction of competition as its sole aim but also pursues other legitimate objectives.

- The proposed agreement had as its object to encourage some of the beef processors to leave the market and therefore hindered the independence of these companies' conduct on the market.

- The proposed agreement obstructed other means to combat the crisis without resorting to industry-wide coordination such as (i) intensified competition between the processors; or (ii) mergers between individual processors.

- Moreover, the ECJ found that the agreement would ultimately also be likely to induce certain processors to freeze their production (i.e., their output).

16. Last, the proposed agreement dissuaded new entry of competitors in Ireland as the plants which would be decommissioned pursuant to the agreement could not be made available to new entrants.

3.2 Assessment under Article 101(3) TFEU

17. Article 101(3) provides for an exception from the prohibition of Article 101(1). According to the case-law of the EU Courts, any agreement which restricts competition, whether by its object or its effects, may in principle satisfy Article 101(3) TFEU.[11] However, the more severe the restriction of competition the less likely it is that an exemption will be available.[12]

18. The application of Article 101(3) is subject to the following four cumulative conditions:

- The agreement must contribute to improving the production or distribution of goods or contribute to promoting technical or economic progress;

- Consumers must receive a fair share of the resulting benefits;

- The restrictions must be indispensable to the attainment of these objectives; and

- The agreement must not afford the parties the possibility of eliminating competition in respect of a substantial part of the products in question.

19. According to Article 2 of Regulation No 1/2003, the party claiming the benefit of Article 101(3) TFEU shall bear the burden of proving that the above four conditions are likely to be fulfilled. It is for the national court to determine whether those conditions are satisfied.

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[11] Joined Cases 56/64 and 58/64 Consten and Grundig v Commission [1966] ECR 299, pp. 342, 343 and 347, and Case T-17/93 Matra Hachette v Commission [1994] ECR II-595, paragraph 85.

[12] Commission guidelines on the application of Article 81(3) of the Treaty, OJ C101, 27.4.2004, paragraph 46.

20. When these four conditions are fulfilled the restrictive effects on competition generated by the agreement can be considered to be offset by its pro-competitive effects, thereby compensating consumers for the adverse effects of the restrictions of competition.

21. The following sections of this paper will discuss these conditions in the context of capacity-reducing restructuring agreements by drawing on both the jurisprudence of the ECJ and the principles underlying the Guidelines. This paper will not address the condition relating to the elimination of competition.[13]

3.2.1 The first condition – the agreement must contribute to improving the production or distribution of goods or contribute to promoting technical or economic progress

22. This condition requires an assessment of the pro-competitive benefits, i.e., efficiency gains, which result from the agreement at issue.[14] As stated by the ECJ in its *GlaxoSmithKline* judgment of 6 October 2009, the agreement should lead to "*appreciable objective advantages of such a kind as to compensate for the resulting disadvantages for competition*".[15] The ECJ added that:

> *"As the Advocate General observed in point 193 of her Opinion, an exemption granted for a specified period may require a prospective analysis regarding the occurrence of the advantages associated with the agreement, and it is therefore sufficient for the Commission, on the basis of the arguments and evidence in its possession, to arrive at the conviction that the occurrence of the appreciable objective advantage is sufficiently likely in order to presume that the agreement entails such an advantage".*[16]

23. In order to assess whether the pro-competitive benefits flowing from an agreement being examined under Article 101(3) TFEU outweigh its anti-competitive effects, it is necessary to verify the following:

- The nature of the claimed pro-competitive benefits;
- The link between the agreement and the pro-competitive benefits;
- The likelihood and magnitude of each claimed pro-competitive benefit; and
- How and when each claimed pro-competitive benefit would be achieved.[17]

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13 Reference is made to the Guidelines for a comprehensive examination of each of the conditions.

14 Commission guidelines on the application of Article 81(3) of the Treaty, OJ C101, 27.4.2004, paragraph 50.

15 Joined Cases C-501/06 P et al, GlaxoSmithKline, paragraph 92.

16 Joined Cases C-501/06 P et al, GlaxoSmithKline, paragraph 93. In paragraph 193 of her opinion of 30 June 2009, Advocate General Trstenjak stated as follows: "an exemption, which under Regulation No 17 is granted ex ante for a specified period, may require a prospective analysis regarding the occurrence of the advantages associated with the agreement, and thus contains a prognostic element. A prognosis can ultimately never be made with 100% certainty. It is therefore sufficient for a finding of an appreciable objective advantage for the Commission, on the basis of the arguments and evidence submitted, to arrive at the conviction that the occurrence of the appreciable objective advantage is sufficiently likely in the light of actual experience […] The question of what degree of probability must exist for it to be considered that there is an appreciable objective advantage does, admittedly, arise in principle in this context. In my opinion, a high degree of probability must be set here. That is because, with infringements of Article 81(1) EC [now: Article 101(1) TFEU], the existence of losses in efficiency in the form of a restriction of competition must already be postulated."

