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Choose a recent competition case in the UK or at the level of the European Union. Briefly describe the facts of the case and the reasoning of the competition authority in reaching its decision. Critically assess this reasoning.

The European Commission vs. Microsoft

Introduction

This paper aims to explore the antitrust competition case between Microsoft and the European Commission.

Section 1 gives a brief overview of the case and the findings of the Commission as well as the remedies that the Commission imposed on Microsoft. Section 2 gives an analysis of the economic reasoning behind the Commission's decision to remedy the situation. This is followed by section 3, which provides a critical assessment of the remedies that the Commission ordered as well as the effects that these remedies had on the incentives of Microsoft and her rivals to innovate. This is followed by section 4, which concludes the paper. It is worth mentioning here that there were 2 main issues in the competition case between Microsoft and the Commission: Microsoft's refusal to supply information, and their bundling of Windows media player (WMP) into their PC server. Due to the limiting word count, the majority of this paper is focused around the issue of Microsoft's refusal to supply information, with only brief coverage of the issue of bundling WMP in section 3.

Section 1- The Case

In 1998 Sun Microsystems had written to Microsoft asking them to 'provide complete information that would enable Sun's operating system to interoperate with Windows operating systems.'[1] 4 months later Sun Microsystems lodged a complaint to the European Commission regarding the antitrust behaviour of Microsoft and the possibility that they were breaching competition laws due to their restriction of access to information on Microsoft's systems.

The European Commission launched an investigation, and 5 years later in march 2004, found Microsoft guilty of abusing their dominant market position under

[1] Ahlborn, C. and Evans, D (2009) pg.1

article 82 of EU law and fined the company a sum of €497 million, the largest fine ever given in an antitrust case. The commission found that Microsoft were guilty on two counts: firstly of refusing to supply information to other competitors which had been 'deliberately restricting interoperability between Windows PCs and non-Microsoft work group servers'[2], and secondly of "bundling" its 'Windows Media Player, or WMP, a product where is faced competition, with its ubiquitous Windows operating system.'[3] Both of these issues shall be further examined below.

Refusal to supply Information

Initially, the Commission had found that Microsoft had refused to supply important information about 'computer networks that link client computers used by employees for their daily work with server computers that perform specialized tasks including managing the network.'[4]In 1998 when Sun Microsystems contacted Microsoft asking for information, the majority of companies were already using the Windows system for their client computers. But Microsoft had only recently began producing server operating systems and so consequently had a small market share of 18% whilst other companies such as Sun had a market share of 41% [5] therefore these companies would need to have full information about Microsoft's Windows system in order to interoperate it with their server computers that were still largely in use throughout organisations.

The job of the Commission was to decide whether the information that Sun Microsystems had requested from Microsoft and had been refused was in fact needed by the rival server system manufacturers in order to interoperate with Microsoft's client computers and also with Microsoft's work group server computers or not. Eventually the Commission decided in favour of Sun and that Microsoft's rivals did require access to the information concerning the protocols that would allow them to produce systems that interoperated with Windows systems.

[2] Genakos, C. and Kuhn, K. U. and Van Reenen, J. (2008) pg.3
[3] Ibid pg.3
[4] Ahlborn, C. and Evans, D (2009) pg.3
[5] Ibid pg.3

The Bundling of WMP

The second part of the case formed around the bundling of WMP, a type of media player software that permits computers to play back media content.

Microsoft 'controlled over 90% of the market for PC operating systems'[6] and the Commission was concerned that by bundling Windows with WMP, Microsoft had in effect gained an unfair competitive advantage and guaranteed WMP's dominance of the secondary market. And whilst the Commission had no qualms about Microsoft making Windows available with WMP, they did have a problem with making Windows unavailable without WMP. Therefore in the pursuit of fairness, the Commission ruled that Microsoft had indeed gained a competitive advantage over other rival media player producers.

As a result of these two offences, the commission decided that along with the €497 million fine, Microsoft had to rectify the situation and to:

-'Disclose complete and accurate interface documentation which would allow non-Microsoft work group servers to achieve full interoperability with windows PC and servers'[7] within 120 days, and to offer to PC manufacturers a version of its windows client operating system without windows media player'[8] within 90 days.

