

COMMENTARY

## Judgment Day

By YANNIS KATSOULACOS  
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On Monday, the next chapter in Europe's most important antitrust case -- Brussels' historic ruling against Microsoft for anticompetitive practices -- will be written. The EU's Court of First Instance has a chance to reverse a decision that not only harmed the American software giant, but is very likely to harm European competition law and the high-tech sector more broadly.



David Gothard

In 2004, after a six-year investigation, the European Commission found that Microsoft had abused its dominant position in the software market in two ways. The first concerned the company's "bundling" of its Media Player for digital music and videos with its ubiquitous Windows operating system. The second involved Microsoft's alleged refusal to supply its competitors with the details of how its Windows products for computer servers interact. As a result, the Commission fined Microsoft a record €497 million. It also ordered the company to market a version of Windows without Media Player -- a product which consumers subsequently judged to be worthless -- and forced it to license interoperability technology on "reasonable terms" -- a remedy that has proved very difficult to enforce.

The Commission's use of economic analysis, its procedures and its suggested remedies were all controversial. Let's take the bundling decision first.

The Commission assumed that Microsoft wanted to keep competitors out of the multimedia market. Yet economic research suggests that bundling itself, even when used by dominant market players, rarely generates anticompetitive effects. It can hardly be presumed to be an illegal activity.

The Microsoft case was the first time the Commission had to deal with a bundling case in which one of the goods (Windows) is an assembled product and the other good (Media Player) is one of its components. In other words, there was a physical or technological integration rather than a mere commercial tie between two distinct products -- as in the Tetra Pak case involving carton-filling equipment and cartons, and all other previous Commission investigations.

As a result, the Commission focused on whether there was a distinct market for Media Player rather than whether there was a distinct market for Windows without Media Player. This led to the incorrect conclusion that, by integrating Media Player into Windows, Microsoft was bundling two distinct goods. When, following the

Commission's orders, Microsoft marketed a version of Windows without Media Player, hardly anyone bought it.

It is worth noting that this test, known as the "separate consumer demand" test, has long been criticized in American case law. In the U.S. Department of Justice's case against Microsoft, the court emphasized that the use of this test could have adverse effects on innovation because it focuses on past behavior. Hence, firms engaging in new and innovative product integration might be found guilty of illegal bundling if less innovative competitors continue to offer the products separately.

The Commission could not have plausibly claimed that consumers suffered any direct disadvantage from buying a product that included Media Player. Due to a U.S. judgment in 2002, Microsoft had already agreed to allow Windows users to remove the Media Player function if they so desired. Instead, the Commission reasoned that packaging Media Player with Windows would allow Microsoft to obtain an advantage in the market through "indirect network effects" -- i.e., that content providers would have an incentive to encode their songs or videos so that they worked only with the market-dominating Media Player and not in other formats, whether due to the cost of multiple formatting or some other reason.

As a result of these effects, the Commission argued, the market would tip toward Media Player and in the long run give Microsoft a dominant position. However, even though the "indirect tipping effect" is well-established in economic theory, we lack persuasive proof that it occurs in practice except under very specific circumstances. The Commission failed to demonstrate that those circumstances were present.

Moreover, a closer examination of the evolution of the multimedia market does not support the Commission's dire predictions. Content providers have continued to encode their music and videos in multiple formats, and computer manufacturers have been installing alternatives to Media Player, which has not gained anything like the dominance the Commission predicted.

Another contentious aspect of the decision involves intellectual property rights. Microsoft's refusal to share interoperability information for Windows with its competitors, the Commission said, hampered the ability of other firms to create products that worked with Windows. The Commission ordered compulsory licensing of this technology.

Economic theory unequivocally suggests that it's acceptable to refuse to supply technological information protected by intellectual property law. This protection has been established to encourage companies to invest in R&D. Most companies would be reluctant to do so if they had to reveal the fruits of their efforts to competitors for free or for a negligible sum. In just four cases have European or American courts found the refusal to license intellectual property to be abusive -- and only under "exceptional circumstances."

In the Microsoft case the Commission, abandoning its traditional "exceptional circumstances" test, argued that the software maker's refusal to supply information was abusive and thus illegal because it could not be shown that this practice did not

reduce innovation in the industry as a whole. Proving a negative such as this one is, of course, almost impossible.

Yet the Commission not only advanced unsound economic arguments. It also failed to consider the wider implications of its decision. If the Commission's new approach creates a precedent, competition authorities may increasingly question intellectual property rights -- making it much more difficult for companies to estimate correctly the returns on R&D investments, and tending to reduce innovation.

There is probably some truth in the claim that the Commission's very tough regulatory stance has forced Microsoft to become a more "responsible" company in some aspects -- particularly in regard to interoperability. However, the net effect of the decision, especially if upheld by the Court of First Instance, will very likely be negative -- increasing legal and business uncertainty and harming European companies and consumers.

***Mr. Katsoulacos, a professor of economics at Athens University of Economics and Business, was a member of the Hellenic Competition Commission from 1995 to 2005.***