



Brugge

College of Europe  
Collège d'Europe



Natolin

Global Competition Law Centre

# **GCLC Research Papers on Article 82 EC**

**July 2005**

Global Competition Law Centre  
College of Europe, Bruges  
Dijver 11, BE-8000, Belgium  
<http://gclc.coleurop.be>

## Table of Contents

List of Contributors.....	1
Introduction..... <i>D. Geradin</i>	4
The Concept of Dominance..... <i>D. Geradin, P. Hofer, Fr. Louis, N. Petit and M. Walker</i>	6
The Concept of an Exclusionary Abuse under Article 82 EC..... <i>J. Temple Lang and R. O'Donoghue</i>	38
Predatory Pricing..... <i>G. Goeteyn, S. Mavroghenis, M. Piergiovanni, E. Reed and D. Ridyard</i>	65
Rebates as an Abuse of Dominance under Article 82 EC..... <i>J. Padilla and D. Slater</i>	84
Price Discrimination under Article 82(c) EC: Clearing up the Ambiguities..... <i>D. Gerard</i>	105
Refusal to Deal..... <i>Ch. Humpe and C. Ritter</i>	134
An Antitrust Analysis of Tying: Position Paper..... <i>Ch. Ahlborn, D. Bailey and H. Crossley</i>	166

## **List of Contributors**

### **Editor**

Damien Geradin	Director of the Global Competition Law Centre, Professor at the University of Liège and at the College of Europe
----------------	--

### **Contributors**

Christian Ahlborn	Partner, Linklaters
David Bailey	Associate, Linklaters
Helen Crossley	Associate, Linklaters
Damien Geradin	Director of the Global Competition Law Centre, Professor at the University of Liège and at the College of Europe
Damien Gerard	Associate, Cleary Gottlieb
Geert Goeteyn	Partner, Howrey Simon Arnold & White LLP
Paul Hofer	Senior Consultant, Nera Economics Consulting
Christophe Humpe	Associate, SJ Berwin LLP
Frédéric Louis	Partner, Wilmer Cutler Pickering Hale and Dorr
Stephen Mavroghenis	Senior Associate, Howrey Simon Arnold & White LLP
Robert O'Donoghue	Associate, Cleary Gottlieb
Jorge Padilla	Managing Director, LECG
Nicolas Petit	Maître de conférences, University of Liège
Michele Piergiovanni	Associate, Cleary Gottlieb

*GCLC Research papers on Article 82 EC - July 2005*

Eileen Reed	Director, CapAnalysis
Derek Ridyard	Partner, RBB Economics
Cyril Ritter	Associate, Morrison Foerster
Donald Slater	Associate, Ashurst
John Temple Lang	Counsel, Cleary Gottlieb
Mike Walker	Vice-President, CRA International

**Other Contributors**

Jean-Francois Bellis	Partner, Van Bael & Bellis
Onno Brouwer	Partner, Freshfields Bruckhaus Deringer
Cristina Caffarra	Vice-President, CRA International
Gloria Crichlow	Lawyer, Bonelli Erede Pappalardo
Jacques Derenne	Partner, Lovells
Giulio Federico	Senior Consultant, CRA International
Kurt Haegemann	Associate, Baker & McKenzie
David Hull	Partner, Covington & Burling
Pierre Kirch	Partner, Paul Hastings
Ritter Lennart	Of Counsel, Bonelli Erede Pappalardo
Penelope Papandropoulos	Principal, CRA International
Michael Rowe	Partner, Slaughter & May
Simon Topping.	Partner, SJ Berwin
Anne Vallery	Counsel, Wilmer Cutler Pickering Hale and Dorr
Betina Volpi	Lawyer, Bonelli Erede Pappalardo

*GCLC Research papers on Article 82 EC - July 2005*

Denis Waelbroeck

Partner, Ashurst

## **Introduction**

Damien Geradin<sup>\*</sup>

This report contains a set of research papers produced under the auspices of the Global Competition Law Centre (GCLC), a research centre based at the College of Europe in Bruges. The papers comprised in this report cover the main issues raised by the application of Article 82 of the EC Treaty, which prohibits abuses of a dominant position. These papers were written by teams of lawyers and economists specialized in the competition field. The authors of these papers also benefited from comments from a wider range of experts.

The teams that produced these research papers were instructed to critically examine the way Article 82 EC has been used to tackle a variety of anti-competitive behaviour by dominant firms, but also to come up with a set of policy proposals designed to offer some guidance on how the way Article 82 EC has been applied by national competition authorities, the Commission, as well as national and Community courts, could be improved. The objective of this report is thus not so much to criticize past decisions and judgments, but to come up with concrete proposals for improvement.

