




COMMENT

Whither Dominance?

Adrian Majumdar*

 Dominant position; EC law; Market abuse; Market power

Recently there has been considerable debate as to whether the European Commission should move towards an effects-based analysis of abusive behaviour.¹ This article considers the extent to which a role for the dominance test remains in an effects-based regime and comments briefly on the approach to dominance taken by DG Comp in its Discussion Paper on Art.82 ("DG Comp Discussion Paper").²

Drop dominance and focus on what matters?

In a recent report for DGComp, "An economic approach to Article 82", the EAGCP (a group of economists from Member States) writing in favour of an effects-based approach stated:

* RBB Economics, January 2006. I am grateful to Derek Ridyard and Simon Bishop for helpful discussions on these themes. An earlier version of this article was published in the *Centre for Competition Policy Newsletter*, University of East Anglia, November 2005.

1 See the influential speech by Vickers, "Abuse of Market Power" (2004) available at www.ofc.gov.uk/NR/rdonlyres/948B9FAF-B83C-49F5-B0FA-B25214DE6199/0/spe0304.pdf.

2 DG Competition Discussion Paper on the application of Art.82 of the Treaty to exclusionary abuses, December 2005.

"In contrast to a form-based approach, an effects-based approach needs to put less weight on a separate verification of dominance. . . . *If an effects-based approach yields a consistent and verifiable account of significant competitive harm, that in itself is evidence of dominance.*" (Emphasis added).³

At first sight, this argument is appealing. Ultimately, competition policy should protect consumers' interests by protecting competition. So why waste time worrying about market shares and entry barriers when we can go straight to analysing the competitive effects? If consumers are harmed substantially, is that not a sufficient case for intervention?

However, while this argument undoubtedly has its merits, in practice, it raises some awkward questions:

- What role remains for theory?
- How often can we demonstrate harm to competition and consumers independently of an analysis of market power?
- What is the relationship between market power and dominance?
- To what extent do we lower the threshold for intervention by discarding the dominance hurdle?

We address these points in turn. Then, in light of the above, we briefly debate the approach taken to dominance in the DG Comp Discussion Paper.

What role remains for theory?

In horizontal merger analysis, empirical tests can be crucial in determining likely competitive effects. For example, a commonly used test is to compare (quality adjusted) prices in areas where only one of the merging parties competes with prices in "overlap" areas where both compete. If prices are lower in overlap areas (after controlling for other factors that may influence price), this supports the view that the merger would be harmful.

A similar technique can in principle be used for the analysis of alleged exclusionary practices: prices can be compared "before and after" an alleged harmful practice or in areas "with and without" the practice (i.e. where the practice is employed only in a subset of markets in which the dominant firm operates). However, where alleged abusive behaviour concerns a risk of foreclosure

3 http://europa.eu.int/comm/competition/publications/studies/eagcp_july_21_05.pdf.

occurring in the future, consumers are not yet harmed and so a “before and after” test or a “with and without” test cannot be conducted.

In all cases, however, empirical tests should be used *in conjunction* with theory. Economic theory should be used to establish a coherent story of harm to competition and consumers that can be tested with empirical techniques. Where data limitations occur,⁴ evidence from a variety of sources must be assessed—theory provides the structure within which the evidence can be organised.⁵ In particular, foreclosure relates to a *market* meaning that identifying harm to a particular customer is not sufficient to identify harm to competition (see an example below).

The role of an assessment of market power

While the assessment of market power is not the ultimate goal of an effects-based regime, its importance is in helping us arrive at our goal more quickly and more robustly.

First, where it is clear that the firm does not have market power, the case can be dropped at an early stage on the basis that anti-competitive effects are not feasible.⁶

Secondly, an assessment of market power involves analysing: (a) the scope for demand and supply side substitution; (b) the extent of barriers to entry and growth; and (c) the strength of buyers. An abusive practice would adversely affect any of the above “competitive constraints”. Thus, in carrying out the assessment of market power, we establish the context in which the alleged abuse takes place.⁷

4 Can we measure factors that consumers value such as price, quality and innovation? Can we control for other influences on those factors (e.g. changes in costs and demand)? To what extent do data limitations mean that the results are subject to a wide margin for error and/or a priori assumptions imposed by the data analyst?

5 This is consistent with the view set out in the EAGCP report. The need for a fact-based story of harm to competition before finding behaviour to be abusive is developed in detail in RBB Economics, “Selective price cuts and fidelity rebates” a report for the Office of Fair Trading, July 2005. Full report and annexes available at www.offt.gov.uk/NR/rdonlyres/DB851D94-1FBE-46EA-85A4-53E4DA0BB0F8/0/oft804.pdf and www.offt.gov.uk/NR/rdonlyres/4C7A8159-C277-4B9B-8D16-DEB565B1342D/0/oft804a.pdf.

6 For example, it may be clear that in any plausible relevant market the firm in question has a low market share and/or faces strong potential competition.

