The Response of RBB Economics to the DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses

March 2006

RBB | Economics

The Response of RBB Economics to the DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses

March 2006

1 Introduction

In December 2005, the European Commission published the *DG Competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses*. The paper contains a rather detailed analysis of exclusionary abuses, and sets out a proposal for reform of the competitive assessment for this type of practices. With the publication of the discussion paper (hereafter DP), the Directorate General for Competition also opened a public consultation whereby all interested parties are invited to make comments on the paper.

This paper sets out our observations in response to the Commission's call for comments. It contains an economic and policy assessment of the general policy approach envisaged by the DP as well as a more detailed analysis of the specific methodology proposed for each type of exclusionary abuse. In carrying out our evaluation of the Commission's paper, we have considered specifically the following issues:

- Is the DP based on sound economic analysis?
- Does the DP make real progress towards implementing an effects-based system?
- What stance is taken on the risk of over-intervention and deterring pro-competitive behaviour?
- To the extent that the DP supports form-based rules, do these provide legal certainty? Are they biased towards over- or under-intervention?
- Is the approach taken consistent across each form of abusive practice?

Section 2 discusses the general policy approach and objectives of the DP. The remainder of the paper analyses, in the subsequent sections, the issues of market definition and dominance (Section 3), predatory pricing (Section 4), single branding and rebates (Section 5), tying and bundling (Section 6), refusal to supply (Section 7), and aftermarkets (Section 8).

2 General Themes

2.1 Objectives of the discussion paper

The introduction and general tone of the paper suggest a move towards an effects-based approach whereby consumer welfare and economic efficiency are the guiding principles in the application of EC competition law. In particular, the DP states that:

> With regard to exclusionary abuses the objective of Article 82 is the protection of competition on the market as a means of enhancing consumer welfare and of ensuring an efficient allocation of resources. […] In applying Article 82, the Commission will adopt an approach which is based on the likely effects on the market.[1]

The adoption of an effects-based regime would be, if realised, a positive development. Past experience and economic analysis have shown that a form-based approach generally fails to protect consumer interests, as it can often discourage pro-competitive practices while failing to deter truly anti-competitive behaviour. Adopting an effects-based approach is particularly important in the assessment of exclusionary abuses.[2]

First, most commercial practices that have potential exclusionary effects are also likely to have efficiency-enhancing properties, even when undertaken by dominant firms. A form-based approach therefore runs a serious risk of preventing the attainment of those efficiency gains and suppressing desirable and legitimate commercial freedoms, while not allowing sufficient flexibility to prevent innovative exclusionary strategies.

Second, exclusionary practices necessarily harm competition through harm to competitors. This makes it particularly difficult for form-based rules to distinguish between practices that reduce consumer welfare from those that simply harm rival firms through the normal competitive process. To put the point another way, it should be recognised that market exit resulting from intense competition on the merits is a feature of efficient markets, even in the presence of a dominant firm, and intervening to prevent these events is generally bad for the economy.[3] In this respect, the DP apparently sets out with clear policy objectives. It states:

> [I]t is competition, and not competitors as such, that is to be protected. Furthermore, the purpose of Article 82 is not to protect competitors from dominant firms' genuine competition based on factors such as higher quality, novel products, opportune innovation or otherwise better performance.[4]

This approach is sensible and, if followed through in the remainder of the DP, would make real progress towards realising an effects-based system. The paper does indeed propose fewer form-based rules than could be supported by a faithful reading of the case law, and this development should be welcomed.

Yet, the key issue faced by the DP is to set out the specific policy instruments that would make the above principle operational. In our opinion, the DP does not measure up well against this benchmark. The stance adopted in most of the key sections 5 to 10 clearly contradicts the "competition, not competitors" principle. As a result, the publication

1
See paragraph 4.

2
In our view, (anti-competitive) foreclosure should be defined as *a practice by a firm with market power that harms consumers in the long run by (a) marginalising and weakening existing competition in markets where entry barriers exist; and/or (b) raising entry barriers to markets where existing competition is not effective.* (See Section 1.8 of RBB Economics, *Selective price cuts and fidelity rebates*, report for the Office of Fair Trading, U.K., OFT804, July 2005: http://www.oft.gov.uk).

3
Save for exceptional circumstances. However, it is highly questionable whether competition law enforcement rather than explicit and transparent industrial policy intervention is the appropriate instrument in these circumstances.

4
See paragraph 54.

of this discussion paper can be seen as a missed opportunity for the Commission to make a significant progress towards realising an effects-based enforcement regime.

The Commission apparently regarded a fully effects-based system as excessively open-ended and effectively introduced in the DP a number of form-based or nearly form-based *presumptions* that supposedly would provide greater legal certainty and, most importantly, simplify the Commission's work in the assessment of Article 82 cases. But an effects based regime is not simply a *more complex* set of rules approximately grounded in economics. Instead, it should start from the recognition that the same business conduct, even when practised by dominant firms, can be anti-competitive in some circumstances and pro-competitive in many others. This means that, in order to make a finding of abuse, competition authorities should present a *coherent theory of harm* and prove it against alternative explanations on the basis the facts of the case. Guidelines should provide a framework for this analysis grounded in economic principles, and should provide legal certainty for firms by introducing safe harbours and screening devices designed to dismiss cases that have no merit in the early stages. On the contrary, what an effects based approach should *not* do is set out presumptions of abuse without requiring the authority to test whether the underlying theory of harm fits the facts of the industry.[5]

5 A detailed discussion on the appropriate way to realise an effects-based regime in the context of abuse of dominance cases can be found in *Selective price cuts and fidelity rebates, op. cit.*, Section 2.

In the remainder of this section we review the general policy approach set out in the DP in order to illustrate the wide gap that still remains between the proposed regime and a genuine effects-based system that protects consumer interests and economic efficiency.

2.2 The pro-competitive potential of dominant firm behaviour

This section illustrates the main reasons why dominant firms cannot be generally *presumed* to behave anti-competitively when engaging in the commercial practices described in the discussion paper. Section 2.2.1 argues that most, if not all, conducts that could potentially have foreclosure effects are generally efficiency-enhancing. Not only does economics not support a general proposition that these practices are in themselves likely to harm competition when carried out by dominant firms, but there is a strong case for protecting pricing and commercial freedom of such firms, as efficiency gains can normally be expected.

Section 2.2.2 analyses specifically the incentives that firms may have to foreclose rivals in a vertically related or complementary market.[6] Economic analysis demonstrates that firms which are dominant in one market cannot be generally presumed to have an incentive to drive their competitors out of these related markets. Instead, firms have a *general incentive* to foster economic efficiency in complementary (or vertically related) markets.

6 This issue is relevant to the assessment of predation in related markets, tying and bundling, refusal to supply and after-markets.

Consequently, serious analysis is normally required in order to develop a robust story of harm to competition that (a) fits the facts of a case, and (b) fits the facts better than other competing theories which indicate the absence of harmful effects.

2.2.1 Efficiency gains are generally expected

Most, if not all of the conduct analysed in the DP is generally pro-competitive, even where carried out by dominant firms. For example, the potentially abusive practice in predation cases is a price reduction. This generates an immediate benefit for consumers and is normally the essence of competition on the merits. Similarly, rebate schemes are efficient when they make the price of incremental sales closer to marginal cost, or when they provide distributors with incentives to put a greater effort into selling the supplier's products. In fact, rebates should normally be considered as an indication of robust price competition.[7] In most cases, bundling and tying practices are also likely to enhance economic efficiency by generating savings in production or transaction costs, by eliminating externalities, by enhancing product compatibility, and so on.[8] Often, ties simply reflect the normal evolution of products over time, driven by the development of consumer preferences as well as by changes in production or distribution processes. Refusal to supply is in general simply the legitimate exercise of a firm's property rights.

All of these practices are widely used in competitive markets and are often undertaken by non-dominant firms for whom foreclosure cannot plausibly be the motivation.[9] This observation supports the proposition that such conducts normally generate efficiency gains and are to be considered as pro-competitive unless proven otherwise.[10] Clearly, this is not to say that these types of conduct cannot give rise to anti-competitive effects, mainly through the foreclosure of competitors.[11] However, in contrast to horizontal mergers where the pro-competitive and anti-competitive impacts are potentially separable, it is important to recognise that the source of the potential harm in abuse cases (as in non-horizontal mergers) is often one and the same with the source of the efficiency gain. This means that efficiencies are often crucial to achieve a proper understanding of the conduct in question and therefore should be incorporated in a coherent way in the possible theory of harm. As a result, a careful analysis of the overall impact on consumers is warranted when assessing the potential competitive concerns.[12]

Although the presence in the DP of an efficiency defence is at least a partial recognition of the pro-competitive potential of some of these practices, in many respects the approach set out in the paper continues to present a serious risk that effective competition will be chilled by overly restrictive enforcement. This risk is particularly severe given the difficulty of establishing dominance in the first place (e.g. as a result of Cellophane fallacy considerations) and is reinforced by the apparently lower market share threshold (25%) proposed for this purpose in the DP.

For this reason, the DP should at least contain a clear upfront statement that these practices are generally to be encouraged, even when undertaken by dominant firms. Further, the risk and substantial cost of over-intervention should also be explicitly recognised. A general theme of the DP is that the Commission's desire to retain discretion to intervene against all kinds of behaviour, even those (e.g. above-cost predation) whose potential for true anti-competitive effect is very hard to envisage as a practical proposition, means that many essentially benign business practices are brought into the potential scope of the Article 82 prohibition. Yet the DP does not acknowledge the substantial cost, in terms of uncertainty and scope for false convictions, that flow from the Commission's desire to keep its options open.

2.2.2 The incentive to foreclose

In the approach proposed by the DP the Commission is normally not required to assess whether the dominant firm has an economic incentive to foreclose. In a number of places, including the analysis of predation, tying and bundling, refusal to supply and after-markets, the DP seems to postulate that firms can generally increase their profits by driving rivals from the market, and therefore would naturally seek to do so whenever they had the ability. This assumption has support in economic theory only in limited circumstances.

The idea that firms can increase their profitability by leveraging their market power from one market to another, previously competitive,

7 See *Selective price cuts and fidelity rebates*, *op. cit.*, 4.19–4.35.

8 See Section 4 of RBB Economics, *The efficiency-enhancing effects of non-horizontal mergers*, report for DG Enterprise and Industry, European Commission (2005): http://europa.eu.int/comm/enterprise/library/lib-competition/doc/non_horizontal_ mergers.pdf

9 See for example M. Salinger and D. Evans, "Why Do Firms Bundle and Tie? Evidence from Competitive Markets and Implications for Tying Law", *Yale Journal on Regulation*, Vol.22, pp.38–89 (2005).

10 See also W.J. Baumol and D.G. Swanson, "The new economy and ubiquitous competitive price discrimination", *Antitrust Law Journal*, Vol.70, p.661 (2003).

11 Some theoretical economic literature indicates that certain of these practices can also be used to reduce the intensity of competition, thus leading to higher prices. However, we are not convinced that this concern is sufficiently concrete and practically verifiable to justify intervention.

12 This point is further developed in Section 5 of *The efficiency-enhancing effects of non-horizontal mergers*, *op. cit.*

market has a long history in anti-trust enforcement. However, since the early 1970s economic theory has consistently shown that it is far from trivial to show that there are robust incentives to foreclose in vertical and complementary product markets.[13] Further, to the extent that there is no such incentive, it must be presumed that the dominant firm has engaged in the investigated conduct in order to realise efficiency gains (i.e., it is pro-competitive).

In the economic literature, foreclosure theories typically are developed for near monopolists and are not well developed for firms with a lesser degree of market power. Even for near monopolists, theory indicates that a case by case assessment of behaviour is required because dominant firms also have incentives to increase profits through pursing more efficient practices. Thus, there can be no general presumption that dominant firm behaviour is typically designed to harm competition.

Indeed, on a general level, it is a basic principle in economics that a company that is dominant in a particular market has an incentive to *enhance* economic efficiency in a complementary area.[14] If the quality of the complementary good increases, or its price decreases, the demand for the original product would normally rise, thereby increasing the profits of the dominant firm. The presence of independent suppliers for the complementary good may well therefore serve the interests of the dominant firm, particularly in differentiated product markets where the existence of a larger variety of products may increase total demand.[15]

The absence in the DP of any serious analysis of the incentive of dominant firms to foreclose, and in particular the absence of any reference to the "one monopoly profit" principle raises serious concerns as to whether enforcement will be genuinely based on sound economics. The extensive report recently prepared by Professor Church on behalf of DG Competition clearly shows that the large number of existing leveraging theories cannot be summarised in a few general principles.[16] Serious leveraging theories are highly facts-specific, which is why we need an effects-based approach to assessing the conduct of dominant firms. Although developing such a theory in any given case can be a difficult exercise, there is no reason for the Commission to shy away from this task, given the generally pro-competitive nature of most conduct. Crucially, this includes establishing that an incentive to foreclose exists.

2.3 The threshold for abuse

2.3.1 The "as efficient" competitor test

One of the key tools proposed by the Commission in implementing its effects-based approach is the "as efficient" competitor test. In the words of the Commission:

> [I]n general only conduct which would exclude a hypothetical 'as efficient' competitor is abusive. The 'as efficient' competitor is a hypothetical competitor having the same costs as the dominant company. Foreclosure of an as efficient competitor can in general only result if the dominant company prices below its own costs. [17]

This is an appropriate principle. First, when combined with other evidence that foreclosure is feasible, it offers a reasonable benchmark for competition authorities to distinguish harm to competitors that arises from competition on the merits from anti-competitive exclusion. In particular, it clearly states that foreclosure of a less efficient competitor would normally not be considered abusive. Second, it provides dominant firms with at least some degree of certainty as to the type of behaviour that might be considered lawful (provided that consistent

13 The one monopoly profit principle discussed by the "Chicago School" of economics demonstrated that *naïve* leveraging theories are often inconsistent with sound economic reasoning. See R. Bork, *Antitrust paradox,* (1978, New York: Basic Books); R. Posner, *Antitrust law,* (1976, Chicago: University of Chicago Press).

14 J. Farrell and P. Weiser, "Modularity, vertical integration, and open access policies: Towards a convergence of anti-trust and regulation in the internet age", *Harvard Journal of Law and Technology*, Vol.17, pp.86–134 (2003).

15 A similar incentive holds for vertically related products where a dominant manufacturer may well realise greater profits by selling to a competitive and efficient downstream distribution market than by operating its own exclusive distribution network.

16 J. Church, *The impact of vertical and conglomerate mergers on competition,* Report for DG Competition, European Commission (2004): http://europa.eu.int/comm/competition/mergers/others/#study. Even though Professor Church's report has been prepared with reference to non-horizontal mergers, the economic literature on which it is based, and the issues discussed, are highly relevant also to the assessment of exclusionary abuses under Article 82 EC.