Section 2- Reasons for the Commission's decision

Market power

One of the Commissions main reasons for its decision in finding Microsoft guilty of breaching EU law was that of market power. The Commission argued that Microsoft extended it market power from the PC operating systems, in which they enjoyed over 90% of the market share, into the market of operating systems for work group servers, a complimentary market that the likes of Sun Microsystems were part of. Microsoft was able to do this because in order for server operating systems to work efficiently, they must be able to communicate easily with the PC operating system.[9] This is known as "efficient interoperability". The fact that Microsoft had near total control of the PC system meant that they could limit the "efficient interoperability" between their PC systems and their rivals server operating systems by not disclosing full information on their PC system. The Commission further argued that Microsoft had

[6] Kuhn, K.W. and Van Reenen, J. (2008) p.4
[7] http://ec.europa.eu/comm/competition/antitrust/cases/microsoft/investigation.html
[8] http://ec.europa.eu/comm/competition/antitrust/cases/microsoft/investigation.html
[9] Genakos, C. and Kuhn, K. U. and Van Reenen, J. (2008) pg.3

both Static and Dynamic motivations to 'foreclose' their rivals from the more competitive server operating market. The Dynamic long run reasons were probably the main force behind Microsoft's actions, as they were worried that if their rivals maintained a large market share in the Server operating market, then they may begin to lose the high profit levels they enjoyed from their monopolisation of the PC market if consumers begin to rely less on PCs by using software such as spreadsheets on servers instead, for example. The commission argued that if Microsoft were able to extend their dominance from the PC market to servers as well by refusing to supply information and restrict interoperability, then they would have been able to get rid of this threat. The Commission's arguments were proved correct by emails between senior figures in Microsoft stating this was the case. 'Bill Gates wrote: "What we are trying to do is use our server control to do new protocols and lock out Sun and Oracle specifically....'[10]

Microsoft's market share in the server operating market rose from 18% in 1998 to over 60% in 2001, whilst other firms in the market such as Linux only controlled around 10%[11]. The Commission argued that a substantial amount of the market share increase Microsoft enjoyed was down to their anti-competitive behaviour limiting the interoperability between rivals and their PC servers, and their ability to do this was down to their control over the PC market with over 90% market share, which was a key factor in what was regarded as a 'leveraging' case.

Microsoft's Economic Incentives to Foreclose their Rivals

We shall now examine whether or not Microsoft would have had any Economic incentives to foreclose the rivals through 'leveraging'.

Microsoft claimed that they as a monopolist did not have any incentives to monopolise a complimentary market, such as the server operating systems market, because their profits could have been extracted as efficiently by just increasing the price of their monopoly product. This is known as the 'One monopoly profit theory' or the Chicago argument, where limiting the interoperability between Windows PC systems and rivals server operating systems would have actually lost revenue for Microsoft as consumers would be less willing to pay as much for the Windows system because of its hampered performance with rival server systems that were still in use.

[10] Genakos, C. and Kuhn, K. U. and Van Reenen, J. (2008) pg.4
[11] Ibid pg.4

Microsoft claimed that instead of going through the costly process of monopolising the server market by limiting the quality of service produced by the rivals, they could instead just charge a higher fee for their PC systems over which they already had a monopoly and extract the all of the consumer surplus and profits still available in that market. The Chicago argument goes even further and claims that Microsoft would have had liberal reasons to increase their market share in the server systems market, such as to reduce the excess profit enjoyed by rival firms in that market.

However, the economic theory of 'foreclosure' provides several alternative rationales to suggest Microsoft had both dynamic and static incentives to foreclose their rivals, providing an alternative argument of the Chicago view.