7 By the same argument, a role for market definition remains if market definition is viewed as a first step in the assessment of

Consider, for example, a margin squeeze scenario in which an integrated raw material supplier has introduced a new pricing structure which favours its own downstream manufacturing operations to the detriment of a non-integrated manufacturer (the complainant). Further, suppose that econometric techniques establish that since the introduction of the integrated firm’s pricing policy, the integrated firm has increased the price of its manufactured good by 5 per cent and that the complainant has increased its price by 10 per cent (after controlling for other factors that may increase price, including quality improvements).

At first sight, we might argue that the effects are clear. Consumers are now worse off. However, this price rise needs to be put in context. For example, are there any other suppliers of the raw material (i.e. to what extent does the integrated manufacturer face competition in the upstream market)? How did buyers react to the price rise of the manufactured goods? For example, suppose most downstream buyers switched to buying substitute manufactured goods such that the higher prices affected only a tiny proportion of the relevant market. Here, the case for intervention is weak. In short, even if we have evidence on how (quality adjusted) prices change following alleged abusive behaviour, we still need an assessment of market power to put these effects in context.

Thirdly, the degree of market power matters. Theories of anti-competitive exclusionary behaviour are relatively well developed for near monopolists but are far less developed for firms with a lower degree of market power. For example, a near monopolist is better able to recoup losses incurred during an exclusionary pricing strategy than a firm that would still face some existing competition even after marginalising one of its competitors. Refusal to supply is generally perceived to be more of a problem in relation to bottleneck facilities (i.e. monopoly power). To be credible, leverage theories require the pre-existence of substantial market power in at least one of the markets concerned.

market power. That is, market definition (properly conducted) identifies the most immediate competitive constraints on the firm in question and provides a context in which to analyse entry barriers, the strength of buyers and how these are affected by the conduct in question. This point is not altered by the cellophane fallacy. Even if we accord lower weight to certain evidence on switching (because switching may take place at prices which are already above competitive levels), the concept of a market remains important for the assessment of entry barriers and buyer power. These competitive constraints can be assessed for each of the plausible market definitions.

Finally, even where a firm is likely to have substantial market power, we still need to analyse whether the practice in question has harmed (or is likely to harm) consumers. While the assessment of market power is necessary, it is not a sufficient step in the process.

The relationship between market power and dominance

Broadly speaking, economists link the legal concept of “dominance” with the economic concept of substantial market power.⁸ Competition economists have a relatively well-developed concept of market power. A firm with market power does not face sufficient competitive pressure from any of the following sources: existing competitors, potential competitors and buyers in the relevant market. As a result, it can profitably sustain prices above (or hold quality below) competitive levels in the long run. This definition seems entirely consistent with the spirit of dominance—indeed in the DG Comp Discussion Paper dominance is equated with “substantial market power”.⁹

However, economists would criticise some of the case law on dominance. First, contrary to established precedent, dominance should not necessarily be presumed from a market share persistently in excess of 50 per cent.¹⁰ This is because focussing on market shares alone downplays the importance of product differentiation, the scope for new entry and buyer power.

Secondly, some would also argue that the “special responsibility” of a dominant firm is an unhelpful and unclear concept that at worst chills competition (because the dominant firm must at times refrain from pro-competitive strategies that would harm its rivals) or at best is a trite reminder to dominant firms that they should not break the law. According to this view, an advantage of losing the dominance test would be dropping the “special responsibility” tag that shackles certain beneficial behaviour.

In short, the argument that dominance should be retained so as to maintain legal certainty and to benefit from existing case law is relatively weak (at least from an economics perspective).

We should, however, retain an economic assessment of market power that is free from case law that surrounds the dominance test. For example, competition authorities could replace the dominance test with a commitment to conduct an economic assessment of market power as an integral part of an effects-based analysis. Since the concept of market power is well developed and relatively uncontroversial, there should not be great difficulty establishing robust guidance.¹¹ Market share safe harbours can be retained (although presumptions of dominance based on market shares would not be desirable).

Discarding dominance leads to excess intervention

A better argument for retaining the dominance test *and an essential argument for retaining an assessment of market power* is that, without it, the doors are potentially open for excess intervention.

The success of an effects-based approach depends crucially on the strength of evidence that is required to establish harm to competition and consumers. If, for example, abusive behaviour need only to be “capable” of harming competition¹² then at the very least there should be a market power hurdle to establish that anti-competitive effects are feasible.¹³

Without the dominance hurdle—and given that direct tests of the effect of alleged abusive behaviour are usually not robust when employed without a prior consideration of market power—nearly *all* firms could face genuine uncertainty that would chill price competition. For example, discounts are *capable* of having an anti-competitive effect. Almost all firms offer discounts and, when they do, their rivals tend to suffer. Suppose an inefficient rival left the market as a result of a discount policy adopted by a firm that had no market power. In the short term at least, some customers of the inefficient firm would suffer. But this “consumer harm” is not a good case for intervention. If it were, firms without market power could reasonably fear that

8 See, e.g. S. Bishop and M. Walker, *The Economics of EC Competition Law: Concepts, Application and Measurement* (2nd edn., Sweet and Maxwell, London, 2002).

