February 2004

RBB Brief 13

RBB | Economics

The special responsibility of dominant firms under Article 82: don't compete on price

In the last six months the CFI has issued two long-awaited judgments on dominant firm pricing behaviour. In both cases – Michelin II and British Airways (BA) – the CFI has upheld the Commission's earlier finding that these firms had pursued price and rebate schemes that amounted to an abuse of a dominant position.[1]

These judgments come at a critical time, because the Commission's policy in this area has come under intense criticism in recent years, and DG COMP has committed to a review of policy that may lead to the publication of enforcement guidelines providing a more coherent economic approach to the analysis of Article 82 cases.[2] However, by endorsing the formalistic approach that the Commission has taken, the CFI has almost certainly hindered the prospects for much-needed reform in this area.

This Brief examines some of the economic issues behind the two cases.

Predatory v exclusionary pricing

Predatory pricing is the extreme form of abusive exclusionary pricing. In its purest form, it involves a decision by a dominant firm to "invest" in the destruction of a rival so that it can earn a "return" in the form of monopoly power and monopoly pricing once competition has been eliminated. This characterisation has led to a definition of predatory pricing as price cuts that can be justified only if they succeed in the elimination of a rival.

Cases such as BA and Michelin, however, concern forms of allegedly exclusionary pricing behaviour by dominant firms that fall short of the predation standard. Both firms were accused of operating discriminatory and/or exclusionary discount schemes that had harmful effects on rival suppliers and thereby acted to strengthen their dominance. According to the CFI, their behaviour violated the special responsibilities required of dominant firms, but both firms claimed that they were simply engaged in price competition designed to protect their legitimate commercial objectives.

This highlights the big policy question raised by these cases. Can a dominant firm ever be deemed to have committed an abuse by charging prices that do no more than respond to short term commercial pressures? If so, when must a dominant firm act to accommodate competitors even if doing so does immediate harm to its commercial interests?

The conduct and business rationale of BA and Michelin

In essence, both BA and Michelin operated pricing schemes that were designed to provide targeted incentives for customers to buy more of their brand. In BA's case, the incentives were in the form of higher commission rates payable to travel agents on BA ticket sales if they matched or exceeded the previous year's sales. Michelin sought to encourage incremental sales through a greater variety of incentive schemes and rebates that ranged from volume rebates to more complex rewards for retailer loyalty.[3]

The other key common theme in the two cases is the fact that both "dominant" firms were clearly operating in an environment in which their market leadership was under long term competitive threat from rival brands. There is no suggestion that either firm enjoyed "super-dominance", whereby successful elimination of one competitor could realistically hold out the prospect of more or less unchallenged market dominance. Indeed, there is evidence that both BA and Michelin were tending to lose market share to rival brands.[4]

1

Michelin v Commission, Case T-203/01, 30 September 2003, and British Airways v Commission, Case T-219/99, 17 December 20003.

2

See speech by Philip Lowe of DG COMP to the 2003 Fordham antitrust conference, available at http://europa.eu.int/comm/competition/speeches/text/sp2003_040_en.pdf

3

This Brief focuses on Michelin's volume rebate scheme, the element that most closely corresponds to the BA travel agent incentives.

4

BA's share of the market as defined in the decision fell from 47% to 38% over the course of the investigation. Michelin similarly claimed that its margins and share of the French truck tyres market were suffering from competitive pressures (see para 236 of CFI Judgment).

Such evidence is grounds for questioning whether these firms were truly "dominant" at all, but at the very least it ought to inform the analysis of whether the practices were capable of having an exclusionary impact.

One does not need in-depth knowledge of either the airline or the tyres industry to appreciate that a legitimate commercial justification for the firms' pricing was the attraction of making incremental sales. Firms that have made large investments in building assets such as factories, intellectual property, aircraft fleets, brand image and/or distribution infrastructure seek to earn a return on those investments through selling their products at prices which earn margins in excess of short run marginal costs.