The timing of this report is not without its reasons. Over the past year, the Commission has engaged in a major internal effort to review the way Article 82 EC is applied to the business conduct of dominant firms. This initiative has been welcome by academics, practitioners, judges, and policy-makers as a positive development. While several areas of EC competition law have indeed been witnessing key reforms (modernisation of the application of Article 81, the new merger control regulation, etc.), Article 82 EC was seen by many as the next competition law provision, which needed to receive the attention of the Commission.

Drafts of these papers were delivered at the GCLC's Second Annual Conference, which took place on 16-17 June 2005 in Brussels, in the presence of DG Competition's Director-General Philip Lowe as well as the members of the Commission team in charge of reviewing Article 82 EC. They have benefited from a wide range of comments subsequent to the event and can be found hereafter in their final form. We hope that these

---

<sup>\*</sup> Damien Geradin is Director of the Global Competition Law Centre, Professor at the University of Liège and at the College of Europe.

papers will contribute to the debate on the future of Article 82 EC and hopefully positively influence the draft guidelines that the Commission is planning to release by the end of 2005.

I should point out to the readers that the various positions defended in the papers do not represent the views the GCLC, but only of the individual authors.

I would finally like to thank the authors of the papers for the time they spent preparing these reports, as well as the sponsors of the GCLC whose financial assistance has made the activities of the centre possible.

July 2005

Prof. Damien Geradin  
Director of the Global Competition Law Centre  
<http://gclc.coleurop.be>

# The Concept of Dominance

Damien Geradin, Paul Hofer, Frédéric Louis, Nicolas Petit and Mike Walker\*

## I. Introduction

The first prong of Article 82 EC requires, prior to the identification of abusive behaviour, evidence that the firm under scrutiny enjoys a dominant position. Surprisingly, this issue seems to be sometimes overlooked. Enforcers, practitioners and scholars have recently paid greater attention to the concept of abuse than to the question of dominance when discussing Article 82 EC. This should not, however, be interpreted as a sign that the law of dominance is clear. Quite to the contrary, the concept of dominance raises a wide array of questions which are discussed in the sections that follow. Following this introduction, section II discusses the definition of dominance. Section III reviews the factors for establishing dominance. Section IV makes comments on the concept of collective dominance. Finally, section V formulates policy recommendations.

## II. The Definition of Dominance

### A. The definition of dominance stemming from case-law

The term “dominance” is a legal concept. Yet, the assessment of dominance is ultimately very heavily influenced by economic considerations. This requires the identification of corresponding legal and economic concepts.

In the seminal *United Brands* and *Hoffmann-La Roche* cases, the European Court of Justice (“ECJ”) defined dominance as:

“a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power

---

\* Damien Geradin is Director of the Global Competition Law Centre, Professor at the University of Liège and at the College of Europe; Paul Hofer is Senior Consultant at Nera Economics Consulting; Frédéric Louis is Partner at Wilmer, Cutler Pickering Hale and Dorr; Nicolas Petit is Maître de conférences at the University of Liège; Mike Walker is Vice-President, CRA International.



to behave to an appreciable extent independently of its competitors, customers and ultimately of its consumers.”<sup>1</sup>

Certain authors have seen two elements in this definition, namely (i) the power to behave independently of competitors, customers and consumers; and (ii) the ability to prevent effective competition being maintained on the relevant market.<sup>2</sup> However, as Neven, Nutall and Seabright have rightly observed, it seems that on the legal ground, these elements are simply one and the same thing.<sup>3</sup> This is confirmed by the rulings of the Community Courts which have never drawn any distinction between these elements.

Nonetheless, the formulation used by the ECJ is not entirely satisfactory. The concept of “acting independently” does not provide an adequate basis for discriminating between dominant firms and non-dominant firms. No firm can act to an appreciable extent independently, since every firm will be constrained by its respective demand curve. First, every firm is limited in its commercial behaviour to some extent by competitors since the presence of these competitors affects the firm’s demand curve. Although this is by definition true for firms operating in a competitive market, it is also true for a dominant firm. All firms, including those that are held to be dominant, will increase prices to the point at which further price increases would be unprofitable. In this sense, competitors do constrain the behaviour of firms so that even a dominant firm does not act independently of its competitors.<sup>4</sup> Second, an individual firm’s demand curve is equally affected by the behaviour and preferences of its customers. Firms typically face downward sloping demand curves, indicating that a higher price comes at the expense of fewer sales: it is not generally open to a firm to raise prices and sell the same quantity as before. Again, this is true of a dominant firm just as much as it is true of a non-dominant firm.<sup>5</sup>

---

<sup>1</sup> Case 27/76, *United Brands v. Commission*, [1978] E.C.R. 207 at para. 65 and Case 85/76, *Hoffmann La Roche v. Commission*, 1979] E.C.R.-461 at para. 38. This definition has since then been repeatedly used by the Commission and the Community judicature in most Article 82 EC judgments, see Case C-171/05, *Piau v. Commission* para. 109, not yet reported; Case T-219/99, *British Airways v. Commission*, not yet reported, at para. 189, Case T-65/98, *Van den Bergh Foods v. Commission*, [2003] E.C.R. II-4653, at para. 154, Case C-396/96 *Compagnie Maritime Belge Transports v. Commission*, [2000] E.C.R. I-1365 at para. 34, Case T-128/98 *Aéroports de Paris v Commission* [2000] E.C.R. II-3929, at para. 147.