Dynamic long-run incentives

The Chicago view that Microsoft used to defend its actions to the commission, presumes that the monopolist Microsoft, 'holds an unchallenged position with no threat to future entry in the primary market'[12] which was in this case the PC market, and so therefore Microsoft would have no long run incentive to foreclose its competition in the secondary market. However this was unlikely to be the case for Microsoft in such a high tech industry. Although there are short run barriers to entry into the market such as loyalty to producers already in the market, there were dynamic threats. Microsoft had a significant competitive advantage in the PC market because of the large range of applications such as Word and Excel on the PC platform. However throughout the 1990s the rise of the internet meant that large-scale platform threats were emerging and these applications found on windows could be downloaded straight onto other server systems, which operate on 'open standards' that software developers can easily access and use instead of the protected windows system. This would directly challenge Microsoft's monopoly of the PC system market, as consumers would no longer need to buy windows software and could download cheaper internet software onto server operating systems, making them a competitor for Microsoft. The 'Dynamic foreclosure theory' is based around the idea that an action can shift the short run market share, which will have long term benefits to the monopolist as it reduces competitors incentives to generate new technology that will rival the monopolies. This theory fits the Microsoft case well, as an increase in

[12] Genakos, C. and Kuhn, K. U. and Van Reenen, J. (2008) pg.4

Microsoft's market share in the server operating systems market would cause the developers of new software to stop creating non- Microsoft programmes. This would have the long run effect of further increasing Microsoft's market share because consumers would move away from rival products as there would be fewer software programmes available for these systems, and so the process would continue. This is known as the 'applications network' effect[13].

Static Short-run Incentives

Even though in the short run Microsoft may have taken losses, the dynamic 'applications network' effect is viable for this case, especially when static incentives to foreclose their rivals are taken into account as well. The major short run incentive Microsoft would have had through controlling the complimentary server operating systems market would have been to more efficiently price discriminate between small firms and larger firms. Microsoft as a monopolist would ideally want to extract the maximum amount of consumer surplus in its monopoly market of PC systems by charging higher prices to larger firms and lower prices to smaller firms. For a monopolist firm such as Microsoft this would have been hard to do because larger firms have the ability to act as though they are a small firm. However large firms would have the need to use server operating systems to manage their network of PC systems, and so would highly value these server operating systems, whereas small firms wouldn't benefit as much from using server systems as they have less resources to share. Therefore if Microsoft were able to monopolise both markets then they would be able to charge higher prices in both markets and extract extra profits, an obvious and large static benefit to Microsoft.

The Commission examined the evidence, such as executive emails from Microsoft, as well as Microsoft's explanation for its actions and the economic dynamic and static incentives that Microsoft had to refuse to supply information to server systems manufacturers such as Sun Microsystems. They decided that Microsoft did have sufficient dynamic and static incentives to foreclose their competition and was subsequently found guilty of anti competitive behaviour. This decision resulted in the

[13] Ibid pg.5

Commission ordering several remedies, already outlined in section 1, that Microsoft had to abide by. These remedies shall be explained and critically assessed below.

Section 3- The Remedies

Due to the fact that the software markets Microsoft and its rivals operate in are very fast paced in terms of innovation, a popular view amongst new economy supporters is that European law does not sufficiently and fairly rule these markets. For example Microsoft argued that the remedies that the Commission ordered, particularly that of compulsory disclosure of information to allow interoperability would have a large counteractive effect on innovation in the market, because instead of new products being invented, Microsoft products already available would just be copied, therefore the negative long run effect of less innovation would outweigh any short run positive effects that interoperability may bring. The Commission claimed that '...on balance, the possible negative impact on Microsoft's incentives to innovate is outweighed by its positive impact on the level of innovation of the whole industry.'[14]

The fact that the Commission ordered Microsoft to reveal information only that is necessary for rival firms to interoperate with the windows system, and not important information, such as the Windows source code or security information, that would allow firms to imitate the Windows system is a key discretion when analysing the remedies and the effects that they will have on innovation. If the Commission remedy had asked for the information that would allow imitation, then this would have caused concern for limiting future innovation as it would result in firms just copying Microsoft's system. Indeed the initial request by Sun Microsystems did only ask Microsoft for technical information that would allow them to create software that would interoperate effectively with Microsoft's system, and not for any security information that would allow cloning. Therefore proves Microsoft's claim that the remedy would decrease innovation as incorrect, as the remedy would not give firms the ability to copy Microsoft's systems and decrease innovation.

