

EDITORIAL
THE ARTICLE 82 DISCUSSION PAPER: A MISSED OPPORTUNITY

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In December 2005, the Commission published a Discussion Paper which discusses the competitive analysis of conduct of dominant firms that might constitute exclusionary abuse.¹ The introduction and general tone of the paper, reflecting the comments made by the Commissioner for Competition at Fordham 2005,² 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.³ The adoption of an effects-based regime, if realised, would be a positive development. Past experience and economic analysis have shown that a form-based approach generally fails to protect consumer interests, not least by discouraging pro-competitive practices. We therefore consider whether the Discussion Paper does indeed embody a more effects-based approach or whether it simply represents continued formalism, albeit dressed up with some new jargon.

A. WHY DO WE NEED REFORM?

Before commenting on the Discussion Paper, it is worthwhile reviewing the current approach to assessing competitive conduct under Article 82. The current approach adopts a two-step process: first, the assessment is concerned with whether the firm under investigation enjoys a dominant position; secondly, if dominance is found, the conduct of the firm is assessed to establish whether it constitutes an abuse. In principle, there is much to commend this two-step approach with the requirement to establish dominance providing a useful screen: if the firm is not dominant then there can be no anti-competitive effects and therefore no further analysis is required.

¹ DG Competition discussion paper on the application of Art 82 of the Treaty to exclusionary abuses, 19 December 2005, available at <http://europa.eu.int/comm/competition/anti-trust/others/discpaper2005.pdf>.

² "I am convinced that the exercise of market power must be assessed essentially on the basis of its effects in the market", N Kroes, "Preliminary Thoughts on Policy Review of Article 82", speech at the Fordham Corporate Law Institute, 23 September 2005.

³ See, eg Discussion Paper, para 4.

The criticisms of the current approach relate primarily to the current approach to the assessment of abuse. When assessing the conduct of dominant firms, the Commission, supported by the Courts,⁴ has tended to focus on the form of the conduct rather than its competitive effects.⁵ This approach is at odds not only with standard economics but also with the stated goal of the Article 82 reforms—namely, to better protect consumer interests by moving towards a more effects-based approach. A genuine effects-based approach recognises that the same business conduct, even when practised by dominant firms, can in some circumstances be anti-competitive and in others pro-competitive.⁶ For example, although in certain circumstances the business conduct of tying or bundling of products or offering additional payments for reaching certain targets (ie loyalty rebates) may foreclose competition with adverse consequences for consumers, in many, if not most, other circumstances the same business conduct yields significant benefits to consumers. The fact that these business practices are routinely adopted by non-dominant firms demonstrates clearly that they often represent normal competitive practices.⁷ Moreover, the business practices addressed in the Discussion Paper share a common feature in the sense that any alleged competitive harm arises indirectly via harm to competitors and only becomes manifest in the medium to long term. It should also be noted that many of these practices deliver immediate benefits to consumers, either in the form of lower prices or a unique product offering.

By giving such prominence to the form of conduct, the current approach places undue weight on the establishment of dominance. This problem is exacerbated by the tendency to define dominance primarily with regard to a firm's market share. Furthermore, placing market definition at the centre of any investigation risks market definitions being reverse-engineered: "I don't like what you are doing, so you must be dominant." Although there are good practical reasons for retaining the need to establish dominance as a useful screening device (only if the firm might be held to be dominant is there a need for further investigation of the effects of its business conduct), it needs to be recognised that it merely represents a first step in the competitive assessment.⁸ In other words,

⁴ Case 85/76 *Hoffmann-La Roche & Co. AG v Commission* [1979] ECR 461; Case T-203/01 *Manufacture française des pneumatiques Michelin v Commission (Michelin II)* [2003] ECR II-4071, Case T-219/99 *British Airways plc v Commission* (17 December 2003), not yet reported.

⁵ There are some who argue that Art 82 effectively embodies a *per se* approach to certain business practices.

⁶ This is also recognised in the law – even dominant firms are able to engage in what is termed "normal competition". Unfortunately there has been no attempt by either the Commission or the Courts to provide an operational definition of that term.

⁷ This is not to say that such business conduct when practised by a dominant firm cannot lead to anti-competitive outcomes. It is only to state that the fact that non-dominant firms engage in such conduct demonstrates that such conduct can be pursued for benign reasons.

⁸ Note that this approach differs from that put forward in the paper prepared by the EAGCP, which appears to argue that the establishment of dominance is not required in an effects-based analysis (available at http://europa.eu.int/comm/competition/publications/studies/eagcp_july_21_05.pdf).

assessing whether conduct represents an abuse should be based on the competitive effects of the particular business conduct under investigation and not on whether the firm is dominant.