<sup>2</sup> See R. Whish, *Competition Law*, 5<sup>th</sup> Ed. LexisNexis-Butterworths, 2005 at p.179 and S. Bishop and M. Walker, *The Economics of EC Competition Law*, 2<sup>nd</sup> Ed. Sweet and Maxwell, London, 2002 at para. 6.06.

<sup>3</sup> See D. Neven, R. Nutall and P. Seabright, *Merger in Daylight – The Economics and Politics of European Merger Control*, CEPR, 1993 at p.18. Rather, when one of these conditions is satisfied, the Courts have tended to infer the satisfaction of the other. Some consider that these two elements are equivalent.

<sup>4</sup> This seems to be understood in the case-law as the Community courts have constantly held that the existence of some form of competition in a market did not necessarily rule out a finding of dominance. See *United Brands*, supra note 1 at paras. 113-121 and *Hoffmann-La Roche*, supra note 1 at paras.39, 69-78.

<sup>5</sup> Equally, when a firm’s customers are not the end consumers (e.g., wholesale markets), the firm is still not able to behave independently of consumers. This is because demand for intermediate goods is a “derived” demand, i.e. it is ultimately determined by end consumers.

There is, of course, one important sense in which a dominant firm can act to an appreciable extent independently of its competitors. A dominant firm can increase its price above the competitive level and so can to some extent act independently at the *competitive price*. As Professor Whish notes, “the ability to restrict output and increase price derives from independence or, to put the matter another way, freedom from competitive constraint.”<sup>6</sup> However, there is a measurement problem here: how can one measure whether a firm has the ability to price above the competitive price level? The competitive price level is virtually always impossible to calculate (on both conceptual and data grounds). More fundamentally, if it could be routinely calculated then the identification of a dominant position would become redundant, since one could simply adopt the rule that all market participants are required to price at the competitive level.

**B. The economic approach – dominance as substantial market power**

For these reasons, a better economic test for identifying a dominant position lies in the other part of the definition of dominance, i.e. a firm’s ability to engage in business activities that “prevent effective competition from being maintained”.

From an economic perspective, competition can be said to be effective when no firm, either acting individually or in concert, is able to exercise substantial *market power*. The standard definition of market power is the ability to profitably raise price (through the restriction of output) above the level that would prevail under competitive conditions. This definition is already used by a number of competition authorities. For instance, the European Commission considers that “market power is essentially measured by reference to the power of the undertaking concerned to raise prices by restricting output without incurring a significant loss of sales or revenues”.<sup>7</sup> The UK Office of Fair Trading (“OFT”) has also adopted a close definition. It refers to market power as “the ability to raise prices consistently and profitably above competitive levels”.<sup>8</sup>

---

<sup>6</sup> R. Whish, *Competition Law*, 5<sup>th</sup> Ed., Butterworths, 2003 at p.179. Other interpretations have also been proposed. Professor Motta observes that behaving independently of competitors might be formalized where the (dominant) firm maximizes its profits taking into account the best replies of its competitors. See M. Motta, *Competition Policy – Theory and Practice*, Cambridge University Press, (2004) at note 88.

<sup>7</sup> See Commission Working Document on the Proposed New Regulatory Framework for Electronic Communications Networks and Services: Draft Guidelines on market analysis and the calculation of significant market power (2001) at para. 65. See also Commission Notice - Guidelines on Vertical Restraints, (2000) O.J. C 291, pp.1-44 where the Commission defines market power as “the power to raise price above the competitive level and, at least in the short term, to obtain supra normal profits”. Scholars have endorsed a similar definition. Mehta and Peepkorn state that “The answer given by economists on the first question - what is market power? - concentrates on the power to raise price above the competitive level.” See §1.18 of Chapter I by K. Mehta and L. Peepkorn in J. Faull and A. Nikpay, *The EC Law of Competition*, Oxford University Press, 1999.

<sup>8</sup> See para. 1.2 of the Guidelines of the OFT on the Assessment of Market Power, OFT415, 1999.