17 See paragraph 63.

cost benchmarks are employed). Since the test is based only on the costs and prices of the dominant firm, it is in principle possible for companies to assess whether their commercial behaviour is likely to comply with competition law. Third, the approach has sound theoretical underpinnings. Generally, pricing below avoidable cost (if correctly measured) is indicative of some form of strategic behaviour and therefore it is reasonable to consider further whether the conduct may be part of a wider anti-competitive strategy. However, there are many instances where pricing below cost is not anti-competitive, and this is helpfully recognised by the DP.[18] Of course, the outcome of the test will often depend on the specific cost measure used (e.g. avoidable costs, total costs) and selecting the appropriate cost measure is crucial.

However, the practical value of the "as efficient" competitor test is seriously undermined by the exceptions set out in the subsequent paragraphs. For example, paragraph 67 states that

> …it may sometimes be necessary in the consumers' interest to also protect competitors that are not (yet) as efficient as the dominant company.

In particular, the DP indicates that it may intervene to protect competitors harmed by the dominant company's exploitation of efficiencies such as

> …economies of scale and scope, learning curve effects or first mover advantages that later entrants can not be expected to match even if they were able to achieve the same production volumes as the dominant company.[19]

This contradiction illustrates a policy dilemma that surfaces at a number of points throughout the DP.[20] The key problem can be illustrated with the following example. Consider a market where a monopolistic supplier produces at a cost of €5 per unit and sells at a price of €10. A second firm can enter the market and produces a similar product for a cost of €7 per unit (the new entrant is less efficient than the incumbent), and undercuts the monopolist by charging a price of €8. A possible response would be for the incumbent to undercut its new rival by charging a price of €7 (or less). The incumbent can charge this price and still make a profit. But the less efficient entrant will be forced to exit the market, at which point the monopolist can revert to a price of €10.[21] This outcome is likely to materialise even if the dominant company has no "intent" to foreclose. For example, if the entrant's offering represents a serious threat of loss of business to the monopolist, pricing at €7 in order to recover those lost sales may well be the short-term profit-maximising reaction for the dominant firm.

Viewed from a static, short-term perspective there is an evident case for intervention. Consumers are better off in a market where the dominant firm is constrained by an inefficient rival than they are when faced with an efficient monopoly. Intervention to prevent the dominant player from undercutting its rival therefore generates a clear consumer benefit. This is the stance that has been implicitly taken by the Commission in a number of places throughout the DP. For example, the DP appears to suggest that dominant firms may be required to accommodate entry by not using certain of their economic efficiencies and possibly by pricing above the level that would maximise their short-term profits.[22] However, such a policy of accommodation is both impractical and inappropriate to protect consumers, for the following reasons.[23]

First, the DP appears to take the view that encouraging entry by inefficient firms is good for consumers because inefficient competition is better than no competition at all. However, there is no reason to assume that the correct counterfactual is "no competition" because the potential entrant could strive to enter the market through innovation that lowers its cost base or offers a differentiated product.

18
At least in part. See for example paragraph 119.

19.
See paragraph 67.

20
For example, in paragraphs 129 and 190.

21
This would be true only if there was some reason, such as the existence of sunk costs, to deter re-entry after prices had been elevated again. We make no attempt in this very simple illustration to capture this complexity.

22
See paragraph 190.

23
See also *Selective price cuts and fidelity rebates, op. cit.*, paragraphs 3.103–3.124.

Second, a policy whereby new entrants are protected from the superior efficiency of the incumbent is highly likely to reduce economic and consumer welfare in the long-term, by reducing the incentive to increase efficiency for both the dominant firm and the new entrants. Notably, the entrant will know that lowering its costs will merely open the way for price reductions by the incumbent and that any benefit it might otherwise have got from lower costs will be largely offset by the lower prices against which it must compete. Even more problematic would be a situation in which the entrant, knowing that it could not be undercut, was able to raise prices (e.g. by inflating its cost base, above which the dominant firm must price), so generating higher profits for both itself and the incumbent. In effect, to the extent that the law prevented the incumbent from undercutting the entrant it would be acting as a facilitating device for a price-increasing cartel. Such outcomes are unlikely to operate in the interests of economic or consumer welfare in either the short or long-run.

Third, there is no practical policy rule under which a dominant firm can determine a lawful course of action. This is because in order to prevent the foreclosure of a less efficient rival, the relevant test would need to be based on the costs of the rival rather than on the costs of the dominant firm. This requires the dominant player to know the cost structure of its competitor in order to be able to set its own price. Moreover, even assuming that these data were available, the notion of "non-replicable" efficiencies, widely used in the DP, is so vague that it would be virtually impossible to determine in practice which cost benchmark is to be used, and the scope for the entrant to game the system would be enormous.

Using Article 82 in this way would represent a form of industrial policy. Indeed, the parallels are close. Industrial policy often seeks to identify circumstances in which subsidised entry or growth is desirable because of the longer-term benefits that may accrue if a rival becomes established in the market. The subsidies necessary to achieve this objective are typically transparent and paid out of general taxation. Applying any form of "less efficient" competitor test under Article 82 amounts to the same policy, but one lacking in transparency and one in which the subsidy is paid by consumers, who are denied the short-term benefits of the lower prices, higher discounts or superior products of the dominant firm.

Of course, in specific circumstances it might be justified to encourage or facilitate market entry through appropriate industrial policies.[24] For example, this may be the case in recently liberalised sectors where former state-owned monopolies maintain a market position approaching monopoly and entry is made difficult by the historic advantages of the incumbent. In such sectors, the risk of adverse precedent is limited because interventions are "ring-fenced" and should not spill over into other industries beyond the remit of the sector-specific regulator. However, we are not convinced that Article 82 is an appropriate tool for addressing such broad issues of economic policy. Extending the scope of Article 82 to allow for the active management of competition runs the risk of arbitrary enforcement, which protects and perpetuates inefficiency in the market. Moreover, the risk of adverse precedent is magnified – an interventionist stance in one market can potentially constrain pro-competitive behaviour in all markets. For this reason we believe that most of the exceptions to the "as efficient competitor" rule should be dropped.

24 Appropriate policies may include subsidies as well as measures seeking to lower barriers to entry and expansion, for example by reducing the costs incurred by customers in switching to a new supplier.

2.3.2 Appropriate cost measures

The DP makes extensive use of cost benchmarks in order to establish whether the conduct under investigation has the capacity to foreclose. The cost measures that are most used throughout the DP are average avoidable costs (AAC), the long-run average incremental costs (LAIC), and average total costs (ATC).[25] Pricing below one of these cost measure can give rise to a (rebuttable) presumption of abuse, or is a key piece of evidence in reaching this presumption. In principle we agree that the use of cost benchmarks is useful, as it may simplify the competitive assessment and provide greater legal certainty for firms under investigation (in particular where cost benchmarks are used to create safe harbours). However, the way cost-based tests are used in the DP is not consistent across the different categories of abuse, nor indeed within some of these categories. Furthermore, certain of these tests raise serious doubts as to whether they effectively protect competition rather than simply protect inefficient competitors.

25 These cost measures are defined in paragraph 64.

The application of the cost-based test is best explained in the section of the DP devoted to predatory pricing. In this section it states:

> If the price charged by the dominant company is below AAC this means that the dominant company incurred a loss that it could have avoided. It is, at least in the short run, not minimising its losses. This is sufficient to presume that the dominant company made this sacrifice in order to exclude the targeted competitor.[26]

26 See paragraph 109.

The AAC test is a useful starting point for the competitive analysis, since pricing below the AAC threshold can potentially exclude "as efficient" competitors, which may prefer to reduce production rather than selling at a cash loss. Where the available evidence suggests that foreclosure is feasible, it is reasonable to require that the firm pricing below AAC justifies its actions in terms of the pro-competitive benefits that it believes its conduct delivers.[27]

27 Reference to AAC allows direct comparison with any given price. In general, however, since an avoidable cost test can be applied to a wide range of commercial decisions, it is often more satisfactory to assess whether the revenues achieved by any given commercial decision cover the avoidable costs of that decision, i.e. to use a broader concept of avoidable costs, rather than average avoidable cost (AAC).

A similar but arguably more general test would compare the *revenues* generated by a certain pricing or output decision to the avoidable costs associated with that decision. The two tests are identical if all units are sold at the same price, but the latter is more directly related to the issue being investigated, namely whether the firm has engaged in an exclusionary conduct. Moreover, the test based on revenues and avoidable costs is more easily applicable to situations where the price and cost of a single unit are ill defined, for example because different customers pay different prices but share much of the costs.[28]

28 A typical example is airline pricing schemes, also know as "yield management", whereby the price of each ticket depends on a large number of parameters such as seats availability, flexibility, comfort class, and so on. Yet, the majority of costs are common to all passengers of that particular flight.

However, the DP also introduces less appropriate cost measures, namely ATC and LAIC. Crucially, a pricing behaviour whereby a firm sells part or even all of its output at prices below ATC (or LAIC) but above short-term AAC is widely used in competitive markets. Such prices may only raise competitive concerns in the long-term, to the extent that an "as efficient" rival is unable to fully recover fixed costs and is forced to exit the market (or operate inefficiently) as a result of its financial constraints. Nonetheless, the concept of avoidable costs provides sufficient flexibility to assess also long-term exclusionary strategies, since to the extent that the firm can control (avoid) more costs over a longer time-frame these can be included in the (long-term) avoidable cost measure.

The main problem with an ATC measure is that is inevitably arbitrary, since there is no economically meaningful way to allocate common fixed costs (e.g. administrative overheads) across different products.[29] The Commission recognises this difficulty, and specifies that common costs should be allocated in proportion to each product's turnover. Yet, this allocation does not have better theoretical underpinnings than any other, for example attributing all common fixed costs to one product. Further, we note that fixed costs, and therefore ATC, could change arbitrarily if the firm exchanged debt for equity, wrote off goodwill, changed depreciation profiles or carried out other financial re-structuring.

29 In a similar way, within a single product line, the allocation of fixed costs across different units of output is also arbitrary.

Policy rules based on ATC measures effectively require firms to price according to costs they cannot control, and provide no basis for a rational pricing strategy. This is illustrated by the following example. Suppose Domco makes widgets and gadgets from the same factory and is dominant in both. The factory has an overhead cost of 250 (in the form of a depreciation charge). Widgets and gadgets both cost 1 per unit to manufacture, and Domco makes 100 units of both, selling both products at 3 per unit. Hence total factory costs are 450, the ATC of widgets and gadgets is 2.25 (following the DP's convention on fixed cost allocation), revenues are 600 and profits are 150.

How can Domco respond if an entrant starts producing widgets at a price of 2? If it is constrained to price so as to cover ATC, its lowest admissible price is ATC = 2.25. In that case Domco might have to give up all its widget sales, and thus its widget business will make no contribution to overheads. As a result, its gadget sales become loss-making. Does it have to raise prices there as well? Maybe it has to exit both markets? None of this makes any economic sense. Although the DP allows a "meeting competition" defence that might apply to these circumstances, why should Domco be required to justify its behaviour where there is a no reason to suspect an abuse in the first place?

Where a dominant firm prices above AAC, it is likely to be very difficult to distinguish harm to competition from harm to competitors without carrying out a full assessment of the ultimate impact on consumers. Yet, the DP continues to make extensive use of rebuttable presumptions for prices above AAC, and even above ATC. This means that the policy approach envisaged by the DP risks chilling price competition and other pro-competitive practices in a number of markets where firms have a position suggestive of dominance. This is a potentially serious risk in several instances.

First, in its discussion of predatory conduct, prices between AAC and ATC are viewed with suspicion,[30] particularly if targeted at specific customers.[31] Pricing below LAIC is presumed predatory in cases concerning legal monopolies[32] or recently liberalised sectors.[33] Finally, prices above ATC can be seen as predatory where they harm inefficient competitors that suffer from a non-replicable advantage.[34]

Second, in discussing rebates, pricing below ATC is considered as presumptively abusive in a number of circumstances, including selective unconditional rebates on additional units and conditional rebates on all purchases provided certain conditions are met.[35]

Third, mixed bundling is considered as exclusionary if the price difference between the bundle and the stand-alone product price of one component of the bundle is lower than the LAIC of the dominant company of including that component in the bundle.

Employing such a wide range of cost benchmarks and differing presumptions prevents a consistent application of Article 82 across the different exclusionary abuses. Particularly surprising in this respect is the use of the LAIC benchmark in certain cases of predation and in mixed bundling. It is also interesting to note that the suggested tests are accompanied by such a large number of exceptions and caveats that they ultimately provide little guidance to dominant firms as to what conduct may be regarded as lawful, although they do provide some certainty as to the (many) conducts that are apparently likely to be deemed abusive.

2.3.3 Price discrimination

The DP purports not to address price discrimination.[36] This is surprising, since much of the conduct which the DP suggests may result in

30 See paragraph 102.

31 See paragraphs 111 and 112.

32 See paragraph 125.

33 See paragraph 126.

34 See paragraph 129.

35 See paragraphs 171 and 154.

36 See paragraph 3.

the foreclosure of competitors achieves its ends through price discrimination of one form or another.[37] First, practices that target specific customers with rebates, price reductions or bundled offers are a form of price discrimination.[38] Second, offering a rebate on incremental sales to a given customer is also a form of price discrimination. These practices are regarded as a serious concern throughout the paper, and often give rise to a presumption of abuse. We would argue that to the extent that these practices amount to price discrimination they are not generally anti-competitive, and that a presumption of abuse is not justified, as long as the pricing conduct does not amount to predation.

The Commission is apparently concerned that, by charging a price lower than ATC to certain customers or on a certain proportion of its sales, a dominant firm may be able to exclude smaller rivals while recovering all of its fixed costs from the remaining part of its sales. Since the recoupment of losses is accomplished during the predation period these exclusionary strategies are seen as easier to employ, and therefore potentially more problematic than "classic" predatory strategies where recoupment takes place in the long-term.[39]

As discussed in section 2.3.2, the problem with this approach is that firms have the economic incentive to make additional sales as long as the price of these sales is above AAC. Crucially, this incentive holds regardless of whether rival firms are likely to be marginalised as a result. It can well be a short-term profit maximising strategy. Charging lower prices to price sensitive customers is a common commercial strategy that is widely used in competitive markets.[40] Offering lower prices to the customers that are more readily supplied by rivals or potential entrants is in most cases likely to be a normal application of this principle, since the demand of these customers can be expected to more elastic. Similarly, the demand from a given customer is normally more elastic for the marginal units sold than it is for infra-marginal sales. This justifies charging a lower price for additional units. It also means that the DP's distrust of price cuts that are "targeted" at rivals is wholly misplaced. The existence of targeting cannot in itself provide any useful evidence of the dominant firm's conduct departs from normal competitive behaviour, notwithstanding the case law on this point.