B. WHAT DOES AN EFFECTS-BASED APPROACH ENTAIL IN PRACTICE?

Moving to an effects-based system raises the immediate issue: how do we discriminate between pro-competitive and anti-competitive behaviour of dominant firms? After defining the relevant market (hopefully taking into account all the inherent issues in that step) and identifying whether the company has substantial market power, an effects-based assessment of the conduct of dominant firms should embody the following consumer-welfare based tests/considerations.

1. An effects-based assessment needs to provide a coherent explanation of anti-competitive harm.

Such an explanation is particularly important in the context of exclusionary abuses (ie the type of conduct covered by the Discussion Paper), where the need to distinguish between harm to competitors and harm to competition is particularly acute. As noted above, each category of potential exclusionary abuse has potentially important pro-competitive and efficiency-enhancing benefits. Moreover, harm to competitors does not necessarily, or even usually, translate into harm to competition. To guard against the tendency to forget this important fact, a central element of any investigation should explain, first, how the conduct of the dominant firm leads to the foreclosure of competitors and, secondly, why the consequent change in the structure of the market ultimately harms consumers. By requiring competition authorities to spell out such a theory of harm in each case, it becomes clear that establishing harm to competitors is a necessary (but not sufficient) element of any theory of anti-competitive harm.

2. Foreclosure should be defined with reference to harm to competition not harm to competitors.

It is important to be clear as to what is meant by the marginalisation of competitors. Simply noting that a dominant firm's rivals are adversely affected in the sense that they will find it harder to make sales is insufficient to conclude that these firms are marginalised. Indeed, harming competitors is an integral part of the competitive process: the harder one firm competes, the harder it is for its rivals to win sales. Firms can be said to be marginalised only if the ability to compete for future sales is permanently reduced even if prices were to be increased above competitive levels. Sustainable price increases can occur only if

either competitors are forced to withdraw existing products permanently from the market or the marginal cost of supply is permanently adversely affected.⁹

This definition of foreclosure is at odds with Court judgments where the central issue is the protection of the structure of the market so that any adverse impact on competitors is deemed to harm “competition as such (as an institution)”.¹⁰ This definition of foreclosing conduct is explicitly not aimed to protect consumers but rather to protect competitors based on the assumption that long-term harm to consumers is to be expected, an assumption that is itself predicated upon a finding of dominance. Such views would appear to be in conflict with the views expressed by the Courts in the context of merger control.¹¹

3. A proper effects-based system should have regard to actual market evidence.

Almost by definition, a proper effects-based assessment will consider whether market evidence is consistent with competitors being harmed. Whether rivals are harmed can be assessed empirically by considering the behaviour of the dominant firm’s customers over time. For example, when assessing the competitive effects of, say, a loyalty rebate scheme, if it can be seen that individual customers switch from supplier to supplier from year to year this would indicate that customers are not “loyal” to suppliers.

Furthermore, where the evidence shows that competitors are able to increase their market share, this raises a strong economic presumption that the competitive conduct under investigation is not foreclosing *competition*. However, the converse is not true: a decline in a firm’s market share is *consistent with* but *does not prove* exclusionary conduct on the part of the dominant firm. To conclude that the conduct of the dominant firm is exclusionary, one therefore needs to consider whether the dominant firm is increasing its market share by competing on the merits or through anti-competitive conduct.

4. In order to distinguish between these two possibilities regard is usually given to whether the competitors represent equally efficient competitors.

If rival firms can be shown to be less efficient than the dominant firm, it is unlikely that the loss of market share is the result of anti-competitive conduct. In order to determine whether competitors represent equally efficient competitors, reference is made to cost benchmarks: if the dominant firm can be shown to be

⁹ Note that, although the loss of sales may lead to an increase in a firm’s average cost, this will only result in that firm’s marginalisation if its unit costs are adversely affected or if it ceases to invest in the development of new products. This is consistent with the approach adopted by the Commission in *GE/Amersham*, Case No COMP/M.3304, January 2004.

¹⁰ Opinion of Advocate General Kokott, Case C-95/04 P *British Airways plc v Commission*, February 2006, para 68.

¹¹ See, *inter alia*, *Tetra Laval*, Cases T-5/02 and T-80/02 *Tetra Laval v Commission*, October 2002.

pricing above the appropriate cost benchmark, then exclusionary conduct can be ruled out.