Where firms earn high margins on their products, there are strong incentives to seek extra sales volumes, since additional sales can yield further contributions towards profit. But achieving extra sales by a simple across-the-board (or "linear") price cut is expensive because it means that those sales are achieved at the cost of giving up some of the valuable margin on the sales that have already been secured. Reflecting this commercial reality, firms devise numerous non-linear pricing schemes aimed at securing extra sales by targeting price reductions or incentives on what they perceive to be incremental sales opportunities. As consumers, we are bombarded with such offers in the form of retailer store loyalty cards, mobile phone company packages, and even discounted offers for the extra pound of bananas bought at the local street trader's stall.

If the street trader routinely makes non-linear price offers to its customers, it cannot be right to object in principle to similar price incentives when they are practised by firms such as BA and Michelin who enjoy positions of market leadership. However, under some conditions firms with significant market power might achieve economic effects through such pricing policies that could harm competition and damage consumer interests in a way that is clearly not feasible for the street trader.

This is the ground on which the policy debate on Article 82 enforcement ought to be taking place. Whilst there is nothing necessarily sinister in non-linear, loyalty-inducing pricing by dominant firms, and active price competition by dominant firms should be encouraged, it is potentially valid for competition law to intervene in those cases where such prices have harmful effects on competition and ultimately on consumers. Unfortunately, by endorsing the formalistic approach taken by the Commission in the recent Article 82 cases, the CFI has set back the chances of constructive debate on this agenda.

The Commission and CFI concerns

A review of some of the detailed reasoning of the Commission and the CFI in the BA and Michelin cases serves to illustrate the problem.

High marginal discounts

A commonly voiced objection to incentive schemes is their tendency to generate very low marginal prices, whereby a customer can qualify for a lower price once its purchases cross a specified target threshold. In the BA judgment, this quality is illustrated (at para 30) by the case in which the effective commission rate paid to the agent on the last £1,000 of BA ticket sales could be 17.5%, more than double its standard rate of commission.[5]

Such illustrations, however, lack any of the market context required to assess whether the rebates tip the balance of power in favour of the dominant firm. Where there is some retroactivity in the rebate schemes it is frequently possible to show that the marginal unit is in effect supplied at a negative price because the discounted price applies across all sales once the threshold has been crossed. Superficially, such price patterns appear to violate the Akzo predatory pricing "rule" that outlaws prices below variable cost. However, when assessed in the proper context of ex ante sales incentives offered to a customer

5 A similar illustration is drawn at para 87 of the Michelin judgment, based on the effects of a customer meeting incremental steps in Michelin's volume rebate scheme.

at the start of a trading period, the probability that such incentives represent a deliberate attempt to sacrifice profits for predatory purposes is remote. Moreover, the impact that such incentives have on opportunities for rival firms cannot be ascertained without a detailed study of the nature of the competitive process.

Efficiency justifications

In both the BA and Michelin cases, the CFI suggested that an economic efficiency defence could justify non-linear discounts, but then fell short of a satisfactory discussion of the business rationale. At paras 284 and 285 of the BA judgment, for example, the CFI acknowledges that BA has an incentive to achieve marginal sales to secure better occupancy of its aircraft, but then asserts that this incentive is "considerably reduced" by the fact that it offers higher incentives to agents in order to secure those extra sales. However, there is no specific analysis of the benefits to BA from incremental sales, and how those benefits compare with the additional costs to BA of conceding extra commission payments to secure them, merely an assertion that those costs must be "disproportionate to the productivity gain achieved".

The Michelin judgment is similarly vague on this key point. Para 96 acknowledges that the aim of any discount system is to encourage the customer to purchase more, and para 98 states that dominant firms are entitled to offer more favourable tariffs if the supply of additional quantities results in lower costs. However, the CFI notes (at para 108) that Michelin did not provide specific information on the cost savings, and at para 110 it asserts that Michelin's volume rebate scheme should be outlawed because it does not allow customers to change supplier "without suffering any appreciable economic disadvantage".