Moreover, most economists would agree that price discrimination can allow firms to recover their fixed costs at a lower total cost to customers as a whole than by charging a uniform price.[41] In other words, price discrimination can increase social welfare. Recent economic research has shown that it also can increase consumer welfare by inducing firms to compete more aggressively.[42]

The central policy issue regarding customer "targeting", or price discrimination, is similar to the one discussed in Section 2.3.1. Although successful entry, or expansion of small competitors, can potentially bring benefits to consumers, this does not justify a policy that aims at protecting these competitors by effectively requiring dominant firms to accommodate entry by competing less aggressively. Prohibiting practices that are normally pro-competitive and that maximise firms' short-term profits is both impractical and counter-productive. If firms are not allowed to set their commercial behaviour following the principles of non-strategic profit maximisation, at least they ought to be given precise guidance as to the practices that are considered lawful. This is very hard to achieve without stifling competition in the many instances where price discrimination is beneficial to consumers. The DP fails in both respects.

2.3.4 Dominance and captive sales

One of the key conceptual tools of the framework proposed by the DP is the notion of "must stock" or "must have" product (see in particular the analysis of rebates, tying and bundling, and refusal to supply). In essence,

37 Indeed, it is not clear whether the DP considers anti-competitive price discrimination to be a third class of abuse (i.e. an abuse even if it neither excludes nor exploits), a subset of exploitation, or a practice with both exclusionary and exploitative consequences. The last of these seems the most appropriate categorisation and would call for the inclusion of price discrimination in the current paper.

38 See paragraphs 112, 118, 171 and 196.

39 See paragraph 118.

40 Baumol and Swanson., *op. cit.*

41 Farrell and Weiser, *op. cit.*; J. Hausman and J. MacKie-Mason, "Price discrimination and patent policy", *RAND Journal of Economics*, Vol.19, pp.253–265 (1998).

42 L. Stole, "Price discrimination and imperfect competition", in: M. Armstrong and R. Porter, eds., *Handbook of Industrial Organization*, Vol. III (2005, Amsterdam: Elsevier North-Holland).

this refers to the idea that a dominant firm does not face any significant competitive constraint over at least a certain part of its demand. This may happen because some of its customers have no choice but to buy from the dominant firm (e.g. for lack of alternative suppliers), or because they are forced by commercial considerations (e.g. consumer preferences) to purchase from it at least *some* of their requirement. This means that the demand faced by the dominant firm can be divided into a "captive" part and a "contestable" part, where competition is only possible for the latter.

The concept of "captive sales" can be useful in the assessment of exclusionary abuses. However, it should not be used indiscriminately without assessing whether, and to what extent, it can be applied in the specific circumstances of the case under investigation.[43] In particular, it is important to estimate what proportion of a customer's requirement can effectively be regarded as captive, and to what extent the product is a "must have" for different groups of customers.

43
There is also a question as to what "captive" means. Even dominant firms face some natural constraints on the extent to which they would wish to raise price, and it is seldom the case that a supplier is able to extract all rents from the customer by virtue of threatening to withhold supply.

Although from an economic perspective the attributes of a "dominant firm" are ill-defined, what is clear is that the definition of dominance used in the DP does not guarantee that a significant part of the firm's demand can be considered captive. This is even more so given that a firm can be deemed dominant with market shares as low as 40% or, in the DP's new proposal, perhaps even 25%.

Yet, in a number of places, the DP seems to postulate that *all* dominant firms have captive customers. The "must have" assumption is crucial to the DP's assessment of conditional rebates, although it is tempered by the consideration that customers may be unable to switch only with respect to *part* of their demand.

Even this weak caveat is unfortunately absent from the DP's analysis of tying and bundling. Here the "captive sale" assumption plays a pivotal role in establishing a rebuttable presumption of abuse, since it is assumed that all customers of a tie or of a pure bundle are "clearly foreclosed" from the market, and the same conclusion holds for mixed bundling where the price of the additional component is below the cost benchmark (long-run incremental costs).[44]

44
See paragraphs 189–190.

The DP's suggested "equation" whereby dominance implies a "must stock" product (which in turn implies foreclosure) is inconsistent with an effects based approach oriented towards protecting consumers. In particular, it results in an excessively low threshold for reaching a presumption of abuse. What is required, instead, is an assessment of the degree of market power enjoyed by the firm at the centre of the investigation, and an analysis of the likely impact of its conduct on consumers, based on the specific facts of the case.

2.4 Efficiency defence and objective justification

2.4.1 The "Article 82(3)" proposition

The DP at various points proposes the use of a two-stage competitive assessment. In the first stage, the Commission conducts its analysis in order to establish a preliminary finding of abuse. This *prima facie* evidence, which is often achieved through the use of "rebuttable presumptions", can be reversed by the dominant firm in the second stage of the assessment by showing that the conduct is objectively justified or generates valuable efficiency gains, along lines analogous to an Article 81(3) exemption.

It is useful to consider the merits of this proposal against the Article 81 experience. Historically, the two-stage approach in Article 81 has been extremely detrimental to the development of a rational economic approach to competition law because it has led to far too many restrictions being caught in 81(1) and then a complicated collection of block exemptions under 81(3) whose real role has been to state the circumstances in which the restriction should not have been considered anti-competitive in the first place (e.g. the 30% market share threshold for vertical restraints). It is only in the last few years that a more effects-oriented approach to Article 81 has begun to reform this very inefficient approach, and as such it is a highly unattractive model to copy.

If this approach is taken, it is important to ensure that it does not suffer from over-inclusiveness in the first stage. Only conduct that is truly exclusionary in its effect should arouse initial suspicion and require justification. An efficiency defence should then be used as a way to show that the exclusion is a result of the dominant firm beating its rivals as a result of superior efficiency, and not through strategic anti-competitive actions. But the DP does not appear to be advocating this model.

The DP does not provide guidance as to the types of efficiency gains that may be considered relevant, but it implies an unjustifiably strong focus on proving productive efficiencies. There is no mention of the allocative efficiency advantages that can flow from Ramsey pricing, the elimination of the Cournot effect, the setting of marginal price incentives that mimic marginal cost conditions, or of the general desirability of low prices and discounts. Similarly, there is no mention of efficiency gains such as market expansion that can be achieved by reducing agency costs (principal-agent problems), and which may motivate certain rebate schemes.

2.4.2 An asymmetric standard of proof

The real impact of the proposed two stage approach on competition policy enforcement depends on the balance between the threshold for reaching a presumption of abuse and the standard of proof required to rebut it. Although this depends on everyday application at least as much as on the wording of guidelines, the criteria provided in the DP provide a strong indication that this balance might be biased towards creating an overly restrictive regime. This is a fundamental concern.

A successful efficiency defence must meet all of the following four conditions:[45]

45 See paragraph 84.

- that as a result of the conduct concerned, efficiencies are realised or likely to be realised;
- to realise these efficiencies, the conduct concerned is indispensable;
- the efficiencies benefit consumers; and
- competition in respect of a substantial part of the products concerned is not eliminated.

Proving all these conditions is likely to be extremely difficult in any practical case, especially starting from a position of a dominant firm whose conduct has been shown to have market-foreclosing effects. First, there is a striking difference between the wording of paragraph 58, which requires the Commission to show that a market distorting foreclosure effect is "likely", and the lack of similar qualifications in conditions 2 to 4 above.

Secondly, in order to demonstrate that efficiencies benefit consumers, the dominant firm must demonstrate that the gains "…at least compensate consumers for any actual or likely negative impact".[46] In other words, the defence is required to carry out a full-fledged analysis of the impact on consumer welfare, while the Commission can reach the conclusion that the conduct is abusive simply on the basis of the effects on "the market".[47] Note, in particular, that the criteria provided in paragraph

46 See paragraph 88.

47 See paragraphs 58 and 59.

59 for determining "market distorting foreclosure effects" do not include any reference to impact on consumers. The defence must also take into account that "...the later the efficiencies are expected to materialise in the future, the less weight the Commission can assign to them",[48] although there is no hint in the DP that a similar approach would be applied by the Commission to assess practices that may harm consumers only in the long-term, as frequently happens in foreclosure cases.[49]

48 See paragraph 89.

49 See for example paragraph 91.

Thirdly, the last condition apparently takes back what the DP conceded with condition 3. Even if the conduct generates sufficient efficiency gains to outweigh the possible harm, where competition is significantly reduced, the harm to competitors will nonetheless be considered paramount. Although there might be good reasons to take this stance, the interplay between the last two conditions is, at best, unclear.

As we note, above, however, imposing a tough standard on dominant firms that wish to use the efficiencies defence for their conduct may not be problematic provided that the presumption that triggers the need for the efficiency defence has been set at an appropriately robust level. Our primary concern is that the DP casts the net of initial suspicion too widely at the first stage, such that far too many cases need to rely on the efficiency defence in order to establish the legality of their behaviour.

2.5 Conclusions

In our view, the forthcoming guidelines on the application of Article 82 should provide:

- A clear statement that low prices and, more generally, pricing and commercial freedom should be encouraged, even for dominant firms, because efficiency gains are generally expected to flow from such commercial freedoms;[50]
- A consistent definition of foreclosure that distinguishes between behaviour that leads to a rival's lower market share (or exit) due to competition on the merits versus harmful exclusionary outcomes that arise from the strategic use of market power and that are ultimately bad for consumers;
- A requirement that in order to make a finding of abuse competition authorities must present a *coherent theory of harm* and prove it against alternative explanations on the basis of the facts of the case. At a minimum, the actual market evidence should include the following elements (in addition to proving dominance):
  - Evidence that competitors are harmed. For example, where the evidence shows that competitors are able to sustain or even increase their market share, this raises an economic presumption that the competitive conduct under investigation is not hampering *competition*.
  - Where competitors are harmed by the pricing conduct in question, cost-based tests should be carried out to establish whether an "as efficient" competitor would be foreclosed. Where revenues are greater than avoidable costs, there should be a presumption that the conduct is not anti-competitive.

50 There should also be an explicit acknowledgement that intervention can chill future competition, in particular where the authorities' decision can be interpreted in a way that goes beyond the specificities of the case.

Guidelines should set out a framework for the analysis grounded in economic principles, and should provide legal certainty for firms by introducing safe harbours and screening devices designed to dismiss cases in the early stages.

In the movement towards the realisation of an effects-based system, the discussion paper is a move in the right direction, but still falls short in many respects. The statement made in the DP that the purpose of Article 82 is to protect competition, and not competitors as such, is to be welcomed. It should also be recognised that the DP supports fewer form-based rules than could be justified on the basis of a faithful reading of the case law. Yet, the key issue faced by the DP is to set out the specific policy instruments that implement the “competition, not competitors” principle. In our opinion, the DP does not measure up well against this benchmark.

3 Market Definition and Dominance

3.1 Introduction

There is much with which one can agree in the DP's detailed discussion of market definition and dominance. However, the DP nevertheless leaves the impression that one can never be sure of the appropriate market definition in abuse of dominance cases, nor that one can ever be truly certain whether a particular firm holds a dominant position. This is an impression which almost certainly reflects reality, but the profound consequences of this reality are not properly explored in the discussion document.

The most obvious issue raised by the lack of certainty in this area is whether firms, even if they take expert advice on the point, can ever be sure whether they are dominant or not, or whether the competition authorities are likely to view them as dominant or not. In the light of the intrinsic uncertainty surrounding dominance, how can the "special responsibility" of dominant firms be interpreted? To the extent that the DP provides some guidance on the assessment of dominance, it seems to place an excessive weight on market shares, which are used not only to establish safe harbours but apparently may also give rise to a (rebuttable) presumption of dominance, in spite of the well known fallacies of this instrument to assess market power, particularly in cases of abuse.

A second fundamental issue on which it would be useful for the paper to shed further light is what it means by the terms "effective competition" and the "competitive price", as liberally used throughout the section. Even a theoretical discussion of what is meant by the Commission when it uses these terms would be useful. It clearly cannot mean the textbook standard of perfect competition, which is rarely, if ever, observed in real world markets. So, in a world with fixed costs, and other "imperfections", such that firms are unlikely to cover their costs with marginal cost prices, what exactly is meant by effective competition? This is not a purely academic question, as throughout the section on dominance the Commission contrasts the position of a dominant firm with that of firms in competitive markets. Unless the benchmark against which dominant firms are to be contrasted can be clearly articulated (i.e. what is effective competition), it is impossible to know whether, in any particular case, a firm is deviating from that benchmark and may therefore be considered dominant.

3.2 Market definition

The discussion of market definition correctly identifies the cellophane fallacy as a fundamental issue in market definition in cases in which the pre-existence of significant market power is suspected. This is undoubtedly true, but we do not agree that the problems associated with the cellophane fallacy apply to the application of the SSNIP test "in particular". In fact, as a conceptual framework for market definition, we are unaware of any adequate alternative to the SSNIP test. In our view the guidelines should explicitly state that the appropriate market definition test in such cases should be the SSNIP test applied at the competitive price level. The possibility of using a different conceptual approach to market definition from that embodied in the SSNIP test should be expressly rejected by the guidelines. Ultimately the issue is not about conceptual alternatives to the SSNIP test, but rather about the interpretation of evidence, in the light of the possibility that prices have been elevated above the competitive level.

When dealing with pre-existing market power all market definition techniques are tainted by the cellophane fallacy and it would be a matter of considerable concern if the existence of the cellophane fallacy were to lead to the rejection of the SSNIP test and the conceptual rigour that it brings to market definition. Inevitably, whatever alternative were put in its place would be less rigorous and would remain subject to the problems associated with the cellophane fallacy, even if less transparently so than the formal SSNIP test. For example, consideration of product characteristics may be useful, and should surely be used to inform the market definition debate in Article 82 cases, but whether the characteristics of two different products are such as to make them substitutable in use from the perspective of the customer is inextricably linked to their perceptions of the relative price of the two products concerned and hence is affected by cellophane fallacy considerations.

The guidelines cite ways in which the difficulties of market definition in this context may be addressed. The approaches considered are sensible and should be considered in any practical attempt to define markets under Article 82, but all have very serious problems and do not constitute a complete solution to the problem either individually or in combination. Notably, reconstruction of the competitive price is likely to be virtually impossible in almost all cases, not least without any clear definition of what the competitive price should be, even in theory (see point above). Price concentration studies may be worthwhile, but must be undertaken with care (as noted in the DP). They are really only one method of attempting to reconstruct the competitive price.

We agree with the Commission that market definition may be frequently applied in markets relevant to the discussion of abuse, without cellophane issues arising, where that is not the market in which the allegedly dominant firm is currently believed to hold market power. This is to be particularly welcomed if it means that the Commission will employ rigorous market definition techniques to associated markets (e.g. the tied market in tying cases), potentially resolving issues of whether competition can be harmed by the alleged abuse on market definition grounds (e.g. the market is wider than the set of products which the potentially foreclosed rival currently supplies). If this is the case, an express statement to that effect would be welcomed.

