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Agenda

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Establishing predation? *France Telecom* and Article 82 reform

The latest Court of First Instance ruling on predation appears to signal a victory for form-based competition law over effects-based tests. How does the *France Telecom* judgment affect the review of Article 82 currently being undertaken by the European Commission? Does the judgment reveal an inconsistency in the move towards effects-based competition policy?

In January 2007 the Court of First Instance (CFI) upheld a fine of €10.4m imposed by the European Commission for abuse of dominance in France's high-speed Internet access market.[1] France Telecom's Internet arm, formerly Wanadoo Interactive, was found by the Commission to have undertaken predatory pricing in 2001–02, offering its services below cost in order to eliminate competitors from the market for Internet access.[2]

The CFI decision to uphold the Commission's ruling is controversial from an economist's perspective, since it reiterates the form-based precedent in *AKZO* for relying purely on the rule that pricing below average variable cost is always predatory, and pricing between average variable cost and average total cost is always predatory if there is intent to exclude competitors.[3] Although the *AKZO* test is well-established, the issue is the exclusive, form-based focus on this rule alone, as opposed to a fuller effects-based test that would also assess factors such as the feasibility of predation and harm to consumers.

Before France Telecom's possible further appeal to the European Court of Justice—due by the end of March—it is timely to ask: should the CFI's decision be challenged? Does this set an undesirable precedent for future cases on predatory pricing? And how is this ruling consistent with the European Commission's discussion paper on the reform of Article 82 (the follow-up to which is expected this year)?[4]

What did the CFI decide?

In a case that was initiated by the Commission itself, rather than being referred from the French competition authority, the CFI's final decision states that:

- prices below average variable costs give grounds for assuming that a pricing practice is eliminatory;
- prices below average total costs but above average variable costs must be regarded as abusive if they are determined as part of a plan for eliminating a competitor;
- it was not necessary to establish proof that Wanadoo had a realistic chance of recouping its losses;
- Wanadoo cannot rely on a right to align its prices with those of its competitors to justify its conduct.

The key element of the judgment is its reliance on form-based rules of conduct for predation, establishing that there is no need to show that actual harm to competition occurred as a result of below-cost pricing. Unlike other elements of competition law, the legal test for predation still differs significantly between Europe and the USA. In Europe, competition authorities apply a pure price–cost comparison, whereas the USA follows an effects-based test for predation. The Supreme Court established in *Brooke Group v. Brown and Williamson* that, to prove predation, the plaintiff must demonstrate that prices are below cost, and in addition, prove that there is a 'likelihood of recoupment'.[5] The Supreme Court reaffirmed this effects-based test in February 2007 in *Weyerhaeuser v. Ross-Simmons*.[6]

Why price below cost?

The European Commission's view is that if a dominant company charges a price below average variable cost (or average avoidable cost), the firm incurs a loss that it could have avoided.[7] Since it incurs an avoidable loss, it is not maximising its profits, and this is taken as sufficient evidence to presume that this 'irrational' behaviour can only be motivated by a plan to exclude rivals from the market.

While in itself the avoidable cost rule is in line with economics principles, the problem with applying it too rigidly is that businesses (and economists) can think of several reasons to price below cost which are consistent with profit maximisation. In multi-product retail pricing it is well known that it can be efficient to set different mark-ups for different products due to product

complementarities. In restaurants, for example, the main meal can be good value but the side orders expensive. Similarly, in the car market, the basic model can be priced competitively, but the 'optional extras', such as air conditioning and electric windows, can be costly. In supermarkets, the known-value items may be loss-leaders to attract customers to the store where high-margin products are also available.

There are also several reasons why a non-dominant firm might price below cost. Switching costs make it rational to persuade locked-in customers to change supplier by offering a below-cost deal. The same applies for network externalities: if consumer demand depends partly on the number of other subscribers, it makes sense to cut prices to reach a critical mass. In addition, learning effects or significant economies of scale can create a rationale to cut prices in order to reach improved efficiency levels.