17 Commission guidelines on the application of Article 81(3) of the Treaty, OJ C101, 27.4.2004, paragraph 51.

24. This paper will focus on the nature of the pro-competitive benefits which may result from a capacity-reducing agreement. It would appear that any possible pro-competitive benefits in the meaning of the first condition of Article 101(3), which would result from such a capacity-reducing agreement, would generally fall into one of two categories.

25. First, an agreement reducing capacity may achieve pro-competitive benefits by removing inefficient capacity from the industry. However, any such pro-competitive benefits would need to be properly substantiated by the party seeking the benefit of Article 101(3) TFEU. In particular, that party should be able to establish that the agreement in question ensures that inefficient capacity will exit the market.

26. As noted above, the precedents in this area are limited. However, in a series of decisions taken before the adoption of the Guidelines, the Commission exempted agreements under Article 101(3) TFEU where those agreements achieved efficiency gains by removing inefficient capacity from the market.[18] More recently, in its 2002 decision to initiate a state aid procedure concerning the rationalisation of pig slaughterhouses, the Commission expressed doubt about applying Article 101(3) TFEU where, *inter alia*, it could not be shown that "*the slaughterhouses which will be closed are (in all cases) the least efficient*".[19]

27. If the restructuring agreement at issue does not ensure that inefficient plants are decommissioned, then any plant, including efficient plants, may exit the market. A situation where efficient plants, rather than inefficient plants, exit the market would fly in the face of the normal competitive process.[20] Not only would this fail to achieve economic benefits, but it would in fact have to be seen as a further competitive disadvantage.

28. In order to permit an assessment of whether efficient or inefficient capacity will exit the market, the restructuring agreement should provide sufficient indication of what capacity will be removed. Depending on the circumstances, this may be done by actually specifying which firms are to reduce capacity or which firms are to leave the market altogether. Even if the restructuring agreement does not specifically identify exiting capacity or firms, it should set out the criteria under which an assessment can be made as to what capacity is to exit the market.

29. Second, where a restructuring agreement cuts capacity by facilitating the complete exit of certain players from the market, those undertakings which remain on the market may be able to increase output in

[18] Commission decision of 4 July 1984 in Case IV/30.810 Synthetic Fibres (OJ 1984, L 207/17), paragraph 39 ("The Agreement also ensures that the shake-out of capacity will eliminate the non-viable and obsolete plant that could only have survived at the expense of the profitable plant through external subsidies or loss financing within a group, and will leave the competitive plants and businesses in operation"); Commission decision of 29 April 1994 in Case IV/34.456 Stichting Baksteen (Dutch Bricks) (OJ 1994, L 131/15), paragraph 26 ("As the capacity closures concern production units that are the least suitable and least efficient because of obsolescence, limited size or outdated technology, production will in future be concentrated in more modern plants which will then be able to operate at higher capacity and productivity levels") and paragraph 29. See also Commission decision of 21 December 1994 in Case IV/34.252 – Philips/Osram (OJ 1994, L 378, p. 37), paragraphs 25-26.

[19] See OJ C 37, 9.2.2002, p. 19.

[20] Indeed, it may in fact be that efficient undertakings, rather than inefficient undertakings, exit the market in question.

order to win market share previously held by the exiting players. In this scenario, there may be economic benefits through an increased capacity utilisation rate by the remaining players.[21]

30. This kind of pro-competitive benefit is premised on increases in output by the undertakings remaining on the market. If the restructuring agreement contains limitations on output increases, then serious questions arise as to whether these kinds of pro-competitive benefits can be obtained. The effect of any output limitation needs to be examined on a case-by-case basis and would appear to depend on the precise nature of the output limitations, including their temporal scope.

31. In the hypothetical situation where there is no output limitation, it is important to note the type of cost benefits which may arise from greater capacity utilisation in the present context.[22] The most frequent kind of cost benefits arising from increased capacity utilisation would relate only to fixed costs (i.e. those costs which do not vary with the amount of goods produced). Specifically, the undertakings remaining on the market may be able to increase their output and thereby spread their (unchanged) fixed costs over a larger amount of output. This will lead to a reduction in total unit costs, nevertheless this would normally not decrease firms' variable costs and hence is unlikely to benefit consumers (see third condition).