The absence of inquisitiveness by the CFI about the facts behind the efficiencies debate in the two cases is frustrating. It does, however, at least leave the door open to a successful defence of non-linear pricing in some future case. Suppose, for example, that a dominant firm operated a sales incentive scheme in which customers were offered an incremental unit at €1.50, a 25% discount from the normal price of €2. If the supplier's cost of producing a marginal unit was €1, giving a normal price-cost margin of 50%, there are essentially two ways to assess the efficiency justification for the rebate.

An economic approach would argue that this discount would pass the test for being "efficiency justified" because the price for the incremental unit remained above the marginal cost (even if the cost of producing the incremental unit was no lower than the cost of producing the base quantity that had been sold to this customer at the normal price of €2). But an accounting cost approach might require the firm to demonstrate that the average cost per unit of supplying the larger amount was 25% lower than the average cost of supplying the base quantity. Under this accounting-based rule, compliance with Article 82 would come down to a requirement to charge equal price-cost margins on all transactions. It remains unclear whether this is what the CFI has in mind.

Effects

The CFI's approach to the question of effects is also unsatisfactory. Given that non-linear pricing is a commonly observed feature in virtually all competitive markets, enforcement agencies should be required to address the adverse effects of such discounts when practised by dominant firms before condemning them. Yet the CFI's analysis does not do so.

In both the Michelin and BA judgments, the CFI assert that it is not necessary to demonstrate that the abuse had a concrete effect on the market concerned. If one was analysing classical predatory behaviour that could only be explained by anti-competitive intent, there could be some pragmatic justification for this approach. But when analysing normal commercial behaviour for the possibility that it has adverse effects it is nonsensical.

The CFI's actual findings on economic effects argue that any effect on competitors equates to an adverse impact on competition. At para 298 of the BA judgment, for example, the CFI notes that the fact that BA's pricing had not prevented steady loss of market share "does not mean that BA's practices had no effects at all", and that competitors would have gained share even faster had the BA incentives not been in place.[6] As long as BA was correct in its commercial judgment that paying incentives could encourage travel agents to sell more BA tickets, it must be true that its practices raised BA's share above what it would otherwise have been. But this cannot provide a discriminating test for whether the practices were anti-competitive in effect. One might as well argue that operating convenient flight schedules, or making tyres that grip well to wet roads, are anti-competitive practices, since both make life harder for competing firms.

6 Para 245 of the Michelin judgment contains a similar comment.

The missing ingredient in both of the recent cases is any evaluation of whether the competitive process is under threat from the pricing practices under investigation. Evidence that competitors are inconvenienced by the actions of the dominant firm is fundamentally incapable of distinguishing between the pro- and anti-competitive effects of dominant firm pricing. It is essential that the Commission and the Courts move away from examining the form that pricing takes in order to find some more fundamental indicator of the harm to competition and consumer interests that such pricing can, in principle, generate.

Conclusions and implications

The CFI judgments represent a major set-back to the introduction of a more economic effect-based enforcement regime for Article 82. As such, they are bad news for European business, consumers and even for DG COMP.

The adverse impact on business arises from the impracticality of the compliance advice that follows from such judgments. The special responsibility of dominant firms that is sketched out by these judgments appears to translate into a requirement not to compete on price, irrespective of whether that price competition seriously threatens the vitality of the competitive process. The result may make life easier for competitors, but the breadth of the intervention that is implied by the judgments makes it very unlikely that consumers will enjoy more competitive markets and lower prices as a result.

After the recent problems it has had from the CFI in the field of merger control, it might be comforting for the Commission to have its Article 82 decisions so unconditionally endorsed. Yet paradoxically the longer term effect will be quite the opposite. The painful experience of recent CFI merger decision annulments has caused DG COMP to implement substantial reforms to its processes and to strengthen the economic rigour of its merger analysis. Conversely, the comforting (but misguided) judicial endorsement of its decisions under Article 82 will make the much-needed process of reform and modernisation of the rules against dominant firm abuse much harder to implement. The group with DG COMP charged with reform of Article 82 faces a daunting task.