A dominant firm is likely to have few incentives to employ these techniques: its consumers are usually already locked in by switching costs and network effects, and given its large market share, it has presumably already reached the minimum efficient scale. Thus establishing the degree of dominance of the alleged predator is critical to a judgment on predatory pricing, since, in effect, the truly dominant company loses most of its 'excuses' for pricing below cost.

It is hard to prove or disprove a particular rationale for pricing below cost, which will later turn out to be either a sensible or irrational plan depending on market conditions. So how is it possible to distinguish between competitive and anti-competitive pricing strategies? Genuinely predatory prices are an investment in a future monopoly—a sacrifice of today's profits for future profits. If this is the case, the investment in low prices must be 'recouped'. If a monopoly price is impossible at a later stage, the predatory plan is unprofitable and by implication the low price charged now is not predatory. This is the reason for having an effects-based approach: a predatory strategy that will have exclusionary effects is predicated on the feasibility of recoupment.

What's wrong with the *France Telecom* ruling?

Presumption of predation

The European Commission's approach can be contrasted with the recent UK Competition Commission's discussion of predation in its working papers on the supermarkets inquiry. It notes the *AKZO* presumption of predation if prices are found to be below average variable cost, and argues that:

> This may be too rigid a test because of its apparent failure to acknowledge that prices below average variable cost may be set pro-competitively.[8]

It is apparent that the Competition Commission does not consider the *AKZO* guidelines as best practice for its market investigations. It goes on to state that:

> In order to prove that an instance of below-cost selling is a predatory strategy, it is necessary to show that there is a strong likelihood that the predator will recoup the profit it has initially sacrificed.[9]

This suggests that the burden of proof should lie with the complainant or competition authority to show that predation is part of a realistic plan to eliminate competitors.

For the European Commission, however, the burden of proof rests on the dominant company to show exceptional reasons for below-cost selling. The discussion paper on Article 82 reform states that in a case where a presumption of predation is established purely on the basis of a price–cost comparison, the dominant company should be able to rebut that finding by justifying its pricing behaviour.[10] Yet the approach to justifying below-cost pricing is stringent, and the main permissible justification is a strategy of minimising losses (eg, when disposing of perishable excess inventory).

The cost benchmark

The *AKZO* rule is an attempt to bring precision into the law, and so avoid speculation about either the motives of firms or how the market will develop in future. However, this clarity may be lost when an attempt is made to calculate below-cost pricing in network industries. Which costs are fixed and which variable? In broadband, customers typically sign a 12- or 18-month contract, so firms recoup their customer acquisition costs (the modem, connection and marketing cost) over a long time period. Once in place, the variable costs of providing access to an already existing network are close to zero. Furthermore, some of these costs may be common to telephony services and broadband. Which cost should be compared with price?

The average variable cost rule is difficult to apply in the telecoms sector, and so the approach is to calculate some form of incremental cost. But this too is difficult—how much of the capital cost of the network should be allocated to each customer when connections are shared among different services? How should customer acquisition costs be allocated?

The European Commission's calculation in *France Telecom* spreads subscriber acquisition costs (SACs) over 48 months, adds this cost to the monthly variable costs, and subtracts the total from 48 months' worth of monthly revenues. While this sounds straightforward,

there is still doubt over cost allocation where many costs are common among products (telephony and Internet access). There is also a possible problem with timing. If the initial number of subscribers is high in year 1 and then drops below expectations, the amortised SACs carried forward will be spread over a smaller number of customers, potentially inflating the measured cost per subscriber above the retail price in years 3 and 4.[11] A finding of predation could then apply purely because demand was below expectations. The apparent precision and clarity of the *AKZO* rule therefore loses some of its rigour when applied to network industries.

As such, the CFI considered that:

> as the choice of method of calculation as to the rate of recovery of costs entails a complex economic assessment on the part of the Commission, the Commission must be afforded a broad discretion.[12]

It could be argued that courts are in general not well-equipped to adjudicate on pricing decisions in network industries. This may be a task more suited to regulators than the competition courts.