This raises the question as to which cost benchmark should be used. An obvious cost benchmark is average avoidable cost (AAC), since pricing below AAC involves incurring losses that could be avoided. Such pricing has the potential to exclude “as efficient” competitors. In contrast, selling output at a price above AAC is normally consistent with short-term profit-maximising behaviour, since at these prices the dominant firm covers the variable cost of producing the additional output and makes a positive contribution to fixed costs. Accordingly, pricing behaviour whereby a firm sells part or even all of its output at prices below average total cost but above AAC is widely used in competitive markets. Although such prices can in principle raise competitive concerns in the long term,¹² the presumption should be that such pricing conduct represents normal competition.¹³

C. HOW DOES THE DISCUSSION PAPER MEASURE UP?

Unfortunately, the Discussion Paper only focuses on the last of these considerations (ie cost benchmarks) and ignores entirely all the other elements that ought to form part of an effects-based assessment. Indeed, and most importantly, the Discussion Paper only pays lip-service to the need to demonstrate harm to competition. Although general references are made to the need to assess whether competitive conduct gives rise to harm to competition (ie harm to consumers), it is clear that the real emphasis remains on demonstrating harm to competitors. For example, while the Discussion Paper states that “The central concern of Article 82 is foreclosure that hinders competition and thereby harms consumers”,¹⁴ paragraph 58 makes it clear that foreclosure is to be defined as any practice that harms competitors.¹⁵ The Discussion Paper simply presumes that such harm to competitors necessarily translates into harm to competition and hence consumers. That does not constitute an effects-based system.

¹² For example, it might be argued that an “as efficient” rival with a smaller customer base is unable to fully recover fixed costs and is forced to exit the market as a result of financial constraints.

¹³ This issue is analogous to the assessment of conglomerate mergers where potential long-term harm has to be contrasted with immediate observable short-term consumer benefits. See, eg the *Tetra Laval* Court of First Instance judgment, *supra* n 11.

¹⁴ See Discussion Paper, para 56.

¹⁵ Although para 58 goes on to state that

“Foreclosure is said to be market distorting if it likely hinders the maintenance of the degree of competition still existing in the market or the growth of that competition and thus have as a likely effect that prices will increase or remain at a supra-competitive level.”

The more detailed discussion of each potential abuse confirms the view stated in the main text.

In principle, this presumption can be reversed *by the dominant firm* in the second stage of the assessment by showing, analogous to an Article 81(3) exemption, that the conduct is objectively justified or generates valuable efficiency gains. That is, the Discussion Paper envisages introducing a system whereby the parties have to prove that there is no adverse impact on competition.

There are a number of problems with this approach. First, it is useful to consider the Article 81 experience. 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)—any agreement that involves a restriction of action can be held to be a restriction of competition. The primary way out of this mess has been to introduce a complicated collection of block exemptions whose real primary role has been to state the circumstances in which the restriction should not have been considered anti-competitive in the first place (eg the 30% market share threshold for vertical restraints). This is therefore a highly unattractive model to copy. Arguments based on an alleged need for consistency between Article 81 and Article 82 simply do not pass muster.

Secondly, if one adopts a consumer welfare standard as a benchmark as the Discussion Paper suggests, conduct is either pro-competitive or anti-competitive. If this benchmark is employed, then market-distorting foreclosure should properly be defined as conduct that gives rise to harm to consumers. In that case, there can be no role for an efficiency defence. The scope for an efficiency defence therefore arises only because the Discussion Paper adopts an overly restrictive view of foreclosure which is defined in relation not to its effects on competition but merely on its effects on competitors. Hence, although the presence in the Discussion Paper of an “efficiency defence” represents a partial recognition of the pro-competitive potential of some of these practices, the general approach ought to raise significant doubts as to its practical relevance. In particular, the Discussion Paper provides no guidance as to the types of efficiency gains that may be considered relevant except to suggest a strong focus on proving productive efficiencies. There is no mention of the efficiencies of Ramsey pricing, of the elimination of the Cournot effect, of the setting of marginal price incentives that mimic marginal cost conditions or of the general desirability of low prices and discounts. The efficiencies section therefore ignores the key efficiency arising from such business conduct; namely the lowering prices to consumers. For this reason, we can expect in practice few, if any, dominant firms to prevail with an efficiency defence.

D. CONCLUSIONS

So does the Discussion Paper represent a step forward or a step back? The statement made in the Discussion Paper that the purpose of Article 82 is to protect competition, and not competitors, is to be welcomed. It should also be recognised that the Discussion Paper appears to support fewer form-based rules than could be justified on the basis of the case law. Yet the key issue faced by the Discussion Paper is to set out the specific policy instruments that implement the “competition, not competitors” principle. In our opinion, the Discussion Paper does not measure up well against this benchmark since it continues to place undue emphasis on demonstrating harm to competitors and little or none on demonstrating harm to competition.