32. It cannot be excluded that variable cost reductions could also result from a capacity reducing agreement. Variable costs are costs which vary with output. Where variable costs decrease with output, increasing output could cause a downward shift along the variable cost curve (i.e. in this case it could be said that the efficiency of production increases with output). This might occur in cases where higher levels of production enable the utilisation of more efficient production technology. It may be that these kinds of pro-competitive benefits can be gained in industries that lend themselves to learning economies – as experience is gained in using a particular production process or in performing particular tasks, productivity may increase because the process is made to run more efficiently or because the task is performed more quickly.[23]

33. While it can not be excluded that industrial restructuring agreements reduce variable costs, it would appear that they are less likely to reduce variable costs than fixed costs because such agreements generally aim at closing of production plants (that is of fixed costs). These types of cost savings are unlikely to benefit consumers. Overall, therefore, the nature of the potential cost benefits needs to be assessed on a case-by-case basis.

3.2.2 The third condition – restrictions must be indispensable to the attainment of these objectives[24]

34. As noted in the Guidelines, this condition triggers a two-pronged test. First, the restrictive agreement as such must be reasonably necessary in order to achieve the pro-competitive benefits. Second, the individual restrictions of competition that flow from the agreement must also be reasonably necessary for the attainment of those pro-competitive benefits.[25] This paper will comment only on the first of these

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21 Guidelines, paragraph 68 ("Efficiencies in the form of cost reductions can also follow from agreements that allow for better planning of production, reducing the need to hold expensive inventory and allowing for better capacity utilisation").

22 This is of particular relevance in the assessment of whether consumers obtain a fair share of the benefits (see later).

23 Commission guidelines on the application of Article 81(3) of the Treaty, OJ C101, 27.4.2004, paragraph 66.

24 Using the approach adopted by the Guidelines, this Note will deal with the third condition (indispensability) before addressing the second condition (pass-on to consumers).

25 Commission guidelines on the application of Article 81(3) of the Treaty, OJ C101, 27.4.2004, paragraph 73.

conditions in the context of restructuring agreements designed to reduce capacity. The second condition requires a case by case analysis and it is therefore not possible to deal with it here.

35. When assessing whether the restrictive agreement as such is reasonably necessary, it needs to be examined whether there are "*no other economically practicable and less restrictive means of achieving the efficiencies*".[26]

36. It needs to be emphasised that the indispensability being considered under this heading is not indispensability to the existence of the agreement itself, but indispensability for the achievement of the benefits identified under the first condition of Article 101(3) TFEU.[27]

37. One important question in the context of restructuring agreements is whether market forces could have solved within a reasonable period of time the problem of over-capacity without the collective intervention of individual undertakings being necessary.

38. So-called "*crisis cartels*" which aim to reduce industry overcapacity cannot be justified by economic downturns and recession-induced falls in demand. As noted above, a general rule in a well-functioning free market economy is that market forces alone should remove unnecessary capacity from a market. Price should influence the changing relationship between supply and demand. Indeed, when demand falls, it is expected that price should follow as well. In such circumstances, it is for each undertaking to decide for itself whether, and at which point in time, its overcapacity becomes economically unsustainable and to take the necessary steps to reduce it.[28] Indeed, as stated by the ECJ, "*the concept inherent in the Treaty provisions on competition… [is that] each trader must determine independently the policy which he intends to adopt on the common market...*".[29] Hence, it can be expected that competition would itself correct overcapacity problems and would bring within a reasonable period of time the market back to equilibrium, without any need for coordination between the undertakings on the market.

39. Competition in periods of crises may force the least efficient undertakings to exit a market. This is part and parcel of the competitive process. Indeed, the General Court has accepted that "*it is impossible to distinguish between normal competition and ruinous competition. Potentially, any competition is ruinous for the least efficient undertakings*".[30]

40. However, there may be situations where problems of overcapacity are not likely to be remedied by market forces alone within a reasonable period of time which would imply that the overcapacity is of a structural nature (as opposed to the result of a cyclical downturn). As already explained in paragraph 7 of this paper, structural overcapacity exists where over a prolonged period all the undertakings concerned have been experiencing a significant reduction in their rates of capacity utilisation and a drop in output accompanied by substantial operating losses and where the information available does not indicate that any

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26 Commission guidelines on the application of Article 81(3) of the Treaty, OJ C101, 27.4.2004, paragraph 75.