9 At para.23.

10 Case C-62/86, *AKZO Chemie BV v Commission* [1993] 5 C.M.L.R. 215.

11 See, e.g. OFT415a, *Assessment of Market Power*.

12 This follows from Case T-203/01, *Michelin II*, CFI; Case COMP/E-2/36.041/PO, *Michelin* [2002] O.J. L143/1.

13 This would also protect against interventions by authorities that “know abuse when they see it” or that pay lip service to an effects-based analysis but in practice follow a form-based approach to abuse.

by delivering pro-competitive discounts, the authorities could erroneously infer that they have market power!

Even if abusive behaviour must be “likely” or even “very likely” to harm competition, we noted above that in establishing that likelihood an assessment of market power will usually be important. In particular, economists view dominance to be *substantial* market power. While in theory this leaves room for firms with a lower degree of market power to harm competition and consumers, in practice, it is sensible to focus only on those firms with substantial market power since the harm they may cause is correspondingly greater (some theories of harm do not work at all unless firms are near monopolists) and so the risk of chilling price competition by mistaken interventions is correspondingly lower.

The same principle should carry through to an effects-based approach. To infer dominance from direct evidence of competitive effects, should require demonstrating (to a high standard) *substantial* adverse harm to consumers. We should not infer dominance from relatively small adverse effects on consumers given the margin for error likely to be involved.

DG Comp Discussion Paper

The DG Comp Discussion Paper indicates a desire to move towards “an approach which is based on the likely effects on the market”¹⁴ but does not advocate losing the dominance test.¹⁵ The standard of proof is stated to be “actual or likely anti-competitive effects”.¹⁶

While, at face value, an effects-based approach that retains a dominance hurdle is a substantial step forward, the application of the approach in practice could well be another matter (not the subject of this article).¹⁷ For example, if we understand the Commission’s mindset from its discussion of dominance, there is cause for concern.

The Discussion Paper misses the opportunity to narrow the definition of dominance—i.e. to raise the hurdle for intervention. On the contrary, if anything, the threshold for finding dominance is *lowered*. First, the only clear safe harbour is that a firm with a 25 per cent market share is “not likely to enjoy a (single)

dominant position”.¹⁸ Dominance in the 25 to 40 per cent range is countenanced.¹⁹ However, the Commission surely had the scope to say that a share below 40 per cent was unlikely to be viewed as indicative of dominance.

Secondly, the Commission implies that a market share of 50 per cent is “very high” and very likely to indicate a dominant position (where the share has persisted and where other rivals are relatively small). However, a 50 per cent share is not even *likely* to indicate substantial market power without due consideration of barriers to entry and expansion and buyer power.

Thirdly, firms with a 75 per cent market share are deemed to be near monopolists²⁰ for which efficiency defences are unlikely to apply (and presumably where the so-called “special responsibility” is even greater). On this occasion the Commission makes clear that, in addition to the 75 per cent share, existing competition must be almost entirely absent and entry barriers high. However, the Commission had substantial scope to set the hurdle much higher based on existing case law²¹ and so it is odd that the Commission chose a relatively low threshold. Furthermore, the absence of an efficiency defence for “near monopolists” points to a desire to *manage* competition as one might do in a recently liberalised former state monopoly. Where firms have obtained a dominant position through their own innovation, efficiency and superior product placement, to adopt a “regulatory” approach seems counter productive as it would discourage firms from striving to get ahead of their rivals, which is usually the essence of competition.

Conclusion

In debating the role of dominance, we must not lose sight of the following fundamental points.

First, while there is a theoretical case for discarding dominance, as a matter of policy we should retain a dominance hurdle (based on the economic concept of “substantial market power”) as a vital screen to weed out cases where anti-competitive effects are either not feasible or not worth worrying about. Ideally, the substantial market power hurdle would be free of

14 para.4.

15 See s.4.

16 para.55.

17 A full set of comments on the DG Comp Discussion Paper is available at www.rbbecon.com.

18 para.31.

19 See fn.34 of the Discussion Paper and the reference to dominance with a market share as low as 32% for example.

20 para.92.

21 See Whish, *Competition Law* (5th edn.), pp.189–190 for example.

the unhelpful elements of the case law on dominance, which presume dominance from high market shares and which establish a special responsibility for dominant firms.

Secondly, losing the dominance test should not be an excuse to lower the threshold for intervention. While the DG Comp Discussion Paper retains the dominance test, in lowering the threshold for finding dominance it increases the risk of over-intervention. In principle, that risk can be reduced by taking an effects-based approach to the analysis of abuse. In practice, that remains to be seen.

Thirdly, an assessment of market power is necessary but not sufficient for analysing competitive effects. The most important feature of an effects-based regime is demonstrating sufficiently strong evidence of (likely) harm to competition and consumers.²² That requires a credible theory of harm that is strongly supported by the available evidence.

²² See RBB Economics, "Selective price cuts and fidelity rebates" a report for the Office of Fair Trading, July 2005, Ch.2 (fn.5 above).