3.3 Dominance

The main problem with the discussion of dominance is that it largely presupposes that a satisfactory market definition can be found, even when the preceding discussion of market definition strongly indicates that such a satisfactory solution to the problems of market definition in abuse of dominance cases is never likely to be found.

Moreover the discussion of what constitutes a dominant firm, as with many other sections of the discussion document, seeks to describe standard economic principles in terms that make them compatible with past case law, and is less logically argued and less compelling as a result. Notably, in line with case law, dominance is defined as a leading position on a market, which gives the firm concerned the ability to behave (e.g. price) independently of market constraints. As the discussion of market definition makes quite clear, even dominant firms face competitive constraints at prevailing prices, once they have raised price above the competitive level. It is only at the (undefined) competitive price that such firms are unconstrained by their competitors. It is somewhat clearer to define dominance solely as the ability to price above the competitive level (subject to the caveat of the latter concept not being defined), although it is not immediately apparent how the ability to price above the competitive level is synonymous with behaving independently of competitors (at least, not when this is considered at prevailing prices).

The discussion of profits as an indicator of dominance states that high profits may signal the existence of a dominant position, although there is no discussion of the profound problems associated with measuring profitability relative to an asset base which excludes those intangible assets which may effectively represent capitalised monopoly profits. If such assets are included, such analysis, properly conducted, would tend always to show only normal profits. Attempts to correct for these problems, by carving out assets, then run the risk of artificially suppressing the capital base so as to generate the perception of excess returns. This then leads into very difficult territory regarding the appropriate value to ascribe to brands, IP, and other "legitimate" intangible assets.

The DP also claims that if a firm must lower its prices in line with rivals then this would be considered as evidence of the absence of dominance. Whilst we welcome rules that might allow for the positive identification of non-dominance, a rule based around the reaction to rival price reductions seems to be flawed. Clearly, if we start from a position where a dominant firm is pricing up to its closest competitive constraint (i.e. fully exploiting its market power), then if a competitor lowers its price the dominant firm will naturally have to respond. This merely confirms that it is competitively constrained at prevailing prices, but says little about the extent of the constraints it would face at the competitive price level. As such, responding to rivals is not necessarily informative about dominance. It is all the more surprising that the DP uses this test for non-dominance, since many of the pricing practices condemned by the DP involve precisely this kind of selective price response to competition. On the one hand, the DP suggests that a firm that is obliged to reduce price to meet a competitive threat cannot be dominant; later, it suggests that the very same kind of targeted price cuts are indicative of abuse. In fact neither statement is justified in terms of economic principles.

At a practical level, the DP appears to rely excessively on market shares in the assessment of the "market position" of the firm with respect to its rivals. While it is reasonable to consider market shares in order to have "first indications of the market structure and of the competitive importance of the various undertakings"[51], and they constitute a practical tool to establish safe harbours, they generally do not provide sufficiently robust guidance to be relied upon to reach even a rebuttable presumption of dominance. For example, in bidding markets or other markets where rivals can compete for a substantial portion of demand of all or most customers, a firm is not likely to have substantial market power as long as it faces credible bidders. In other words, a firm is unlikely to be dominant where its product is not a "must have" product with respect to a substantial proportion of demand.

51 Paragraph 29.

One of the most striking points in this section of the DP is the suggestion that dominance could be found at market shares of 25% or less. Notwithstanding the profound problems of market definition, as a practical matter allowing for the possibility of dominance starting at such low levels of market share will extend the inherent uncertainty surrounding dominance to many more firms than currently perceive themselves to be at risk with the effective hurdle set at or around 40%. Whilst we would agree that a theoretical risk of significant market power arising at these levels may exist, the number of instances is likely to be small and the cost of widening the net, in terms of increased uncertainty for a potentially substantial number of businesses, is likely to be high. We would therefore see merit in the guidelines referring to a higher threshold, so as to introduce at least a degree of certainty into an intrinsically complex and unclear area. The cost of such an approach may be to limit the discretion of the Commission in those rare cases where market power may arise at lower levels, but this would appear justified given the benefits of relative clarity that this would provide for a considerable number of firms.

The DP rightly considers the role of barriers to entry in the determination of dominance, although again greater theoretical clarity would be useful. For example, the DP talks of IP not creating a dominant position *per se*. However, IP is designed to create static market power and facilitate pricing above marginal cost. Where is the boundary between acceptable IP-generated market power and unacceptable IP-generated market power? How should the concept of dominance and the associated concept of effective competition be applied to the trade-off that exists between static and dynamic competition? IP suppresses the former to promote the latter. How can this be squared with a dominance concept that is essentially static in nature? In an ideal world, all of these issues would be thoroughly aired in any discussion of dominance and its component parts, such as barriers to entry.

The DP also talks of barriers to entry that exist by virtue of the actions of incumbents. Such barriers may exist as a result of existing abuse, but should the market position of the incumbent be defined by reference to the consequences of its alleged abuse? It may make sense to do so, but this introduces an element of circularity in to the analysis, or at least, an iterative element. As such, the DP should then acknowledge that a simple, sequential analysis of the kind that most people would assume was possible under Article 82 (i.e. identify whether dominance exists and then analyse conduct) cannot be done, and that market structure and conduct mutually inform and influence each other.

In summary, it would be welcome if the forthcoming guidelines on the application of Article 82 were to make the following points:

- Clarify that there is no presumption of dominance based on market share and in every case one needs to assess the specifics of the relevant market to determine whether the firm has "substantial market power";
- Specify that bidding markets may require a specific treatment, and dominance is unlikely where credible bidders exist with respect to a significant part of the demand;
- Emphasise the importance of ease of expansion as a key factor along with ease of entry (it is noted in the DP, but not sufficiently emphasised); and
- Stress the need to analyse all available market evidence

3.4 Collective dominance

Finally, the DP talks of the possibility of collective dominance. This concept is apparently used by the DP to address two types of conduct: first, explicit agreements or other links in law and, second, "tacit" forms of collective behaviour.[52] However, the concept of "collective dominance" does not fit naturally in the context of exclusionary abuses.

52 See paragraphs 45–46.

Explicit agreements can probably be pursued under Article 81 so that it is unclear why they should be granted a separate treatment here. If the purpose is simply to highlight an area of potential overlap between the two Articles in order to ensure a consistent enforcement, this should be made clear.

More significant problems arise with respect to tacit collusion. The concept of a tacit form of coordination was developed in the economic literature in the context of pricing conducts, as indeed recognised by the DP at paragraph 47. According to these theories, rival firms would be able to reach and sustain a tacit agreement to raise prices above the competitive level. Although in principle it could be conceivable that a similar form of coordination might be achieved in order to *exclude*, this proposition needs to be carefully examined before it can form the basis for competition law enforcement.

First, to the extent that the ultimate purpose of exclusionary abuses is to raise or maintain prices at a supra-competitive level, it appears that any collusive exclusionary conduct only makes sense as part of a broader (tacitly) collusive strategy. In other words, establishing the existence of a tacit agreement *to raise prices* would appear to be a necessary condition for a finding of tacit agreement to exclude. Yet, the application of this concept to exclusionary abuses seems to reverse the third necessary condition set out in *Airtours*, namely the absence of factors that might disrupt the tacit agreement, such as new entry. The application of the collective dominance concept to exclusionary abuses seems to suggest that market entry, rather than inducing a breakdown of the (tacit) collusive equilibrium, would trigger a (still tacit) reaction from the incumbents aimed at foreclosing the entrant. Such an exceptional degree of stability of the collusive equilibrium appears highly implausible.

Second, the DP does not discuss which exclusionary strategies might be used by a collectively dominant group of firms, and how these would work in practice. For example, a tacit agreement to implement a predatory strategy seems in itself implausible.[53] In principle, a tacit collective strategy to raise barriers to entry by engaging in pure bundling or refusal to supply appears a more realistic possibility. Yet, where all incumbents follow the same commercial behaviour, it is far from clear how one would test empirically whether this behaviour is motivated by anti-competitive intent as opposed to unilateral behaviour such as the pursuit of economic efficiency or customers' preferences.

Presenting a coherent story of harm to consumers, and testing it against the facts of the case, should be a key requirement of all competition law enforcement. However, in the case of exclusionary abuses by collectively dominant firms, such a story is difficult to construct even on purely theoretical grounds, let alone to test in practice.[54] Indeed, in most (if not all) circumstances, market evidence will be consistent with both collective dominance and competition.

53
How can an understanding on predatory pricing be achieved? What kind of retaliation mechanism would make it sustainable over time?

54
Merely replicating the criteria that were developed for the quite different task of addressing a concern of price increase following a merger to the context of exclusionary abuses is clearly an inappropriate way to fill this gap.

4 Predatory Pricing

4.1 Introduction

The DP acknowledges (e.g. at paragraph 94) that "lowering prices, the directly visible part of predation, is also an essential element of competition", which a competition authority would want to encourage. Moreover, the DP implicitly acknowledges that a number of conditions are required for a finding of predation. Thus, the DP defines predatory pricing in the following way:

> The practice where a *dominant company* lowers its price and thereby deliberately *incurs losses or foregoes profits* in the short run so as *to enable it to eliminate or discipline* one or more rivals *or to prevent entry* by one or more potential rivals thereby hindering the maintenance of the degree of competition still existing in the market or the growth of that competition.[55]

55 See paragraph 93, emphasis added.

First, the predating firm should enjoy "…substantial market power on the market in question".[56] In other words, predation is unlikely to be feasible if the firm does not enjoy a dominant position. Without dominance, the possible exclusion of some competitors generally does not weaken competition, and therefore it is unlikely that the firm would be able to recoup the losses incurred in pricing low.

56 See paragraph 97.

Second, it needs to be demonstrated that the predating firm has accepted a reduction in its short-run profits. This does not necessarily mean that the company has made losses, though the Commission presents a number of cost benchmarks as relevant in assessing the likelihood of predatory behaviour.

Third, the firm's sacrifice must have been made "…with the intention to eliminate or discipline rivals or prevent their entry".[57] In other words, intent plays an important role in the analysis, even though the DP makes it clear that the Commission will not have to show intent when the price charged by the dominant firm is below certain cost benchmarks. As we describe below, according to the Commission in these cases "predation can be presumed".[58]

57 See paragraph 96.

58 See paragraph 103.

The Commission also recognises (e.g. at paragraph 97) the inherently "risky" nature of contemplated predation as a profit-maximising strategy for a firm, given that its immediate impact is a reduction in prices. Thus it is described as a strategy that is "to a certain extent self-deterring".

In this context, the DP might have been expected to set out a high threshold for intervention against alleged predation. However, it has not done so.

4.2 Dominance

The DP recognises that predation "…can normally only be effective and profitable if a company has already substantial market power on the market in question".[59] It stresses that, absent such a position, the firm in question is unlikely to be able to implement an exclusionary strategy successfully (where there are strong alternative competitors), or exploit any exclusion that occurs (where there are a large number of competitors). The established concept of dominance

59 Paragraph 97.

provides a practical threshold, below which it is reasonable to assume that sufficient market power to predate will not be held by the firm.

To put the point another way, there is no reason for competition authorities to worry because a non-dominant firm engages in a particularly aggressive pricing strategy. Even if it marginalises some competitors, the conduct does not pose a threat to competition until the firm has achieved a certain degree of market power in the market in question. Pricing low, and even below costs, is indeed normal practice for firms, for example when entering a market or launching a new product, or simply to gain market share.[60] This behaviour is normally good for consumers, and is the essence of competition on the merits. Therefore, it is not necessary and not appropriate for authorities to intervene before the firm has reached a position of significant market power, i.e. dominance. The DP highlights two scenarios where it argues predatory conduct may occur in a market in which the firm in question is not dominant. First, it is argued that a firm that is dominant in one market may sometimes set low prices in an *adjacent* market in order to protect its dominant position; for example, by making entry from the adjacent market into the dominated market more difficult.[61] However, in this case the firm under investigation faces effective competitors in the market in which the low pricing occurs. The DP does not explain why it is legitimate to drop the limb of the "need-for-dominance" argument that requires the capability of the strategy to harm competition in the first place. Dominance in an adjacent market might provide an *incentive* for the firm to exclude, but it does not in itself make anti-competitive exclusion more likely.

Second, the DP argues that predation can arise in a market without dominance, where it is implemented by a firm that has a legal monopoly in another market. Here, the Commission appears to be concerned that a firm with access to considerable financial resources may have a greater ability to predate by pricing low over a long period of time. Indeed, deep pockets may contribute to the success of an exclusionary strategy, not only by supporting the firm through the loss making phase but also by demonstrating the credibility of the exclusionary intent.[62] However, the DP does not explain why (appropriately regulated) legal monopolies should be singled out as a source of such funds. The inclusion of this proviso implies a desire to encompass cases such as the Deutsche Post case within the predation net, without identifying more precisely the general principles underpinning the specific competition concern.

Following European case law, the DP implies that a finding of dominance obviates the need to consider the possibility of recoupment. The logic for this stance is presumably that if likely competitive constraints are sufficient to prevent recoupment, then this also implies sufficient constraint to rule out dominance. Or, to turn this around, a finding of dominance implies a competitive constraint that is too weak to effectively prevent recoupment. While there may be some logical basis for this standpoint, in practice it is important to recognise that dominance assessment is almost always an inherently "noisy" process and therefore that a separate recoupment check is warranted, particularly given the high standard that should be met before a finding of predation is made, and undesirability of false convictions. Under an effects-based regime, the Commission should not be daunted by the need to tie a predation finding to a soundly based prediction of recoupment.[63]

4.3 Profit sacrifice and cost benchmarks

4.3.1 Benefits and drawbacks associated with different costs benchmarks

To assess the likelihood of predation, the DP sets out a number of cost benchmarks below which, according to the Commission, there is more reason to assume the existence of a predatory strategy and/or "…below

60 For example, in a market with switching costs it can be an optimal strategy for a firm with small market share to price low in order to gain new customers, while charging higher prices at a later stage.

61 See paragraph 101.

62 Note, however, that the absence of financial constraint should normally be considered as a legitimate *efficiency advantage* of the firm. Moreover, note that "big" firms do not necessarily have deep pockets. That is, a general presumption that firms with a large turnover are less financially constrained than smaller firms would be inappropriate.

