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Agenda

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The Article 82 discussion paper: a comment on the economic principles

The European Commission's discussion paper on reform of Article 82, published in December 2005, has been successful in at least one respect: it has generated a good deal of discussion. Has the paper paved the way for an 'effects-based' approach to abuse of dominance, or will it leave the current 'form-based' approach in place? Dr Gunnar Niels, Oxera Director, provides some insight

Since the long-awaited publication of the discussion paper in December last year,[1] numerous conferences and seminars have been organised, papers produced, and submissions made to the European Commission (the deadline for these was March 30th). Now that the dust has settled somewhat (at least until the Commission reveals the outcome of the consultation, possibly in the form of guidelines on Article 82), it is perhaps a good time for some reflection on what the Commission is trying to achieve in terms of the economic principles that could, or should, form the basis of policy towards abuse of dominance.

Embracing the principles of an 'effects-based' approach

Article 82 of the EC Treaty prohibits the abuse of a dominant position, and together with Article 81 (on anti-competitive agreements) and the EC Merger Regulation, forms the cornerstone of EU competition policy. Article 82 also has its equivalent in most national competition laws in Member States.

While EU policy on Article 81 and mergers has undergone substantial change in recent years, bringing it more into line with current economic thinking, the case law on abuse of dominance has for many years been criticised as legalistic and overly interventionist.[2] In essence, case law has established a number of virtual 'per se' prohibitions of certain types of conduct—such as discrimination, loyalty rebates, and pricing below average variable cost (AVC)—by firms considered dominant (and the threshold for dominance is itself quite low). The reform of Article 82, which was initiated earlier in 2005, is now seen by many as an opportunity to move towards an approach that emphasises the economic effects of allegedly abusive behaviour on competition and consumers, rather than the form of the behaviour.

In the discussion paper the Commission explicitly endorses this principle. First, it states (para 54) that 'it is competition, and not competitors as such, that is to be protected' (thus addressing the criticism frequently made in the past that the Commission is more concerned with the fate of competitors rather than competition). It then goes on to say that 'Article 82 prohibits exclusionary conduct which produces actual or likely anticompetitive effects in the market and which can harm consumers in a direct or indirect way' (para 55).

The principles for assessing exclusionary abuses that the Commission sets out in Section 5 of the discussion paper indeed open the door to a more effects-based approach. The paper makes the following points clear.

- *The degree of dominance matters* (para 59)—this makes sense from an economic perspective: practices such as below-cost pricing and refusal to supply are more likely to have an anti-competitive effect if the perpetrator has a very high degree of dominance (or even 'super-dominance'[3]), than if it just passes the, currently low, threshold for dominance.

- *The degree of foreclosure matters* (para 59)—the discussion paper states that it is not just the nature or form of the conduct, but also its incidence (ie, the extent to which the dominant firm is applying it in the market). Again, this principle is economically sound, but, as discussed below, is not always followed through in the discussion paper.

- *Only conduct that would exclude 'as-efficient' competitors is abusive* (para 63)—this principle seeks to draw the line between exclusionary conduct that simply reflects 'competition on the merits' and exclusionary conduct that is harmful to consumers.

– *Exclusionary behaviour can still be justified on grounds of objective necessity, meeting competition, or efficiency* (Section 5.5)—the efficiency defence is a new element in Article 82 policy, and recognises the economic principle (also embodied in Article 81) that some restrictive practices may be required to achieve efficiencies.

Are the effects-based principles followed throughout?

Does the discussion paper stick to the principles throughout? Perhaps not surprisingly, given the complex nature of Article 82 policy and the established case law, this question must be answered in the negative. Even Section 5 itself, when read carefully, lends itself to different interpretations of the proposed new approach to Article 82, including one interpretation where little changes with respect to current case law. But the inconsistencies become particularly clear in the four subsequent sections of the discussion paper on specific practices (predatory pricing, single-branding[4] and rebates, tying and bundling, and refusal to supply).

Consider each of the above four principles in turn.

– *The degree of dominance matters*—an example of where this principle gets somewhat lost is Section 7 on single-branding and rebates. A number of statements in this section are reminders of the old 'ordo-liberal' view of a dominant firm as the proverbial bull in a china shop, capable of inflicting damage on its already fragile surroundings. For example, we read that the 'dominant position usually implies that for a good part of demand there are no proper substitutes to the dominant supplier's product because for instance its brand is a "must-stock" item' (para 143)—ie, there is an 'inelastic or "non-contestable" portion of demand of each buyer' (para 153) for which competitors, which are 'smaller', cannot compete (para 154). All these statements about the dominant firm may well be true, but that cannot be assumed from the outset—indeed, they should form an integral part of the effects-based analysis.