27 Commission decision of 24 July 2002, Visa International – Multilateral Interchange Fee (OJ 2002, L 318, p. 17), paragraph 98 ("it should be emphasised that the indispensability being considered under this heading is not indispensability to the existence of the Visa system, but indispensability for the achievement of the benefits identified under the first condition of Article 81(3)").

28 Alternatively, in the case of a cyclical downturn, the undertakings on the market may decide to maintain capacity in anticipation of increasing output in the expected upturn.

29 Case C-7/95 P John Deere Ltd v Commission [1998] ECR I-3111, paragraph 86. See also Joined Cases C-506 P et al, GlaxoSmithKline, paragraph 34.

30 See Case T-29/92 Vereniging van Samenwerkende Prijsregelende Organisaties in de Bouwnijverheid (SPO) [1995] ECR II-289, paragraph 294.

lasting improvement can be expected in this situation in the medium-term. To have a structural overcapacity problem, it may not be necessary in all circumstances for the firms to have incurred substantial operating losses. However, it would seem atypical in cases of structural over-capacity that firms would make sustained profits.

41. Economic theory can help to illustrate why the problem of structural overcapacity cannot always be remedied within a reasonable time period by the free interplay of market forces and the mechanisms of competition. As already explained in paragraphs 8 to 10, this could be explained by a kind of "*war of attrition*" analysis in the context of game theory, where the aim is to induce the rival(s) to exit the market and where, in order to achieve this aim, firms are willing to suffer economic losses for some time. Specifically, in certain circumstances, firms will not want to reduce or close down unutilised capacity because they anticipate that, sooner or later, other firms will leave the market, thus presenting an opportunity to increase production and gain market share. In such situations, even though reducing overcapacity would be beneficial for everyone in the industry, firms prefer not to make the first move of reducing their own capacity. Instead, they would prefer to wait for another player on the market to reduce capacity in order to benefit from the overall fall in capacity in the industry, without incurring the costs of reducing it themselves. In essence, this is a type of "*prisoner's dilemma*" in game theory.

42. It would appear that situations where structural over-capacity cannot be remedied by market forces alone within a reasonable period of time are most likely where:

> *Giving up capacity is costly for the firms. This can occur in increasing returns industries where firms have large fixed or sunk costs and/or marginal costs which decrease with output.*[31] *For these firms, surrendering capacity is costly because it means a lost opportunity to gain market share and thereby reduce costs of production.*
>
> *Stable, transparent and symmetric market structures. Firms are unlikely to participate in a costly "war of attrition" unless they anticipate that they have a good chance of winning. Therefore, the war will tend to take place between firms of similar sizes and cost structures and in relatively stable and transparent environments, where their interests (and perceptions thereof) are sufficiently aligned to maintain capacity at an excess level.*[32] *On the contrary, in heterogeneous market structures some firms would normally suffer more than others from over-capacity and would have a higher incentive to reduce capacity and would be more likely to move first and reduce or close down capacity.*

43. In looking at the first limb of the indispensability condition, it would also need to be assessed whether there is a credible possibility that excess capacity could not be reduced by way of mergers or specialisation agreements. These would generally also constitute a structural consolidation of the industry but would normally cover a smaller share of the market than a full scale restructuring agreement, and hence could constitute a less restrictive remedy. Moreover, it can be assumed that mergers and acquisitions as well as specialisation agreements could in most cases solve the problem of *structural* overcapacity in an industry. This is because the "*war of attrition*" would end as soon as firms form "coalitions" as thereby the necessary condition of the firms' symmetry would no longer be fulfilled.

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[31] See, for example, in the decision to open State aid proceedings with respect to the rationalisation of pig slaughterhouses (OJ C 37, 9.2.2002, p. 19), it is stated that: "It has not been shown that the production process is characterised by high fixed costs, which was one of the reasons to accept that the market was not capable of bringing about the capacity reduction in the decision 'Stichting Baksteen".

[32] Similar factors are relevant to the assessment of potential coordination in the merger context. See the Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings (OJ C 31, 5.2.2004, p.5) at paragraphs 48 and 49.