63 A proper assessment of recoupment requires in particular an assessment of the amount of losses and the time period over which the losses are made before the dominant firm could begin to recoup; furthermore, it requires an assessment of whether potential entry or changes in technology might prevent the recoupment.

which no additional proof may need to be brought by the authority because predation can be presumed." [64]

The average avoidable cost (AAC) is defined as the average of those costs that could have been avoided if the allegedly predating company had not produced a certain amount of output over a certain period of time. There are significant benefits associated with the AAC benchmark relative to the calculation of marginal costs (MC) and average variable costs (AVC). In particular, the AAC addresses the data availability issue normally associated with the calculation of the MC, which may in principle be different for each unit of output. Moreover, unlike the AVC, using the AAC avoids the need to distinguish between variable costs and fixed costs, a distinction which often raises many difficulties and tends to be driven by accounting convention rather than the underlying economics.[65]

Another advantage of the use of an AAC concept is that it can be sensitive to the time period over which it is calculated. In particular, since the proportion of costs that are avoidable tends to increase over time, the AAC is typically an increasing function of the time period. This implies that a pricing strategy will be increasingly likely to be viewed as predatory the longer it is maintained. In other words, prices above short-term AAC can be predatory if they are maintained for a sufficiently long time. Where a firm has sustained prices below *long-term* AAC over a period of time sufficient to avoid these costs, it is reasonable to ask why it has not adjusted its strategy.

Nevertheless, one should also acknowledge that companies can make mistakes. And when revisiting its strategy to remedy for past mistakes, a firm should treat bygones as bygones. In other words, while retrospection might indicate that an alternative course of action would have been more profitable, firms' decisions are necessarily based on an ongoing forward-looking perspective. This circumstance is apparently recognised by the DP at paragraph 131:

> …[An objective] justification could be that although the price is below the relevant cost benchmark and although there is a likely exclusionary effect, the dominant company is actually minimising its losses in the short-run.[66]

The average total cost (ATC) is the average of all the variable and fixed costs. The DP rightly points out the difficulty raised by the allocation of common costs in multi-product settings when calculating ATC, i.e. of those fixed costs that are incurred for the production of several products. The DP indicates that the Commission will normally allocate common costs in proportion to the turnover achieved by the different products. However, this suggested allocation, like any order possible allocation, is clearly arbitrary. This reflects the fact that the ATC is not an economically meaningful measure whenever the allegedly predating firm produces more than one product (that is, in virtually all cases). In other words, ATC should simply not form a basis for assessing exclusionary conduct, or indeed any abusive behaviour.

Long-run average incremental costs (LAIC) excludes an apportionment of common costs, but include all sunk costs associated with an increment of activity. As such it provides little insight into the legitimacy of price levels over the short-term, or if circumstances in the market have changed. At best, LAIC might provide a useful forward-looking benchmark in judging price proposals, since all legitimate incremental projects entered into by a dominant firm ought to be able to show an expectation of recovering their investment costs at the time the investment is committed. However, an avoidable cost concept is equally well placed to play this function, since in the *ex ante* situation prior to incurring investment, those costs are also avoidable.

64 See paragraph 103.

65 Indeed, all those costs that are fixed in the short-term become variable in the longer term.

66 The DP also holds that this justification is unlikely to apply for prices below AAC. However, there is no reason to make this distinction, unless the Commission here intended to refer to *short-run* AAC.

4.3.2 Pricing below avoidable costs

In the introduction to the predatory pricing section of the DP, the Commission acknowledges that pricing is not necessarily "predatory just because the lower price means incurring losses or foregoing profits in the short-run. An investment in temporarily lower prices may for instance be required to enter a market".[67] This is a useful clarification: the DP could in principle have taken a harder line based on the existing case law, and it is encouraging that it chose not to do so.

67 See paragraph 95.

However, the DP does take a harder stance at paragraph 109, where it states that if the price charged by the dominant company is below the AAC, this is sufficient to presume that the sacrifice was made to exclude its rivals from the market. Although the Commission acknowledges that this is a rebuttable presumption, the implication is that in these cases the Commission will not need to build and test a clear theory of anti-competitive harm and, specifically, it will not need to demonstrate either the intent to predate or the possibility to recoup the losses in the longer-term.[68] This position, which is consistent with previous cases brought by the Commission (see for example the AKZO case), presents a number of drawbacks.

68 See paragraph 110.

First, it is not clear why the Commission would want to shy away from the responsibility of putting forward and testing a story of anti-competitive harm if it is implementing an effects-based policy.

Second, by focusing merely on one element of predation (i.e. pricing below a cost benchmark) and ignoring other important issues such as intent and recoupment, the DP dangerously increases the risk that genuine competitive initiatives implemented by a dominant company will be deemed to be predatory.

4.3.3 Prices above avoidable costs but below average total cost

The DP essentially follows the case-law framework established by the ECJ AKZO decision, though with average avoidable cost replacing average variable cost (as discussed above) as the lower cost threshold. In other words, when prices are above avoidable cost but below average total cost, the focus is on intent in determining whether the pricing behaviour is abusive.

Though the DP helpfully recognises[69] that it is not sufficient to identify "…internal general talk" about "crush[ing] the competition" to show predation, it argues that where direct evidence is available "…it may be assumed that the dominant company, as it has devised a clear strategy to predate, also has the means to predate". The DP therefore states that, in these circumstances, other elements of a full predation analysis are not required. This provides further evidence of a retreat from an explicitly effects based approach, and a failure to acknowledge the inherent practical difficulties in judging intent and the desirability therefore of implementing cross-checks whenever they are available. Even apparently good evidence of intent should not obviate the need for comprehensive, rigorous analysis of effects.

69 See paragraph 113.

Where direct evidence of a predatory strategy is not available, the DP states that a number of pieces of indirect evidence will be used, including whether the behaviour only makes commercial sense as part of a predation strategy, the scale of low pricing, etc. In this respect, the DP highlights evidence that the dominant firm selectively targets specific customers, particularly where they are the customers of rivals or are the customers most likely to switch to entrants, as potentially an "important part of the evidence of a predatory strategy".[70] However, since by assumption the Commission here is dealing with prices above AAC, selective low pricing is a short-run profit maximising strategy for

70 See paragraph 118.

the firm precisely where it is necessary to ensure new customers are won or existing customers are retained.

As discussed in Section 2.3.3, this approach is not supported by standard economic principles. The risk is that the Commission's stance will be interpreted as reflecting a desire to maintain a special responsibility on dominant firms in this context to accommodate the entry of rivals, even where it is (short-run) unprofitable for them to do so.

4.3.4 Pricing between avoidable cost and LAIC

The DP identifies two scenarios where Long Run Average Incremental Cost (LAIC) could replace average avoidable cost in the Commission's taxonomy.

The first scenario arises where the dominant firm has activities protected by a legal monopoly. In this case, the DP argues that a LAIC standard is required to avoid "cross-subsidisation". However, the DP does not explain why the legal monopoly operations should be making greater profits, thus providing the firm in question with a deeper pocket, than any other activity (see Section 4.2). This could be the case where regulation of the legal monopoly has failed, but the application of Article 82 should not be conditioned on this. This principle, which is misleadingly referred to as "cross-subsidisation", appears to have been drawn from the Deutsche Post parcels case. It provides an example of the inappropriate transposition of the circumstances of a particular case into a general "principle" that any guidelines should be seeking to eliminate.[71]

In such circumstances, it would be a mistake to adjust the Article 82 standards where the real issue arises with respect to effective regulation of the legal monopoly itself. The key fact to recognise is that any difference between the average avoidable cost and LAIC standards arises because certain costs are sunk and therefore outside the control of the firm going forward.

The second scenario identified concerns sectors "…which recently have been liberalised".[72] While a plausible case may be made for a more pro-active encouragement of new entrants in such sectors, this goal should not affect the standards applied under Article 82. Rather it is an argument for separate, sector-specific regulation, as set out in the EC regulatory framework for electronic communications. Crucially, the fact that particular industry characteristics make entry inherently difficult and often inefficient, e.g. because substantial sunk investment is required, should not cause the standards against which a dominant firm's behaviour is regarded as abusive to change. Paragraph 126 seeks to justify the use of an LAIC benchmark in the telecoms sector (and perhaps other formerly regulated network utility sectors) on the grounds that they have particularly high fixed costs. No empirical justification for this is provided, and we believe it is unlikely to be sustainable.

While it is true that in an industry which has substantial sunk costs (i) it is unlikely that a firm will be found to be pricing below average avoidable costs (i.e. presumptions of predation will be rare to find under conventional standards), and (ii) entry may be unattractive at prices substantially above average avoidable costs, this should not cause a change in the required standard. The fact that the avoidable cost benchmark is low simply implies that the range where pricing is likely to have a plausible pro-competitive explanation is relatively wide. This does not provide the basis for increased intervention.

Furthermore, the sector specific implementation of an adjusted standard again suggests a form-based approach (conditioned on the firm's sector) being preferred to robust, effects-based analysis.

71
As far as we understand, due to the very extended period over which incremental losses were incurred by Deutsche Post in the parcels case, Deutsche Post failed the appropriate avoidable cost test in that case. Thus there is no need to have recourse to a LAIC standard to question the legitimacy of Deutsche Post's behaviour.

72
Paragraph 126.

4.3.5 Pricing above ATC

Although any definition of ATC is inherently arbitrary, and we have argued above that this cost benchmark should play no role in identifying the existence of predatory pricing, there could be some value in adopting an ATC benchmark in order to define a clear safe harbour for dominant firms, providing a reasonable degree of certainty that prices above this threshold will not be deemed predatory. While it may well be the case, as with most safe harbours, that one can envisage circumstances where pricing above ATC might eliminate rivals and thus ultimately harm consumers, there must be recognition that at an appropriate threshold this risk to consumers is outweighed by the collateral damage to competition from excessive intervention. As in other areas, the classic need to balance Type I and Type II errors is relevant in applying the abuse of dominance criterion.

Where a dominant firm covers all its costs in totality and the incremental costs associated with each particular product, then its pricing structures are perfectly sustainable even over the long-term. Such pricing is consis-tent with robust competition. It would be wholly arbitrary and uneconomic if a dominant firm's exposure to predation charges was sensitive to whether the pricing patterns adopted happened or not to reflect the common cost allocation methodology adopted by the Commission.

This stance is all the more surprising given the recognition that predation is at best a risky strategy and generally "self-deterring".

In fact, the DP raises the prospect that a firm may be obliged to concede sales to a less efficient competitor, even though it could price at a level above ATC which recovers all costs and still win those sales (see Section 2.3.1 above). We do not agree with this approach. It is conceivable that, at least in a static sense, even inefficient entry would deliver gains to consumers (a concept that has been embodied in the phrase "inefficient competition may be better than no competition at all"). However, even if the dynamic consequences of such an approach are ignored, it should not be the (special) responsibility of dominant firms to sponsor such market outcomes. Requiring dominant firms always to accommodate even less efficient entry under Article 82 provisions effectively amounts to imposing higher prices on consumers in order to subsidise the new entrant. As discussed in Section 2.3.1, engaging in this type of opaque and inefficient form of active industrial policy is not an objective that can be efficiently pursued under a prohibition-based law against abuse of dominance.

4.4 The efficiency defence

At paragraph 133, the DP states that:

> An efficiency defence can in general not be applied to predatory pricing. It is highly unlikely that clear efficiencies from predation can be shown and … that these benefits outweigh the loss of competition brought about by the predation.

The DP's sceptical stance on efficiencies arising from low-pricing (and potentially predating) behaviour is questionable at least for the following reasons.

First, the approach set out by the Commission is inconsistent with the more open approach adopted *vis à vis* other practices covered in the DP, such as fidelity rebates or bundling. As all these practices have potentially exclusionary effects, it is difficult to see on what grounds a different standpoint can be justified, apart from satisfying a perceived need to remain coherent with existing legal precedents.

Second, it is clear that at least in the short-term consumers benefit from any low prices charged by the dominant firm. This certain and indisputable benefit, which paragraph 133 of the DP seems to totally ignore, has to be assessed against the uncertain risk of higher prices that may result in the longer-term should the dominant firm's rivals exit the market. This trade off between certain benefits in the short-term and uncertain anti-competitive effects in the long-term implies that compelling evidence should be required to establish that a dominant firm has engaged in predatory behaviour.

5 Single Branding and Rebates

5.1 Introduction

Section 7 of the DP sets out the Commission's suggested framework within which to assess the potential exclusionary effects of discount and rebate schemes operated by dominant firms.

There is insufficient regard paid to benign and pro-competitive reasons for discounting. There should be a clear statement up front that, in general, low prices and pricing freedom are to be encouraged, even by dominant firms. On the contrary, the DP demonstrates a considerable degree of suspicion regarding dominant firm pricing. This is exemplified by its introductory comment at paragraph 134. While this starts of with the helpful statement that: "…[a] superior price/quality ratio for individual orders of customers is unobjectionable under Article 82 because it is competition solely based on the merits", the same paragraph goes on to state that a supplier "…may *however* use single branding obligations and rebate systems to attract more of customers' demand". This implies that attracting demand from customers would constitute harm.[73] However, a firm seeking to increase its sales through offering customers a more attractive price, may well be a form of legitimate competition on the merits. Indeed, the fact that pro-competitive motives for such rebate schemes exist is best evidenced by the fact that non-dominant firms engage frequently in same practice to deliver lower prices at the margin and to encourage downstream effort (e.g. in activities which expand market demand).

73
Similarly, at paragraph 141 the DP states: *"Exclusionary rebates are in general conditional rebates which may differentiate the price for each customer, depending on its purchasing behaviour, in order to obtain more purchases from these customers…"* (emphasis added). This is unhelpful because the term "exclusionary" is pejorative. This definition fails to recognise that discount schemes can be *pro-competitive precisely because they obtain more purchases from their customers.*

While the introduction of a cost test for the assessment of "fidelity rebates" is welcome, in particular because it signifies a shift in stance away from a *per se* approach, the choice of benchmark is not appropriate. The ATC pricing benchmark for rollback rebates, share of needs rebates, customised targets, growth targets and selective price cuts is too restrictive of pricing freedom. Further, the DP gives too much credence to the possibility that pricing above ATC could be abusive. Both these factors are a major concern and give rise to a considerable risk of chilling effective price competition.

The chapter would benefit from drawing together some common points in the analysis. We would suggest that the DP highlights initial screens to assess the feasibility of foreclosure and the likely effect of the scheme in question on incentives and only then looking at more detailed tests which assess whether prices are below the chosen measure of cost.

In part the DP seeks to offer some common themes at 145. However, this paragraph needs some clarity and context.[74] It would be helpful, for example, if the DP began with something along the lines of: "Foreclosure relates to a market and not a specific customer. Therefore the Commission will consider whether foreclosure of the market is feasible. In some cases it will not be because alternative routes to market exist through which the rival in question can obtain an efficient scale of production. In assessing these issues, the incidence of the discount scheme is important…."

74
In addition, the paragraph could usefully avoid leaving the door open for over-intervention by offering more clarity for the phrase "a good part of the market" and by removing the suggestion that only a modest incidence of a rebate scheme could lead to foreclosure.