– *The degree of foreclosure matters*—it would have been clearer had the Commission introduced the term 'significant foreclosure' to reflect this principle, as its current definition of foreclosure still focuses mainly on the effect on individual competitors:

> By foreclosure is meant that actual or potential competitors are completely or partially denied profitable access to a market. (para 58)

Yet the important test is whether this foreclosure is occurring to such a degree that it affects most or all competitors, not just individual ones. The first part of the test for loyalty rebates established in Section 7 of the discussion paper actually applies the opposite, and quite counterintuitive, logic: the numerical example presented in the box following para 154 implies that the smaller the 'commercially viable amount' that a competitor would require to operate in the market, the more likely it is that an abuse would be found.[5] In other words, if there is room for very small competitors in the market, intervention against rebates is more likely than where entry requires a large scale.

Another area where the discussion paper does not stick to the principle that the degree of foreclosure matters is predatory pricing (Section 6). A claim of predation is much more straightforward if the dominant firm's price cuts apply to all its products or customers. In contrast, for selective price cuts (eg, targeted discounting or 'fighting brands') the direct link between dominance and the likelihood of success of predation breaks down—the dominant firm is not using the full weight of its market power to exclude rivals, so the existence of dominance by itself would not be sufficient to conclude a high likelihood of success of the predatory strategy.[6] Yet, the Commission applies the opposite logic, looking with more suspicion on selective price cuts, stating that 'a general price decrease applied to all the output of a dominant company is in general less likely to be part of a predatory strategy' (para 118).

– *Only conduct that would exclude 'as-efficient' competitors is abusive*—this principle is already reflected, for example, in the case law on predatory pricing, which states that predation can be presumed if a dominant firm sets prices below average variable cost (the discussion paper emphasises average avoidable cost; both are variations on marginal cost).[7] If prices are above this level, equally efficient firms—those with similar marginal costs—can still compete in the market. However, the as-efficient competitor test may pose practical problems in markets where an incumbent firm faces competition from new entrants which do not enjoy the same scale advantages, and are therefore not as efficient, or at least not yet as efficient.[8] The discussion paper sets out that, in these circumstances, even prices above average total cost could be deemed predatory if certain conditions hold (para 129). Other competition authorities have also considered entrants' costs rather than the incumbent's cost—eg, Ofcom's investigation of a residential telephony service.[9] However, this is risky territory from a public policy perspective, since it could lead to the protection of inefficient firms, which is of little benefit to consumers in the longer term.

– *The efficiency defence*—the discussion paper places the burden of proof for the efficiency defence on the defendant. However, whether the efficiency defence should be a separate part at the end of the effects analysis is questionable—some efficiencies are simply inherent in the conduct being assessed, and may therefore be overlooked in the separate efficiency defence. The clearest example of this is predatory pricing. At the end of Section 6 of the discussion paper, the Commission 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 even when they exist that predation is the least restrictive way to achieve them. In addition, it is similarly unlikely that, in the case that such benefits arise, that in the longer run some of these benefits are passed on to the customers and that these benefits outweigh the loss of competition brought about by the predation. (Para 133)

Nowhere in the discussion paper is it recognised that predation involves low prices to consumers, and that this is the most immediate form of consumer welfare gain one can imagine. This should be taken into account in the assessment, and indeed the discussion paper provides a logical basis for this—ie, when setting out the efficiency defence in Section 5, the discussion paper states that:

> the value of a gain for consumers in the future is not the same as a present gain for consumers. In general, the later the efficiencies are expected to materialise in the future, the less weight the Commission can assign to them. (Para 89).

This same logic should be applied to predation (and rebates): the current price cuts—which are of immediate benefit to consumers—should only be of concern to competition authorities if there is a high likelihood that they will be offset by future price increases once predation has become successful. This is effectively a recoupment test, as applied in the USA but rejected in the EU (see para 122 of the discussion paper). Such a test should form an inherent part of any assessment of alleged predatory prices, and the burden of proof should not necessarily fall on the defendant only.

What about legal certainty?

Various commentators have expressed the concern that an effects-based approach would create legal uncertainty. With the current form-based approach, so the argument goes, dominant firms know exactly what they can and cannot do.

To a great extent this concern arises from a misunderstanding of what an effects-based test would, or should, be about. Such a test does not mean fully quantifying all the pro- and anti-competitive effects of the conduct in each case and then weighing these against each other—even though, admittedly, some economists may have created this impression.

Rather, an effects-based test is about asking some further critical questions beyond the current 'dominance-plus-form' questions, such as: does this conduct foreclose a significant part of the market? Or, is it likely to exclude as-efficient competitors and distort competition? In other words, an effects-based test is about putting forward a plausible story of harm to competition and consumers. This story should be supported by the facts and, where feasible, by some empirical economic analysis. Such an approach would already constitute a significant step beyond the current form-based approach.