44. In fact, if an industrial restructuring agreement is not concluded with the aim to remedy a persistent overcapacity problem, normally the most likely scenario in the market is that any failing firms would be purchased by their competitors or other interested investors. A process of mergers and acquisitions is likely to gradually eliminate inefficient plants and therefore reduce overcapacity in the market, nevertheless generally involving a structural consolidation of a smaller share of the market than in case of an industrial restructuring agreement.

45. In fact, merger control explicitly provides for an appropriate tool to facilitate the consolidation of industries facing structural problems such as overcapacity, namely the *failing firm defence*. It can be applied in situations *"where the competitive structure of the market would deteriorate to at least the same extent in the absence of the merger."*[33]

46. The burden of proof for the failing firm defence is on the parties and, in order to be successful, the failing firm defence would need to fulfil the following three criteria: "*First, the allegedly failing firm would in the near future be forced out of the market because of financial difficulties if not taken over by another undertaking. Second, there is no less anti-competitive alternative purchase than the notified merger. Third, in the absence of a merger, the assets of the failing firm would inevitably exit the market".*[34]

47. Similarly, specialisation agreements could possibly result in a more efficient reallocation of productive resources and a consequent reduction of structural overcapacity, in particular in multi-line industries where firms produce several different products. In terms of economic effects this would be less restrictive as it would involve smaller coalitions of firms still competing with each other, while an industry-wide restructuring agreement would normally lead to a single group of entities covering a major part of the relevant market and eliminating competition to a much larger extent. Since industrial restructuring agreements generally involve physical closures of plants, and often complete withdrawals of some competitors from the market, they also constitute a structural consolidation of the industry, which, however, covers a larger part of the market more quickly.

48. In fact, the Specialisation Block Exemption Regulation[35] allows competitors to enter into agreements by virtue of which one or more parties agree to cease production of certain products while another party agrees to produce these products. The conditions for the regulation to apply are that (i) the parties to the agreement do not have a combined market share in excess of 20%; and (ii) that the party which continues producing the products in question agrees to supply the other parties which remain active in the downstream selling market. Hence, by way of specialisation agreements industry players could react to a situation of persistent overcapacity without resorting to one single agreement between virtually all competitors in the market. Moreover, such an approach would be likely to achieve that the least efficient plants would be closed and that the downstream selling market would at the same time remain competitive. Last, specialisation agreements could be a means to reduce the risk of bankruptcies, thereby mitigating the adverse effects of a consolidation process in an industry.

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[33] Joined Cases C-68/94 and C-30/95 Kali and Salz, paragraph 114; see also Case COMP/M.2314 BASF/Pantochim/Eurodiol, paras. 157-160.

[34] The inevitability of the assets of the failing firm leaving the market in question may, in particular in a case of merger to monopoly, underlie a finding that the market share of the failing firm would in any event accrue to the other merging party. See Joined Cases C-68/94 and C-30/95 Kali and Salz, paras. 115-116.

[35] Commission Regulation (EU) No 1218/2010 of 14 December 2010 on the application of Article 101(3) of the Treaty to categories of specialisation agreements, OJ L 335, 18.12.2010, p. 43.

3.2.3 The second condition – consumers must receive a fair share of the resulting benefits

49. Pass-on and the sliding scale. The party seeking to obtain the benefit of Article 101(3) TFEU needs to show that consumers would receive a fair share of any pro-competitive benefits resulting from an agreement between undertakings to reduce overcapacity. The concept of a "*fair share*" implies that the pass-on of benefits must at least compensate for any actual or likely negative impact caused to consumers by the restriction of competition found under Article 101(1) TFEU.[36] Thus, under the sliding scale envisaged by the Guidelines, the greater the restriction of competition found under Article 101(3) TFEU, the greater must be the pass-on of pro-competitive benefits to consumers.[37]

50. The nature of the cost benefits. It is also important to note that consumers are more likely to receive a fair share of the resulting cost pro-competitive benefits in the case of reductions of variable costs than in the case of reductions of fixed costs.[38] This is because profit maximising firms are expected to price at a point where marginal revenue equals marginal costs. Marginal revenue is the revenue gained by selling an additional unit of output. Marginal cost is the incremental cost of producing that unit and is a function only of variable costs (fixed costs are not affected by output). Therefore, as a general rule, output and pricing decisions of a profit maximising firm are normally not determined by fixed costs but by its variable costs.

51. As discussed above, agreements between undertakings to reduce overcapacity are less likely to reduce variable (marginal) costs, and will generally tend to reduce the fixed cost component of unit costs. This needs to be examined on a case-by-case basis.