While the notion of a captive base is helpful, it is not easy to measure accurately and it is not appropriate to assume that: "the dominant position will in general ensure that most buyers will anyhow purchase most of their requirements from the dominant supplier".[75] This is not a general rule and must be tested against the relevant facts.

In the rest of this chapter, we expand on these points in more detail, with comments on:
– the framework for analysis of rollback discount schemes;
– the analysis of unconditional discounts and the choice of cost benchmark, which needlessly restricts dominant firms' freedom to act as rational profit maximising entities; and
– the use of an average total cost (ATC) benchmark throughout the Section.

5.2 Rebates and foreclosure of competitors

The DP recognises the fundamental distinction between rollback discount schemes, incremental conditional rebates, and unconditional discounts. As discussed below, the analysis of all three forms is predicated on an incorrect cost benchmark. Setting the cost standard aside for the time being, this Section presents a critique of the Commission's proposed approach to investigating exclusionary effects within the first and third type of scheme.

5.2.1 Rollback rebates

Rollback rebates occur where a supplier sets customers a target level of sales, beyond which a discount is applied not only to that customer's purchases above the target, but to all of its purchases. The DP sets out its explanation of how it will assess such schemes at paragraphs 152 to 165. This methodology is poorly explained. Our high level understanding of the DP's approach is set out below. We then comment on each step in the assessment process (as we understand it) in more detail.

We understand the DP to set out the following step-by-step process for the assessment of rebate schemes. As we interpret the scheme, each step represents a screen that may either eliminate a scheme from further consideration because foreclosure effects are not feasible, or require more analysis at the next assessment step.

First, consider whether a rollback scheme's sales target is sufficiently low relative to customers' total needs as to be unlikely to affect customer behaviour.[76] Where this is the case, the scheme is unlikely to have exclusionary effects.

Secondly, consider the "suction effect" – i.e. the fact that reaching the target provides a discount on all units up to that point. Given that the case was not dismissed at the first screen (i.e. the target is set beyond the captive base), the implication is that the discount is targeted in the contestable part of the market.[77] The aim is to assess the effect on commercially viable amounts supplied by (potential), as efficient, competitors of the dominant supplier.[78] In particular, the idea is whether a firm could operate at its commercially viable share and compete for those units just prior to the dominant firm's target (i.e. compete for those units where the "suction effect" is strongest). If so, argues the DP, then if the commercially viable share is 20 units, and the target is 100 units, the implied price of the block of 20 units up to the target (i.e. the 81st–100th unit) must not be below the ATC of the dominant firm. In order to carry out this implied price versus ATC test, there are the following possible steps:[79]

– First, the required share is calculated (the RQS). This requires finding the point after which the extra per unit expenditure required by the customer to reach the target exactly equals the average total cost of producing the extra units purchased.[80] The DP uses the

75 Paragraph 152; see also 143.

76 See paragraph 152.

77 See paragraph 153.

78 See paragraph 154.

79 At paragraph 164, the DP states that where information is not reliable regarding the dominant firm's costs, an *"apparently efficient competitor"* would be considered. However, why would it be *more reliable* to invent a hypothetical efficient firm? The DP should acknowledge that conclusions would inevitably be harder to draw if such a cost test were employed. We discuss this further below.

80 Suppose that ATC is 5 euros. Suppose also that the list price is 10 euros, the target is 100 units and the discount is 10%. A rollback rebate means that on reaching the target the buyer obtains a "refund" of 100 euros. Thus, it costs 900 euros to purchase the target quantity. Purchasing 80 units costs 800 euros. The implied price is therefore 100/20 = 5. This equals ATC. Thus, the RQS is 20% (i.e. 100 – 80) / 100.

expression "required share" because the Commission considers that the rival must capture at least this share to be able to compete. Thus, if rivals' actual shares with a given buyer exceed the RQS, the Commission considers that the scheme will not have a foreclosure effect.[81] Where the actual share of a rival is below the RQS, we move to the next step.[82]

– Second, the commercially viable share (CVS) is measured. The CVS is defined as "the share of customers' requirements an efficient entrant can reasonably be expected to capture".[83] According to the DP, if the CVS is below the RQS, the scheme "is likely to have a foreclosure effect".[84] The DP does not explain the logic of this test. One possible explanation is as follows. If the rival operated at a plausible viable scale and could compete *only for those units where the suction effect is the strongest*, then the rival could not operate profitably.
– The Commission will first approximate the CVS by using the industry minimum efficient scale.[85] If the minimum efficient scale is not sufficient to "overcome" the RQS across which the suction effect implies below cost pricing, the Commission will go on to investigate the likelihood that entry would in fact occur at a greater scale. If, after this investigation, the Commission still concludes that entry would likely be at a scale below the RQS, then it will conclude that the rebate scheme has an exclusionary effect.

This process is surprisingly detailed and yet, despite that detail, leaves open important questions and misses a fundamental point.

First, what matters is whether there is sufficient room for a rival to operate efficiently. If the minimum efficient scale is very small, rivals are less likely to require access to the part of the market where the suction effect is the strongest and so are less likely to be foreclosed. Indeed, most theoretical models of foreclosure require economies of scale (or network effects) to be substantial – paradoxically, the DP argues that if the minimum efficient scale is low, foreclosure is *more* likely.[86] This is a fundamental concern with the DP's approach.[87]

Second, there is much detail as regards the CVS versus RQS distinction and this risks downplaying the very first screen (i.e. is the target sufficiently low relative to customers' total needs that foreclosure is not feasible?). As explained above, if the minimum efficient scale is low, then even if the target accounts for a relatively high share of a buyer's needs, this may not lead to foreclosure because there is scope for rivals to operate efficiently at low levels of output.

Third, the DP does not indicate whether an assessment of the CVS will take into account the volume of non-captive sales available for rival firms. Suppose that a buyer's needs were equal to the target (i.e. if the buyer meets the target, it will not buy from the rival at all). In this case, the issue is whether the contestable share exceeds the RQS. If so, then an equally efficient rival could profitably undercut the dominant firm by competing for all of the contestable sales. If not, the contestable segment is foreclosed.

These criticisms highlight two issues. First, the CVS is a vague concept open to a great degree of discretion. It would be a shame to spend considerable effort on determining the CVS when the theory underpinning the CVS-RQS test is not fully thought through. Second, and more generally, this highlights the problem of using complex rules that are allegedly grounded in economics to determine abuse (the DP's version of an effects-based regime), instead of setting out high level principles which are applied on a case by case basis to determine the likely effect of behaviour in question (a better approach, see the conclusion to section 2 above).

81 See paragraph 155. We note the seemingly nonsensical statement in the same paragraph that a rival operating below RQS would "have to more than double its sales" in order to overcome the foreclosure effect. We cannot see any basis for this statement.

82 The DP is unclear whether this is one step of many or a test in itself. Presumably the former. The DP states that where "…the shares of the customers' requirements purchased from actual rivals are smaller then the required share, the rebate scheme is likely to have a foreclosure effect where there is in addition no indication that these rivals are less efficient". This presumption is overly strong and places a burden on a dominant firm to demonstrate its rivals' inefficiency. Even if the Commission's CVS versus RQS comparison were without problems, an absence of rivals currently operating above RQS should only be used to proceed to the CVS stage of the process, not as sufficient evidence of exclusion.

83 See paragraph 156.

84 See paragraph 156.

85 See paragraph 157.

86 The minimum efficient scale is the first approximation for the CVS. If the former is low, then it is more likely that the Commission will find the CVS to be below the RQS.

87 Consider, for example, a scheme where the target is set at 90% of the buyer's needs. This would most probably fail the first screening step discussed above. If the minimum efficient scale is 1%, then the first approximation to the CVS will almost certainly be below the RQS. However, even if the buyer purchases up to the target, there remains room for ten rivals to operate efficiently in the market and so it is hard to imagine that there is a foreclosure effect.

Thus, the RQS test could lead to false positives and false negatives. First, if the CVS is calculated without regard to the captive sales (assuming the latter can be measured accurately), the estimated CVS may overstate the number of sales that an efficient rival could expect to make, and so its ability to overcome the suction effect of the rebate (a false negative). On the other hand, the RQS may be estimated to exceed the CVS even though the captive base is so small that the contestable share of sales exceeds the RQS substantially (a false positive).

The Commission draws together its analysis at paragraph 162, where the DP sets out five steps which must all apply before presumption of foreclosure is made:

a) The rebate is conditional with rollback discounts;
b) The threshold set is likely to incentivise a "good part" of the dominant company's buyers by penalizing them if they switch;
c) The RQS exceeds the CVS;
d) The dominant company applies the scheme to a "good part" of its buyers and "therefore affects, if not most, at least a substantial part of the market";
e) There are no clear indications of a lack of foreclosure effect such as aggressive or significant entry/expansion or switching by customers.

On the positive side, there are some hurdles established and a link to costs and so there is a welcome movement away from a form based approach. The Commission goes some way towards asking the following questions: Does the scheme affect incentives? Is foreclosure feasible? Is there implied pricing below cost? Is there a fact based story of harm to competition?

However, several concerns remain, apart from the problems with step (c) explained above. First, steps (b) and (d) are focused too much on the dominant firm's *buyers* and this downplays the fundamental point that foreclosure relates to a market and not the dominant firm's customers. The dominant firm's customers cannot be presumed to cover all of the market – that must be tested against the evidence. This point could be made in relation to the meaning of "a good part of the market", a vague phrase which needs more discussion.[88]

Second, step (e) could usefully be bolstered by a clearer statement that an absence of evidence of foreclosure is strong evidence against a scheme having exclusionary effect.

Third, the screen at 162(b) could usefully be stated earlier. The DP is not clear on the chronological order in which it will approach the assessment (and the appropriate order will not always be the same), but this screen could be applied early on, before the more in depth RQS/CVS tests. This would avoid wasteful use of limited regulatory resources and provide a clearer signal as to the approach to enforcement. As noted above, the screen should be extended to consider whether there are alternative routes to market (i.e. without using the dominant supplier's customers).

Finally, the Commission appears to reserve the right, even if a rebate scheme has successfully negotiated the "trial by ordeal" explained above, to hold that a scheme in which pricing below cost (however defined) does not arise over a relevant range of volumes is nevertheless exclusionary. In "exceptional" circumstances a firm with non-replicable productive advantages may be found to be abusing its dominant position by making use of these advantages.[89] This idea that some efficiency advantages should be discounted from the "as efficient competitor" benchmark leads inevitably to greater uncertainty and to a regime of "managed competition", whereby the Commission gets to judge which efficiency advantages are justified and which are not. We believe

88 Paragraph 162 (b) simply considers schemes in which "…the threshold is set so low that for a good part of the dominant company's buyers it can not hinder them to switch to purchase substantial additional amounts from other suppliers without losing the rebate". This condition seems to be asking the sensible question of whether the kink in the dominant firm's pricing schedule lies so far to the left of total demand that the "suction" effect is not relevant. However, it should go further to consider alternative routes to market other than the dominant firm's buyers.

89 See paragraph 165.

that the Commission should forgo this wide-ranging and arbitrary privilege to interfere in the competitive process.

5.2.2 Unconditional rebate schemes

While rollback rebates are a form of conditional discount, that is, discounts offered in response to customers' purchasing behaviour, unconditional discounts are offered to particular customers independent of their purchasing patterns. The DP states that such discounts may be exclusionary where a dominant undertaking charges lower prices to customers particularly likely to switch to competitors.

This position directly imposes a special responsibility on dominant firms not to compete on price, by removing their ability to price discriminate. Simple economic theory tells us that a firm will choose its price with reference to its own marginal production costs, and the alternative options available to potential customers. It is due to the availability of substitutes that an oligopolist will charge a lower price than a monopolist, all else remaining constant, and such pricing in response to other firms is the essence of competition. Thus a customer lying in a particular region such that it can choose between two suppliers benefits from the competition between these two firms in terms of lower prices. The DP, however, would regard an attempt by a dominant firm to compete for that customer's business as abusive, denying that consumer the benefit of the price competition that would otherwise occur. This stance can only harm consumer welfare, by reducing the vigour with which a dominant firm competes for elastic segments of demand.

The DP's statement that "…direct exploitation takes place by discriminating between customers and making customers with a higher willingness to pay and less switching possibilities pay a higher price than others" also contradicts the Ramsey pricing principle by which fixed costs may be efficiently recovered through price discrimination. By seeking to impose linear pricing on dominant firms, the DP would eliminate scope for firms to expand their markets by attracting marginal consumers that are willing to pay the variable but not fixed costs of production. Denying these consumers access to the good is to the detriment of consumer welfare unless the pricing in question can be shown to be part of a predatory pricing campaign.

We regard the discussion of exclusionary unconditional discounting provided at paragraph 171 as unnecessary. Insofar as a dominant firm is excluding current or potential rivals by targeting their customers with below cost prices, this behaviour should be captured by the provisions of Section 6 of the DP. By seeking to extend the predation principle to pricing below ATC (as discussed below), paragraph 171 can serve only to chill potentially dominant firms' incentives to engage in vigorous competition.

5.3 The cost benchmark employed

The exclusionary harm identified by the DP in respect of the various rebate schemes considered at Section 7 is analogous to predation. The fundamental concern in each case is that a dominant firm may use discounts as a tool by which to supply rivals' potential customers at a price that these rivals, even if as efficient as the dominant firm, are unable to match profitably *and* that this has an adverse impact on competition. The DP's analysis of predation, set out at Section 6, proposes the use of an average avoidable cost (AAC) benchmark, which asks whether in serving a particular customer or group of customers the dominant firm covers the additional costs associated with doing so (measured over the relevant time period). Where a firm's pricing fails this test it may be evidence that its behaviour is motivated by other than ordinary competitive considerations – i.e. there is a reason to investigate further.

In respect of rebate and discount schemes, however, the DP switches from an AAC benchmark to an average total cost (ATC) criteria. Where a firm's price to a customer or group of customers does not cover its ATC the Commission will draw a rebuttable presumption of exclusionary effect. This standard is inconsistent with the (valid) statement in Section 6 of the DP that prices "above average total costs are in general not considered to be predatory because such pricing can usually only exclude less efficient competitors".[90] Put differently, the role of the ATC benchmark is switched from safe harbour to a test of harm.

90
See paragraph 127.

Moreover, the setting of price above AAC but below ATC is one of the principal efficiency-improving benefits of rebate systems. Where fixed costs are covered by higher priced sales for which there is a high willingness to pay, it is in the supplier's rational business interest to continue to expand sales at a lower price in order to supply customers that are willing to cover the incremental cost of production. Clearly such a practice is in the interests of the marginal customers concerned, who are able to consume a good that would be denied them in a situation of linear pricing, and of social welfare as a whole.