Impacts on Rival incentives to innovate

The remedies ordered by the Commission would have had several positive ramifications on Microsoft's rivals in the server operating systems market. Firstly, the

[14] Genakos, C. and Kuhn, K. U. and Van Reenen, J. (2008) pg.5

value of rival products as well as sales figures would increase because their systems have interoperability with Microsoft's PC systems. This would also have the effect of increasing rivals returns to research and development because they are selling more products this would further increase rival companies incentives to innovate more, as well as reducing Microsoft's charge on rival innovation. Secondly, Microsoft's rivals would not have to overcome the technical barriers in order to obtain interoperability before the remedies due to lack of disclosure of information on Microsoft's part. Therefore the remedies had a positive effect on rival innovations.

Impacts on Microsoft's incentives to innovate

The remedies would also have had several ramifications, both positive and negative, on Microsoft's incentives to innovate.

Firstly, the fact that rival firms will now have the ability to compete more fairly with Microsoft in the server operating systems market meant that Microsoft's expected market share decreased and prices of rival products increased due to the higher quality. This may have reduced Microsoft's incentives to innovate. However, Microsoft still obtained the monopoly profits in the PC systems market and therefore still had incentives to innovate in the operating systems market. Secondly, increased competition in the systems operating market actually increased the incentives for innovation by all firms in the market, Microsoft included. This is because through innovation, firms can gain a competitive advantage and gain monopoly profits for a short period. Finally, the fact that there will be increased competition may improve the quality of research that Microsoft does, as they are no longer focused on blocking rival innovations, as evidence has shown that they have done in the past. This was known in Microsoft as the ‘Windows tax strategy’ where it was necessary to stop research that led to innovative products because they could potentially weaken the position of Windows in the PC market.

The fact that the remedies lead to increased competition in the server operating systems market may not necessarily have negative effects on Microsoft, and could actually increase the incentive to innovate instead of negatively blocking out rival firms suggests that the remedies the Commission ordered were fair and did not hamper Microsoft's ability to be competitive, whilst at the same time increase the competitiveness of rival firms in the industry.

The second half of the case focused around Microsoft's bundling of Windows Media player into it Windows system. Microsoft claimed that this was to save costs in production and increase the functionality of the Windows software. However the Commission found that in bundling WMP into their system, Microsoft had gained an unfair competitive advantage over other competitors in the complimentary media player market because there would be no need for consumers to invest in alternative media players. The Commission decided that this was anti-competitive and remedied that Microsoft would have to sell a version of Windows without WMP bundled in. They could also still offer Windows with WMP bundled in. Whilst this remedy does mean that consumers now have a choice of obtaining Windows without WMP bundled in it does not solve the complete problem of Microsoft still having the competitive advantage of still being able to bundle WMP into the Windows system. 'A better remedy would have been to combine the unbundling with a 'must-carry' approach'[15]. This would mean that Microsoft would have to include other media players into the version of Windows that they sell with WMP bundled in. This would help to create a more competitive secondary market as consumers would have increased choice in the media player that they use.

Section4- Conclusion

When reviewing the Microsoft case, the Commission had to assess whether Microsoft were actually guilty of anti-competitive behaviour or if Sun Microsystems were asking for unnecessary information. Once the Commission decided that Microsoft was guilty of anti-competitive behaviour, they had to punish Microsoft sufficiently whilst at the same time impose remedies that would not disable their ability to compete, as well as providing rival firms with a more level playing field to compete with Microsoft.

Microsoft was duly fined €497 million. On top of this, the first remedy of ordering Microsoft to release full information that would allow interoperability between rival firms' server systems and Microsoft's PC system had several effects. It prevented Microsoft from continuing anti-competitive behaviour and allowed rival firms to increase competition in the server market by supplying higher quality products. This remedy also had the effect of increasing both Microsoft and its rivals'

[15] Ayres, I. and Nalebuff, B. (2005) pg.4

incentives to innovate, an added benefit. The Commissions second remedy of ordering Microsoft to de-bundle WMP from the Windows system did not completely take away Microsoft's Competitive advantage as they could still produce Windows with WMP bundled in. Perhaps a more effective remedy would have been to order a must carry condition to the Windows system.

Nonetheless the Commission provided remedies that effectively solved the antitrust issue and helped increase competition in the industry in an effective manner without limiting Microsoft's competitive ability.

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