52. The degree of competitive constraint. The degree of competitive constraint on the market players is a central element in the assessment of pass-on. When the agreement in question "*causes a substantial reduction in the competitive constraint facing the parties, extraordinarily large costs efficiencies are normally required for sufficient pass-on to occur*".[39]

53. In assessing competitive constraints, it is important to consider actual competition, potential competition and buyer power.

54. First, with respect to actual competition on the market, a restructuring agreement may go beyond simply reducing capacity on the relevant market and may also lead directly to the withdrawal of certain undertakings. Depending on the facts of the case, this reduction in the number of independent operators on the market has the potential to significantly alleviate competitive pressures on the undertakings which remain.

55. Second, with respect to potential competition, where entry barriers are increased as a result of a restructuring agreement, particularly in an industry with high fixed or sunk costs, the impact of potential competition on the behaviour of undertakings already on the market will be reduced.

56. Third, buyer power is obviously an important competitive constraint. As a general rule, undertakings with excess capacity tend to be subject to greater competitive pressure from purchasers than

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36 Commission guidelines on the application of Article 81(3) of the Treaty, OJ C101, 27.4.2004, paragraph 85.

37 Commission guidelines on the application of Article 81(3) of the Treaty, OJ C101, 27.4.2004, paragraph 90.

38 Commission guidelines on the application of Article 81(3) of the Treaty, OJ C101, 27.4.2004, paragraph 98.

39 See Commission guidelines on the application of Article 81(3) of the Treaty, OJ C101, 27.4.2004, paragraph 101.

undertakings on markets with low overcapacity.[40] Specifically, an agreement between undertakings to reduce overcapacity would generally strengthen their hand against the buyers of their product because of the coordinated decrease in supply on the market. However, this of course depends on the nature of the market in question.[41]

4. Conclusions

57. An agreement to reduce overcapacity amounts in principle to a restriction of competition by object under Article 101(1) TFEU. To obtain the benefit of the Article 101(3) TFEU exception, the parties will have to show that the agreement leads to pro-competitive benefits which offset the restriction of competition and meets the other conditions mentioned in paragraph 3 of Article 101.

58. It is evident from the discussion in this paper that it will be very difficult for parties to succeed with a defence under Article 101(3). There is generally no need for this type of coordinated action between competitions because normally the competitive process alone would remove excess capacity from the market.

59. If increasing capacity utilisation rates indeed reduces undertakings' costs, they would normally have unilateral incentives to close their excess plants and therefore will generally not need any coordinated action with competitors for that purpose. Unless the firms incentives are aligned to keep the unused capacity, despite suffering corresponding economic losses, because they hope that they will be able to take over the market share of their competitors who will exit the market, it seems illogical that firms would choose to only partly utilise their available plants, rather than just releasing the unused capacity and concentrating production to use plants fully.

60. Therefore, when attempting to defend a restructuring agreement on efficiency grounds the parties would need to establish that the industry concerned indeed suffers from a structural overcapacity problem, i.e. market forces alone cannot remove that excess overcapacity. It would appear that this type of overcapacity market failure, though rare, could occur in particular situations of stable, transparent and symmetric market structures and where giving up capacity is costly for the firms.

61. Under Article 101(3) TFEU, the parties will also have to substantiate the nature and magnitude of the pro-competitive benefits resulting from reducing capacity and demonstrate that those pro-competitive benefits will be passed on to consumers in the affected relevant market. It important to note that consumers are more likely to receive a fair share of the resulting cost pro-competitive benefits in the case of reductions of variable costs than in the case of reductions of fixed costs.[42] This can happen when the industrial restructuring agreement allows firms to produce more efficiently due to higher capacity utilisation in situations of important learning economies, or, for example, in situations where the restructuring enables modernisation of plants.

62. The Commission will have to make a detailed assessment under Article 101(3) TFEU of the causal link between the agreement and the pro-competitive benefits, the likely "pass on" of the claimed pro-competitive benefits to consumers and of the indispensability of the agreement for obtaining those pro-competitive benefits. Industrial restructuring agreements imposing restrictions on output or entry barriers are very unlikely to fulfil conditions of 101(3) TFEU.

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40 See Case C-209/07, BIDS, opinion of Advocate General Trstenjak of 4 September 2008, paragraph 70.

41 See Commission guidelines on the application of Article 81(3) of the Treaty, OJ C101, 27.4.2004, paragraph 97.

42 See Commission guidelines on the application of Article 81(3) of the Treaty, OJ C101, 27.4.2004, paragraph 98.