As well as being inconsistent with the proposed analysis of predation set out in the DP, the Commission's suggested approach to the assessment of rebate schemes is inconsistent with that applied in regulated industries. Even where a firm has a captive base conferred by a legal monopoly, on entering an open market it would only be required to price above its long-run average incremental costs on that market. That is the firm must cover the additional fixed and variable costs required to operate on the free market. There would be no requirement to cover overheads associated with the regulated activity *as well*. Hence, under the approach set out in the DP, a dominant firm that has established a captive base through its own efforts would have less freedom than firms that have been arbitrarily awarded a captive base by dint of a legal monopoly.

The DP seeks to justify the use of the ATC, rather than AAC, cost measure by noting that rebate schemes are usually indefinitely sustainable, precisely because they will usually be profitable. On the basis of discounts generally being long-run phenomena, the Commission *presumes* that a long-run cost measure, such as the ATC, is appropriate. This presumption is on the basis that leverage is possible from the "captive" to the "contestable" sales, however, which biases the test by assuming that leverage, which we are testing for, occurs. This *a priori* bias is valid only if we are determining a safe harbour – that is, to state that a scheme in which price is above ATC can be presumed non-exclusionary, but not *vice versa*.

Finally, there are practical problems with the use of the ATC. The relevant ATC is not an easily identified and readily observed cost measure, as there is no economically correct way of allocating fixed costs amongst multi-product firms' activities. The DP appears to implicitly recognise this difficulty at paragraph 164, in which it states that if the dominant firms' costs are not available, the Commission will use cost data of "apparently efficient" competitors. This is a worrying statement. Inventing hypothetically efficient firms is a dangerous approach with significant scope for undermining the equally efficient competitor test. As we have commented above, the concept of avoidable costs can deal with the relevant economic phenomena without the need for such complications and arbitrary calculations. In particular, since a wider set of costs becomes avoidable over a longer time horizon (e.g. because the firm will typically have to make conscious decisions to replace capital assets that might be fixed in the short-term) avoidable cost can clearly encompass the situation in which a rebate scheme is a permanent feature of a firm's pricing policy.

6 Tying and Bundling

6.1 Introduction

Section 8 of the DP addresses the exclusionary effects of tying and bundling. The paper usefully recognises that "tying and bundling are common practices that often have no anticompetitive consequences".[91] Indeed, these practices are highly likely to be a source of efficiency gains. This general proposition is supported by empirical evidence as well as by theoretical economic analysis. Tying and bundling are widely used in competitive markets, presumably because of their potential to enhance efficiency.[92] This suggests that the same efficiencies can also be generated when these practices are used by dominant companies. On a theoretical level, it has been noted that not only do companies often lack any incentive to foreclose, but in many circumstances they have the incentive to actively foster an efficient organisation of supply in complementary markets (see Section 2.2.2 above).

91 Paragraph 178.

92 Salinger and Evans, *op. cit.*

Certainly tying and bundling practices can also be used for anti-competitive purposes which may harm consumers. However, economic analysis shows that this is likely to happen only in specific circumstances. In these cases, the generally pro-competitive or benign nature of these practices warrants a unified assessment of both efficiencies and potential harmful effects. This is for two reasons. First, because of their potential to generate efficiency gains, tying and bundling are often a short-term profit-maximising strategy even in those cases where they may lead to the marginalisation of (less efficient) competitors. Second, the economic analysis shows that the efficiency gains and the anti-competitive effects normally have the same source, so that a coherent theory of harm cannot be developed without taking account of both effects. In contrast, the approach suggested by the DP creates a serious risk that dominant firms will be discouraged from engaging in pro-competitive bundling and tying practices that would benefit consumers.

We also note that a coherent assessment of the effect of tying and bundling on consumers is further complicated by the absence of any explicit analysis of price discrimination in the DP (see Section 2.3.3 above). In most circumstances, tying and bundling combine some form of price-discrimination with other objectives. For example, mixed bundling naturally divides customers into those who use both bundled products and those who use only one component. Ties can also be used as an instrument to achieve price discrimination: a notable example is the tying of toner cartridges and photocopier machines as a means to "meter" use so as to charge a higher price to more intensive users.[93] Crucially, price discrimination is pro-competitive or at least competitively neutral in most circumstances.

93 *The efficiency-enhancing effects of non-horizontal mergers, op. cit.*, Section 4.2.2.

The remainder of this section analyses the specific recommendations made by the DP for the assessment of tying and bundling practices. The DP indicates that four conditions must be met in order for the Commission to establish that the behaviour is abusive under Art 82.[94] These are:

94 See paragraph 183.

- that the company concerned is dominant in the tying market;
- the tying and tied goods are two distinct products;
- the tying practice is likely to have a market distorting foreclosure effect; and
- the tying practice is not justified objectively or by efficiencies.

Each of these steps is discussed in the following.

6.2 Dominance

The DP holds that "…for tying to be abusive the company needs to be dominant in the tying market. It is not necessary that the company also is dominant in the tied market." This is a helpful screening criterion that is consistent with both the case law and economic analysis. Indeed, most economists agree that foreclosure is very unlikely unless the company has a significant degree of market power in the tying market.

6.3 Distinct products

The DP takes the view that a necessary first step in the assessment of tying and bundling is establishing whether the allegedly tied products are "distinct products". This is a well known problem that notoriously has no clear solution. Virtually all products can be seen as a "bundle" of components, but this does not necessarily warrant anti-trust intervention. Even more importantly, products often evolve over time, so that goods that were sold individually in the past are later integrated into a single product. The opposite evolution is also frequent. This dynamic is driven primarily by considerations of economic efficiency and consumer preferences and is commonplace in competitive markets. As we argue above, there is no *a priori* reason to see with suspicion this sort of innovation, even when it is undertaken by dominant companies.

The criterion retained in the DP to identify "distinct products" is to test whether "in the customers' perspective, the products are or would be purchased separately".[95] In spite of its intuitive appeal, this approach falls in well known traps. For example, does the fact that Ikea sells unassembled furniture indicate that other shops are bundling furniture and "assembling services"?[96] Further, this criterion can lead to paradoxical results when used to assess whether a bundle is used to foreclose potential competitors, i.e. to prevent entry. A narrow application of this approach would imply that almost any product is a "bundle", provided some customers would be willing to purchase one component from a possible independent supplier.

95 Paragraph 182.

96 Arguably, unassembled furniture is better seen as a lower-quality product. See J. Tirole, "The Analysis of Tying Cases: A Primer", working paper, 2004.

The impossibility of defining what is a distinct product highlights the fact that the assessment of tying and bundling practices can be controversial when it relies on *per se* rules. This problem has no easy fixes. In terms of the DP's suggested methodology, it means that one of the "necessary" conditions is literally untestable, which cannot be satisfactory. Nonetheless, an analysis of the firm's possible incentive to foreclose, and of the impact on consumer welfare, can provide at least a partial solution to this problem by focusing attention on the effects of the possible bundling practice rather than on formalistic distinctions.

6.4 Market distorting foreclosure

The main competitive concern addressed by the DP is the risk that tying or bundling result in the foreclosure of competitors in the tied market. The paper organises this assessment in two steps. First, the Commission should establish "which customers are 'tied' in the sense that competitors to the dominant company cannot compete for their business". Second, it must establish "whether these customers 'add up' to a sufficient part of the market being tied". The DP holds that "… where the Commission, … finds that the dominant company ties a sufficient part of the market, the Commission is likely to reach the rebuttable conclusion that the tying practice has a market distorting foreclosure effect and therefore constitutes an abuse".[97] This suggested approach raises two general questions. How can we distinguish cases where rivals "cannot compete" from those where they are simply disadvantaged with respect to the dominant firm? What is the benchmark

97 See paragraph 188.

with respect to which we can assess whether the tied customers constitute a "sufficient part" of the market?

With respect to the first part of the analysis, the DP holds that "…in the case of tying and pure bundling the individual customers in question clearly are foreclosed to the competitors". In the case of mixed bundling this is "less clear, because both products are available". The criterion adopted by the DP is that "competitors are foreclosed if the discount is so large that efficient competitors offering only some but not all of the components cannot compete against the discounted bundle".[98] The paper goes on to discuss the price-cost measures that are to be used to apply this criterion,[99] and which essentially involve calculating whether the price difference between the A+B bundle and the individual product A is sufficient to cover the incremental cost of supplying good B.

98 Paragraph 189.

99 See paragraph 190-195.

The second part of the analysis is concerned with an assessment of whether "the market as a whole can be considered to be foreclosed".[100] The DP lists a number of factors that may make this conclusion more or less likely. These include the overall strength of the dominant company in both the tied and the tying market, the identity of the tied customers, the number of customers who effectively buy both products, the existence of scale economies, and the extent of product differentiation.

100 Paragraph 196.

This approach has a number of shortfalls. With respect to tying and pure bundling, the DP seems to assume that dominance is virtually the same as monopoly power, since it assumes that the customers of the bundle are "clearly foreclosed to the competitors".[101] This extreme assertion is unjustified on economic grounds, and risks dismissing all the useful criteria provided in the second part of the analysis. Even customers of a dominant firm may consider switching to alternative suppliers if they find the price of the bundle excessive, or the tied product not adapted to their needs. In other words, a dominant company which bundles a good that its customers do not want may face a serious risk of losing a significant proportion of its customers, thereby reducing its own profits more than those of its competitors. This is a rather general proposition, although it is particularly important in differentiated product markets (as is recognised in paragraph 200). Therefore, it is quite possible that a significant proportion of the customers of the dominant company purchase the bundle out of a preference for those products with respect to competitors, rather than because they have no choice.

101 Paragraph 189.

The suggested approach to mixed bundling seeks to reproduce the type of analysis proposed for tying and pure bundling, and consequently suffers from similar weaknesses as well as some additional ones. First, we note that the price-cost criterion suggested in the DP may well find that the practice is abusive even when the price of the bundle covers the (short-term) incremental cost of selling the bundle, and therefore is profitable for the dominant firm. This is not to say that bundling cannot be anti-competitive where the incremental price covers the avoidable (or short-term incremental) cost. In fact, bundling is widely used for products characterised by a relatively low marginal cost, such as information goods, so that an AAC benchmark is likely to be of limited use. However, this fact does not justify lowering the threshold for the presumption of abuse to the LAIC level, thus potentially including a large number of truly pro-competitive practices.

Secondly, it must be considered that mixed bundling naturally implies some sort of price discrimination, even where this is not the main efficiency that it generates. Mixed bundling effectively separates the customers who intend to purchase both products from those who only need one component. This effect is not only generally pro-competitive, at least to the extent that it is a form of Ramsay pricing, but it also invalidates the approach proposed by the Commission. This is because the price of the bundle cannot be directly compared to the price of the individual components, which are sold to different customer groups that may well have different elasticities of demand.

The paper also ignores the fact that consumers are likely to benefit when competition takes the form of "competition between bundles" rather than "competition between components". The economic literature has shown that this can lead to more aggressive price competition that normally increases consumer welfare and reduces industry profits, even though some consumers who used to "mix and match" products of different brands may be made worse off.[102] In this respect, the DP makes a helpful comment at paragraph 195. However, this is contradicted, without any explanation, at paragraph 197.

102 Stole 2005, *op. cit.*

Overall, the criteria provided in the DP, and particularly in paragraphs 198 to 203, are not without merit and may be useful in the assessment of specific cases. However, these are not sufficiently general to be applied in an indiscriminate way to all circumstances, and the DP does not indicate in which cases they are appropriate. As a result, there is a serious risk that the competitive assessment would rely on a mechanical application of these criteria and would fail to distinguish harm to competition from harm to competitors.

6.5 Objective justification and efficiency defence

Where a tying or bundling practice has been found to have a market distorting foreclosure effect, the dominant company can rebut the presumption of abuse by proving that its practice is objectively justified or generates efficiencies that offset the negative impact of the practice on consumer welfare. However, the list of possible efficiencies set out in the DP is excessively short. It focuses mainly on production and transaction cost savings, even though arguably the most common benefits of these practices are related to pricing efficiencies (e.g. the Cournot effect). Surprisingly, the DP also dismisses the benefits of bundling in protecting consumers and firms from inferior or hazardous products (for which the dominant firm may nonetheless be held liable), and in protecting innovation from imitators.[103]

103 See paragraph 204. A discussion of these efficiency gains can be found in *The efficiency-enhancing effects of non-horizontal mergers, op. cit.*

7 Refusal to Supply

7.1 Introduction

When a firm operates in two complementary activities, it may have an incentive not to supply a buyer of either product if this buyer is also a competitor in the other product.

Any firm, even if dominant, is legally entitled to chose what commercial relationships to enter. As Advocate General Jacobs put it in the *Oscar Bronner* [104] case:

> The right to choose one's trading partners and freely dispose of one's property are generally recognised principles in the law of the Member States, in some cases with constitutional status. Incursion of those rights requires careful justification.

104
Oscar Bronner v Mediaprint and Others, Case C–7/97.

At paragraph 207 of the DP the Commission introduces the section on refusal to supply by stating that:

> Undertakings are generally entitled to determine whom to supply and to decide not to continue to supply certain trading partners. This is also true for dominant companies.

Given that refusal to supply may, and in most cases will, constitute a lawful exercise of property rights, any form of intervention imposing an obligation to supply should be treated with extreme caution.

Refusal to supply may take several forms: refusal to enter a new supply agreement, termination of an existing supply relationship, "…refusal to supply products, to provide information, to license intellectual property rights (IPR) or to grant access to an essential facility or a network".[105] Similarly, practices that result in an effective refusal to supply include practices such as: charging prohibitively high prices, delaying supply, and imposing unfair trading conditions.

105
Paragraph 209.

The DP purports not to consider excessive pricing abuses, but the refusal to supply discussion is one area where this position is untenable. The assessment of excessive pricing, just as the assessment of a constructive refusal to supply, requires the authorities to take a view as to the (hypothetical) competitive price level. Indeed, at the same supra-competitive price level some customers may continue to buy the product while others are excluded from the market, so that the same conduct can give rise to both excessive pricing and "refusal to supply". Moreover, any decision to intervene against a dominant firm's refusal to supply must also require the competition authority to specify the terms on which that supply should take place, i.e. in effect to act as a price regulator.[106]

106
Otherwise the dominant firm could always circumvent the regulatory intervention by charging a price that its customers would not want to pay.

It would be useful for the DP to have acknowledged this more explicitly. Doing so would have helped to establish that the circumstances in which Article 82 will be used to enforce dominant firms to supply their products to others can only apply in circumstances where the breakdown in the competitive process is so profound that only the draconian powers of price regulation can provide an adequate solution. Such cases will in practice be limited to those involving natural monopoly or access to truly essential facilities. However, the DP's failure or reluctance to see this link leads to a risk that it proposes intervention against refusal to supply in much wider circumstances than is justified, thus potentially undermining dynamic incentives and again increasing enforcement uncertainty.