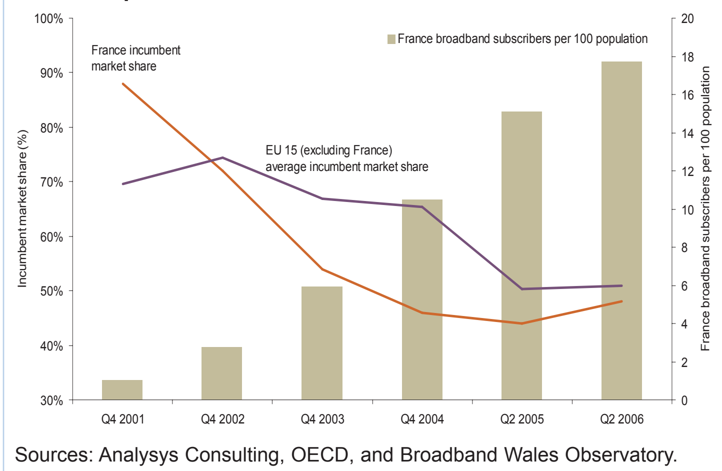
The CFI further held, perhaps surprisingly, that 'it is for the applicant' to prove the unlawfulness of the Commission's test for recovery of costs, rather than for the Commission to establish that it is using the correct test.[13]

The test for dominance

The CFI states that even though broadband access is a rapidly growing market, 'the situation of the relevant market does not support the view that the market shares are an unreliable indication'.[14] Based on *Hoffman-La Roche* and *AKZO*, the message is clear: a market share in excess of 50% is taken as evidence of the existence of a dominant position, in the absence of exceptional circumstances.[15] It can, however, be risky to apply this formulaic methodology to high-technology markets. For example, the UK Monopolies and Mergers Commission decision on video games in 1995 found that Sega had a dominant position, and that Sega and Nintendo had a joint dominant position in home video gaming.[16] Later that year, however, the Sony Playstation was launched, and market dynamics were radically overhauled.

In the French broadband market, France Telecom's share varied from 50% to 72% between the start of the predation period and August 2002, then fell back to 64% in October 2002, the end of the predation period.[17] On this basis there is little evidence that predation had its

Figure 1 France Telecom market share and EU 15 average incumbent market share (2001–06), and broadband penetration in France



Sources: Analysys Consulting, OECD, and Broadband Wales Observatory.

intended effect: increasing market power by eliminating the competition. Furthermore, the appellant claimed the market was characterised by a number of actual and potential entrants, suggesting that barriers to entry may be low, and hence that its market share should not necessarily be interpreted as dominant. At the time of the alleged predation the market for broadband access was growing rapidly, with broadband penetration approximately doubling each year from 2001 to 2004 (see Figure 1), which calls into question the definition of dominance. A 64% share of a market which is known to be doubling in size each year is less secure than a 64% share of a stable market in the presence of switching costs, since entrants can target households without an existing broadband connection.

A full consideration of the likelihood of success of predation in the French broadband market is beyond the scope of this article, but certain features of the market make recoupment appear unlikely. Demand has expanded rapidly, with new entrants such as Free now offering a combined Internet, fixed telephone and television service for €29.99 per month.[18] Entry is facilitated because wholesale access is regulated, and the French Conseil de la concurrence intervened in 2002 to give access to all Internet service providers on the same terms available to Wanadoo.[19] While it is not possible to predict with confidence the evolution of market shares in the absence of the predation ruling, the rapid demise of France Telecom's market share since 2002 does not support the view that Wanadoo had an impregnable dominant position. Indeed, as Figure 1 illustrates, France Telecom has lost market share more rapidly than the average European incumbent operator, making a predatory strategy (aimed at permanently excluding competition) ineffectual.