An effects-based approach does not have to result in legal uncertainty. Indeed, legal certainty can be significantly improved by adopting certain safe harbours in the Article 82 assessment. An example would be a market share threshold below which dominance will not be found—the 'magic' 40% threshold could be used, although from an economic perspective, a higher threshold (say, 50%) might also make sense. Another example is to create a safe harbour for all price cuts above average total cost. While these safe harbours may inadvertently permit the occasional anti-competitive practice, economic logic suggests that, in the majority of cases, they would lead to the right outcome and contribute to legal certainty.

The discussion paper in fact creates legal uncertainty by avoiding the use of safe harbours. Many criteria that are established in the paper are followed by 'exceptional circumstances' where those criteria do not hold. Hence, market shares in excess of 50%, held for some time, are 'very likely' to indicate dominance, but 'also undertakings with market shares below 40% could be considered to be in a dominant position' (para 31). Likewise, the discussion paper states that:

> Price cuts where the resulting price remains above average total costs are in general not considered to be predatory because such pricing can usually only exclude less efficient competitors. (Para 127)

But this is followed by two paragraphs describing exceptional circumstances (including the 'not yet as-efficient competitor' situation discussed previously), and then by Section 7 on rebates, where the price–cost test

is applied only to the commercially viable amount, rather than to all sales of the dominant firm (see above), and hence can also lead to the prohibition of pricing above average total costs.

Concluding comments

The Commission has embarked on the reform of Article 82, and is paving the way for an effects-based test. While many commentators (including this author) have argued that the reform as currently set out in the discussion paper does not go far enough, it should of course be recognised that the Commission also has to take account of current case law on Article 82, which is still very much form-based (although arguably, this case law is in part of the Commission's own making). Reconciling these two positions is far from straightforward.

The discussion paper contains a great deal of detail on some practices, particularly rebates, but less on others. While this has been useful to generate discussion, any guidelines document that might follow may wish to seek a more balanced approach, and perhaps develop the general economic principles somewhat further, rather than focus in detail on their application to specific practices.

Finally, it will be interesting to see how the Commission intends to deal with stage 2 of the reform of Article 82, which will cover exploitative abuses (in particular, excessive pricing and price discrimination). The current focus on exclusionary abuses has probably helped to avoid even more discussion at this stage, and there are indeed some who would argue that Article 82 should target only exclusionary abuses (as with the Sherman Antitrust Act in the USA). But in-depth discussion and reform of the policy on exploitative abuses is also long overdue.

Gunnar Niels

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[1] European Commission (2005), 'DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses: Public Consultation', December.
[2] See, for example, Oxera (2005), 'Reform of Article 82: Where the Link between Dominance and Effects Breaks Down', *Agenda*, May.
[3] Super-dominance was first defined as a 'position of overwhelming dominance verging on monopoly', in Opinion of Advocate General Fennelly of October 19th 1998 on *Compagnie Maritime Belge and Dafra-Lines*, joined cases C-395/96 P and C-396/96 P, para 137.
[4] Perhaps a more common term for single-branding is exclusive dealing.
[5] The rebate test in para 154 seeks to calculate the effective price for the last X number of units bought before the retro-active rebate is applied, where X is the commercially viable amount. In the example, a 2.5% rebate is applied to all sales once 1m units are sold (price falls from €100 to €97.5), and the commercially viable amount is assumed to be 50,000. The effective price over the last 50,000 units (units 950,001 to 1m) is then €50—the 950,000 units would have been sold at an average price of 100, generating revenue of €95m, while the new revenue is €97.5m, so the last 50,000 units brought in extra revenue of €2.5m. This effective price of €50 is then compared with average total cost. This approach means that the smaller the commercially viable amount, the lower the effective price on this amount, and hence the more likely that the rebate will be considered capable of foreclosure. In terms of the above example, if the commercially viable amount were smaller, say, 25,000, the effective price for this amount would be €0, and hence likely to be below average total cost.
[6] See Niels G. and ten Kate, A. (2000), 'Predatory Pricing Standards: Is there a Growing International Consensus?', *Antitrust Bulletin*, **45**, pp. 787–809.
[7] Case C62/86, *AKZO Chemie v. Commission*, [1991], ECR 1-3359 [1993] 5 CMLR 215. Prices in the range between AVC and average total cost are deemed predatory if the purpose of the conduct was to eliminate a competitor.
[8] See Vickers, J. (2005), 'Abuse of Market Power', *Economic Journal*, **115**, pp. F244–61.
[9] Ofcom (2004), 'Investigation against BT about Potential Anti-competitive Behaviour', July 12th.

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