7.2 Possible motivations for refusal to supply

7.2.1 Objective justifications and anticompetitive motivations for refusal to supply

Refusal to supply by a dominant firm may take the form of denying access to an essential input for production in an upstream or downstream market. This can potentially give rise to vertical foreclosure if the buyer is excluded from (or marginalised in) an economic activity in which it competes with the dominant firm. This behaviour, however, does not constitute anti-competitive behaviour *per se*. Foreclosure might be, for example, the result of the lawful exploitation by a firm of its intellectual or physical property rights.

Refusal to supply is normally justified by the owner's legitimate commercial objective in protecting the returns from its investment in or ownership of the asset in question. It might also be due to benign motives such as a genuine concern that the firm's reputation might suffer if the product is offered to an "inferior" downstream firm; lack of spare capacity; the fact that the firm refused the good or service is a bad debtor; shortage of stocks; or disrupted production.

It is clearly not sufficient that a firm is excluded from the market for the behaviour to be anti-competitive. For this to be the case it is necessary that the conduct under scrutiny causes harm to consumers (NB not to competitors), and that intervention to solve the perceived problem does not damage dynamic incentives in such a way as to nullify the original intervention.

It is important for a competition authority to check that the behaviour in question cannot also be justified as a legitimate competitive behaviour. "…If several interpretations are possible, the authority must investigate whether the data permit a distinction as to which of the different interpretations apply".[107]

107
Page 13 of EAGCP, "An Economic Approach to Article 82" (July 2005): http://europa.eu.int/comm/competition/publications/studies/eagcp_july_21_05.pdf.

7.2.2 Does it lead to foreclosure? Is this anti-competitive?

Foreclosing a competitor in a vertically related market is not necessarily a profit enhancing strategy, applied to leverage market power from one market to another. As discussed in Section 2.2.2, the well-known "Chicago school" argument demonstrates that an input monopolist supplying a competitive market at the final good (output) stage will be able to extract the monopoly profit without having to exclude its downstream competitors. There is only one final market, and only one monopoly profit to be had.

There are of course exceptions to this simple principle. "Post-Chicago" theories suggest that an upstream monopolist might be unable to extract the full monopoly profit when it is unable to commit to sell only a certain amount of the input and not to supply to other downstream competitors.[108] In such cases it is possible that refusal to supply has an anticompetitive effect, as the inability to extract the full monopoly profit due to the commitment problem will induce the upstream monopolist to restrict or eliminate competition, thus fostering its ability to exploit its market power.

108
See for example P. Rey and J. Tirole, "A Primer on Foreclosure", in: *Handbook of Industrial Organisation* Vol. III, M. Armstrong, and R. Porter eds., (2005, Amsterdam: Elsevier North-Holland).

More generally, the Chicago School argument relies on a number of assumptions that cannot always be presumed to hold. But the one monopoly profit concept demonstrates that one cannot take a *naïve* view of refusals to supply being aimed at extending market power, nor of necessarily having anti-competitive effects.[109] Both the Chicago School and Post-Chicago school theories demonstrate the need for careful analysis of the effect that refusals to supply have on competitors, markets and, ultimately, on consumers.

109 For example, foreclosure might have a negative effect on consumers' welfare only if it causes input prices to rise and output to fall (i.e., prices to increase downstream). If increased input prices cause a downstream competitor to reduce output but at the same time the integrated firm increases output such that the total market output is unchanged, there is no harm to consumers.

7.2.3 Refusal to supply and dynamic incentives

Having discussed the threat that refusal to supply may present to effective competition it is important to consider the other side of the issue: what are the risks associated with over intervention by authorities against refusal to supply?

As discussed above, the enforcement by an authority of a supply agreement against the will of one party undermines property rights and runs counter to the principle of allowing firms free disposal of their assets. Private property rights are rightly regarded as a cornerstone of economic growth, encouraging efficient investment in productive assets by allowing firms and individuals to capture the returns to such investment. It is therefore clearly important that the Commission sets out an enforcement policy that safeguards firms against the fear that the fruits of their investments will be appropriated by the state and offered to rivals, or at least carefully identifies the possible exceptions to their freedom to enjoy such benefits.

These dynamic incentives to innovation and investment accrue in the long-term and so are less visible than the static competition that takes place between firms on a day-to-day basis. While less visible, however, dynamic competition is significantly more important in determining consumer welfare. It is for this reason that patent law provides time limited monopoly power to innovative firms in order to foster advances in technology and production methods. Equally, competition authorities ought to be wary of intervening to require access or supply of firms, recognising the harm to dynamic competition that must be balanced against the more visible benefits in respect of static competition.

7.3 Comments on the Commission's DP

7.3.1 The DP's approach

A proper effects-based assessment of particular business practices would require the Commission to identify a competitive harm that inflicts a welfare loss on consumers and assess the extent to which this is outweighed by efficiencies. The approach set out by the DP, however, falls uncomfortably short of this objective. The DP defines three scenarios of refusal to supply for which it establishes a rebuttable presumption of abuse, while conceding that it is not possible to provide comprehensive coverage of the various practices and situations covered by the concept.[110] Furthermore, the three cases that give rise to these rebuttable presumptions do not seem to benefit from a theoretical underpinning. The DP does not refer to the Chicago School and "post-Chicago" arguments in providing its guidance on the specific circumstances that call for intervention. An approach that was better grounded in the relevant economic principles might help to minimise intervention in potentially non-harmful cases.

110 See paragraph 215.

7.3.2 Specific refusal to supply scenarios

The DP explains that there is a wide variety of practices that can be classified as refusal to supply. It focuses on three specific forms: (i) termination of existing supply relationships; (ii) refusal to enter into new supply agreements; and (iii) refusal to supply information needed for interoperability. We consider the first two situations together, before moving on to a discussion of the third.

The distinction between the termination of an existing relationship and refusal to enter a new supply relationship is hard to justify in economic terms, even if it is frequently found in the case law. Both scenarios require the following four conditions for conduct to be presumed abusive: (i) the behaviour is properly identified as termination or refusal; (ii) the firm refusing supply is dominant; (iii) the refusal is likely to have a negative effect on competition, and; (iv) the refusal is not justified objectively or by efficiencies. In the case of refusal to enter into a new supply agreement a fifth condition is added by the DP: (v) that the input in question be indispensable.

The distinction between the conditions for a presumption of harm in these two situations is justified on the grounds that a pre-existing relationship demonstrates that "the dominant company at a certain point in time considered it efficient to engage in such supply relationships".[111] It is not clear how this tautology justifies the difference in treatment, however. By omitting the indispensability condition from cases in which a firm terminates an existing relationship, the DP appears to be opening the door to a "convenient", rather than essential, facilities doctrine. This can only undermine dynamic incentives, and runs counter to the well established, and well founded, case law on the issue of mandating access.[112] The tendency for the Commission to have adopted a more interventionist stance in cases of termination of existing relationships serves primarily as an illustration of the extent to which Article 82 enforcement has historically been captured by complainants. One of the attractions of an effects-based regime is that the focus should switch to a greater focus on the net effects of restrictions on consumers. It is hard to see how differential treatment of existing and prospective trading partners is justified in an effects-based regime.

111
Paragraph 217.

112
In particular, *Oscar Bronner, op. cit.*

The DP's position, that a dominant firm's choice to enter into a supply relationship justifies a presumption (albeit rebuttable) that continuing the relationship is pro-competitive, implies that a firm's past behaviour can be held against it. This raises the possibility of unintended consequences and creating perverse incentives: if firms realise *ex ante* that a decision to supply today will impose limits on their behaviour in the future, some may decide not to enter into efficient supply agreements that cannot be reverted without the risk of triggering potential intervention.

Worryingly, at paragraph 236 the DP explains that the conduct is likely to be abusive when "…the investments that have led to the existence of the indispensable input would have been made even if the investor had known that it would have a duty to supply". It is hard to see how the Commission would be able to assess such a case, and to demonstrate that the investment would have been made under different circumstances. The Commission must be very careful of substituting its own *ex post* judgment for the *ex ante* decisions of private firms.

Another example of cases which can be presumed abusive is provided in the same paragraph as cases where: "…the investments behind innovations leading to intellectual property rights may not have been particularly significant, in which case it may be likely that the investment would have been made even knowing that a duty to supply would be imposed".

Furthermore, the DP adds that in its assessment the Commission will take account of the values at stake, including the positive incentives on follow on investments. It is hard to see how this exercise could be anything but speculative. Predicting follow-on investments and comparing the benefits that consumers would derive, *vis à vis* the long-term negative impact on investments is at best hard to assess. It is hard to see how an assessment subject to such a high degree of uncertainty could justify the imposition of compulsory licensing.

The benefits of intervention outweigh the costs of "expropriation" only in very rare cases (e.g. natural monopolies). Mandating access must enhance competition so that the benefits to consumers outweigh the costs associated with intervention, e.g. investment disincentives. Forcing a dominant firm to supply may not be welfare enhancing since this implies that other undertakings could exploit (free-ride on) the part of the benefits of the investment made by the dominant firm, and this would curtail investment incentives. Yet, based on the five conditions established by the DP, a potentially large number of cases might be presumed to be abusive. As mentioned above, reference to the Chicago School and post-Chicago arguments might have helped to provide better clarity and better guidance on what types of behaviour might be presumed anti-competitive, where refusal to supply does not lead to harm to consumers, and the evidential requirements that need to be satisfied to transform a theory of competitive harm into a finding that the theory fits the facts.

Finally, in relation to refusal to supply information needed for interoperability, the DP suggests that where a dominant firm refuses to supply interoperability information in order to leverage its market power from one market to another, even if the information constitutes a trade secret, such behaviour might constitute an abuse. At paragraph 242 the DP suggests that in such cases it might not be appropriate to apply the high standards for intervention set in the cases discussed above. This section of the DP seems to be a fairly naked justification of the Commission's current position on the Microsoft Article 82 case, which is currently under appeal to the CFI. It is questionable whether such a case-specific comment can provide a useful guide to the generality of Article 82 enforcement.

Underlying a competition authority's decision to intervene in cases of refusal to supply there is a fundamental tension between short-term gains to consumers and long-term damages due to a negative impact on investment incentives. The guidance contained in the DP does not appear to provide much comfort in terms of reducing uncertainty for firms committing risky investments. It is unclear, for example, what weight would be put by the Commission on the current gains and what on the future losses deriving from curtailed investment incentives. This is important as the wrong balance between short-term and long-term gains for consumers might ultimately end up protecting competitors rather than competition.

> In the long-term it is generally pro-competitive and in the interest of consumers to allow a company to retain for its use facilities which it has developed for the purpose of its business.[113]

113 Opinion of Advocate General Jacobs in *Oscar Bronner, op. cit. (footnote* 103).

8 Aftermarkets

8.1 Introduction

The focus in the DP's treatment of aftermarkets is on market definition and dominance assessment. In particular, the Commission appears to suggest an approach which could, in practice, result in narrower markets than would arise under conventional market definition. This exposes firms to excessive intervention if offsetting counter-balances in the dominance assessment are not implemented.

8.2 Market definition

Notwithstanding the inherent difficulties in undertaking robust market definition in the abuse of dominance context, the DP is right to argue that the application of market definition to the after-markets context should adopt the "normal approach".[114]

114
See paragraph 247.

However, the DP immediately undermines this stance by stating that the exercise should be done "without taking into account effects on sales of the primary product". Specifically, it proposes to focus only "… on aftermarket sales to customers who have already acquired the primary product". It is straightforward to envisage a situation where the impact on future primary product sales is the key reason why a hypothetical monopoly supplier of related secondary products would not choose to raise prices above competitive levels, and it must be wrong for the DP to dismiss this possibility *a priori*.

The approach proposed in the DP will tend to artificially narrow the definition of the secondary product market. While, in principle, this narrowing may be offset at the dominance assessment stage, there is no guarantee of this. A distortion of the well-established market definition process cannot form the basis of rigorous analysis of abuse of dominance cases.

8.3 Dominance

By suggesting an approach that would artificially narrow relevant market definitions, the DP risks excessive intervention by increasing the burden that must be placed on going beyond conventional market shares in conducting a dominance assessment.

The DP correctly highlights the fact that, even if customers are completely myopic to elevated prices in the secondary market, these high prices may be offset by primary product competition, where integrated suppliers compete vigorously on primary product price to win customers, in order to earn secondary product profits.[115] The DP appears to suggest that this could provide the basis for finding that the secondary market supplier is not dominant.

115
Paragraph 259.

However, this approach does seem to risk introducing potential distortion into the competitive process. Specifically, if a secondary product supplier is found to be able to raise prices substantially in a well defined secondary product market, it would seem perverse if the regulatory framework were to allow it to respond to potential entrants into that market in ways that would not be permitted to a dominant firm, because of the strength of competition in the primary market. If under competitive market conditions, the outcome would be lower secondary market prices and higher primary market prices, it must be questionable whether abuse of dominance rules should be aimed at securing a different outcome, unless there is some compelling efficiency rationale for doing so.

The DP also suggests that a firm may be more likely to be found dominant in the secondary market if it changes its commercial policy in that market ("installed base opportunism").[116] Although the paper identifies the conditions that must be verified for this concern to materialise, it is important to note that a generally suspicious attitude towards "policy changes" in secondary markets is not only generally unjustified, but also potentially harmful to consumers. This is because suppliers might refrain from adopting more open and flexible aftermarket policies out of fear that future changes might lead to a finding of abuse under Article 82, exposing them to fines and damage claims.

116 See paragraphs 261–263.

8.4 Abuse

The section on aftermarkets does not consider in any detail the specifics of conduct in aftermarket settings. However, this section does state that the Commission "…presumes that it is abusive for the dominant company to reserve the aftermarket for itself by excluding competitors from the market". This suggests that the Commission will presume that all actions that have the effect of excluding competitors, including vigorous competition on the merits, will be deemed abusive. As elsewhere, this suggests the Commission is wedded to the idea of a special responsibility on dominant firms to facilitate the entry of would-be competitors.

The Response of RBB Economics to the DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses

Design and typesetting by Polimekanos

Published by RBB Economics
The Connection
198 High Holborn
London WC1V 7BD

www.rbbecon.com

www.rbbecon.com

RBB Economics London
The Connection
198 High Holborn
London WC1V 7BD
T +44 20 7421 2410
E london@rbbecon.com

RBB Economics Rome
Palazzo Valadier
Piazzo del Popolo 18
00187 Roma
T +39 06 3671 2396
E rome@rbbecon.com

RBB Economics Brussels
Rond Point Schuman 6
1040 Brussels
T +32 2 234 6361
E brussels@rbbecon.com

RBB Economics The Hague
Muzenstraat 89
2511 WB Den Haag
T +31 7 0426 2277
E thehague@rbbecon.com