Concluding comments

It is clear from *AKZO* and *France Telecom* that pricing below average variable cost or below average total cost can lead to a finding of abuse of dominance, without proof of the likelihood of recoupment. The crux of this approach is the Commission's view that 'Article 82 EC must be applied where there is a risk of eliminating competition, without having to wait for the object of driving out competition to be achieved.'[20] The 'shoot first' tactic has the merit of preserving competition where it might otherwise die out, but the danger therein is the risk of increasing the number of type 1 errors (false positives), to the detriment of consumer welfare. As the Supreme Court stated in *Brooke Group v. Brown and Williamson*:

> Without recoupment, even if predatory pricing causes the target painful losses, it produces lower aggregate prices in the market, and consumer welfare is enhanced.[21]

Of course the Commission is correct that a test of recoupment makes it harder to prove predation. However, the appropriate test is of likelihood of recoupment ex ante, which is very different from assessing whether actual recoupment of losses takes place ex post. The former requires a more detailed assessment of the market power of the alleged predator, considering the extent to which the target firm constrains the predator's price, the market structure post-predation, and the barriers to entry and re-entry in the market.[22] An ex ante test can be applied without waiting for the objective of exclusion to be achieved.

The issue of predatory pricing deserves further time and attention in the development of an effects-based interpretation of Article 82. In particular, whether the rejection of the recoupment test (which should perhaps be renamed the feasibility test) is good for consumers should be examined. The problem is that the CFI ruling in *France Telecom* does not go in the same direction as the European Commission's movement towards a more effects-based approach (much as the Commission's discussion paper was criticised for not going far enough in that direction). The same could be said of the Advocate General's opinion on loyalty rebates in *BA/Virgin*, which ruled that:

> the reduction which was found in BA's market share did not necessarily ... have to be regarded as an indicator that its commission schemes were ineffective.[23]

This apparent disjoint between the courts and the European Commission is likely to make the ultimate outcome of the current reform of Article 82 even more uncertain.

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[1] Court of First Instance (2007), *France Telecom SA v. Commission of the European Communities*, Judgment, Case T-340/03, January 30th; and Court of First Instance (2007), 'Court Upholds Commission Decision Finding that France Telecom Abused its Dominant Position on the French Market for Internet Access', press release 09/07, January 30th.
[2] European Commission (2003), 'Commission Decision of 16 July 2003 Relating to a Proceeding under Article 82 of the EC Treaty (COMP/38.233—Wanadoo Interactive)', July 16th.
[3] Case C-62/86, *AKZO Chemie BV v. Commission* (1991) ECR I-3359.
[4] European Commission (2005), 'DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses', December.
[5] Supreme Court of the United States (1993), '*Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*' (92-466), 509 U.S. 209, p. 210.
[6] Supreme Court of the United States (2007), '*Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., Inc.*', Opinion of the Court, 05-381, February 20th.
[7] See European Commission (2005), op. cit.
[8] Competition Commission (2007), 'Pricing Practices Working Paper', Grocery Market Inquiry Emerging Thinking, January 23rd, p. 6.
[9] Ibid.
[10] European Commission (2005), op. cit., para. 130.
[11] See E-Konomica (2004), 'Commission Develops New Policy for Predatory Pricing in Network Industries', October 16th.
[12] Court of First Instance (2007), *France Telecom SA v. Commission of the European Communities*, Judgment, Case T-340/03, January 30th, para 129.
[13] Ibid., para 153.
[14] Case 85/76 *Hoffmann-La Roche & Co AG v. Commission* [1979] ECR 461, [1979] 3 CMLR 211; and Court of First Instance (2007), *France Telecom SA v. Commission of the European Communities*, Judgment, Case T-340/03, January 30th, para 111.
[15] Ibid., para 100.
[16] Monopolies and Mergers Commission (1995), 'Video Games: A Report on the Supply of Video Games in the UK', Summary.
[17] Court of First Instance (2007), *France Telecom SA v. Commission of the European Communities*, Judgment, Case T-340/03, January 30th, para. 261.
[18] *International Herald Tribune* (2006), 'French Web Provider Finds Growth isn't Painless', May 31st.
[19] Conseil de la concurrence (2002), Decision 02-MC-03, February 27th.
[20] Court of First Instance (2007), *France Telecom SA v. Commission of the European Communities*, Judgment, Case T-340/03, January 30th, para. 193.
[21] Supreme Court of the United States (1993), op. cit. p. 210.
[22] Competition Commission (2007), op. cit.
[23] European Court of Justice (2006), '*British Airways plc v Commission of the European Communities*', Opinion of the Advocate General Kokott, Case C-95/04 P, February 23rd, para 83.

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