However, the existence of market power is not a zero-one matter. Market power is a continuum and a very large number of firms possess *some* degree of market power.<sup>9</sup> Dominance should therefore apply only to those firms that possess substantial market power or a very high degree of market power.<sup>10</sup> It is worth noting that the equating of dominance with *substantial* (or significant) market power is already made in the definition of dominance formulated by the ECJ. The reference to the ability for a firm to behave independently to an “appreciable extent” indicates that Article 82 EC is not concerned with the minimal amount of market power that most firms enjoy.<sup>11</sup> A similar principle has been recognized in sector specific legislation where the Council and the Parliament explicitly use “significant market power” and dominance as synonyms.<sup>12</sup> Furthermore, in the UK the OFT has indicated that “an undertaking is unlikely to be dominant if it does not have substantial market power”.<sup>13</sup>

In contrast, the European Commission has not explicitly commented on this issue of substantiality. However, it has indirectly equated dominance to substantial market power. The guidelines on the application of Article 81(3) provide for instance that:

“Market power is a question of degree. The degree of market power normally required for the finding of an infringement under Article 81(1) in the case of agreements that are restrictive of competition by effect is less than the degree of market power required for a finding of dominance under Article 82”.<sup>14</sup>

As a matter of policy, the Commission should be encouraged to explicitly clarify that dominance within the meaning of Article 82 EC amounts to substantial market power.

The question then immediately turns on what counts as substantial market power, as opposed to insubstantial or insignificant market power. Scholars and competition law enforcers have identified two forms of substantial market power.

---

<sup>9</sup> See R. Posner, *Antitrust Law*, 2<sup>nd</sup> Ed., University of Chicago Press, 2001 at p.265; D.W. Carlton and J. M. Perloff, *Modern Industrial Organization*, Scott, Foresman/Little, Brown 1989 at 738. It can be so because of product differentiation, switching costs, consumer fidelity etc. See M. Motta *supra* note 6 at pp.115-116. Only in the theoretical model of perfect competition or in the Bertrand model with homogeneous products would firms enjoy no market power.

<sup>10</sup> See M. Motta, *supra* note 6 at p.35.

<sup>11</sup> See I. Van Bael and J. F. Bellis, *Competition Law of the European Community*, 4<sup>th</sup> Ed., (2005) Kluwer Law International at para. 2.23.

<sup>12</sup> See Article 14(2) of Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services, (2002) O.J. L 108, which provides: “An undertaking shall be deemed to have significant market power if, either individually or jointly with others, it enjoys a position equivalent to dominance, that is to say a position of economic strength affording it the power to behave to an appreciable extent independently of competitors, customers and ultimately consumers”.

<sup>13</sup> See para. 2.10 of the Guidelines of the OFT on the Assessment of Market Power (OFT 415).

<sup>14</sup> See Communication from the Commission - Guidelines on the application of Article 81(3), (2004) O.J. C 101, pp.97-118 at para. 26. See also the Guidelines on Vertical Restraints *supra* note 8 at para. 119: “Companies may have market power below the level of market dominance, which is the threshold for the application of Article 82”.

A first form of substantial market power concentrates on the “power over *price*”.<sup>15</sup> But in terms of its implementation, this concept does not say how much power over price there must be (i.e. by *how much* must a dominant firm be able to raise price above the competitive level) to distinguish substantial market power from insubstantial market power. A one-way test can be inferred from the market definition SSNIP methodology used by the Commission. This provides that a group of products forms a relevant market if a hypothetical monopolist can profitably impose a Small but Significant Non-transitory Increase in Price above the competitive level, whereby the “small but significant” is typically taken to mean 5-10%.<sup>16</sup> On that basis, if a firm is in fact able to profitably implement a 5-10% price rise, it follows automatically that the products controlled by that firm already by themselves represent a relevant market, thus making the firm a monopolist. On the basis that a monopolist can safely be assumed to be dominant, it would follow that the ability to raise price by 5-10% amounts to a sufficient degree of “power over price” for a finding of dominance.

The concept of “power over price” is, however, not entirely satisfactory. First, it underplays the fact that substantial market power can be exercised on many other factors such as, for instance, quality, service and innovation.<sup>17</sup> Thus, a definition of substantial market power should also encompass the ability to lower quality or reduce the pace of innovation.

Second, the suggested definition of this concept requires the identification of the competitive price level which is a notoriously daunting task. It is indeed virtually impossible to determine the competitive price level, and if that was possible, there would be no need to be concerned with the concept of dominance. Hence, a test articulated on the “ability of a firm to restrict output substantially in the market place, below its current level” would probably be better suited for the purpose of identifying a substantial market power. If a firm is able to restrict significantly total output in the market by restricting its own output, this indicates that other firms are unable to replace the supply taken away by the allegedly dominant firm. This implies that there are both barriers to entry and barriers to expansion, which suggests that a firm with a large market share may well have substantial market power.

A second form of market power is the “power to *exclude*”. As Krattenmaker, Lande and Salop put it, this form of market power can be found where:

“[a] firm or group of firms may rise price above the competitive level or prevent it from falling to a lower competitive level by raising its rivals' costs and thereby causing them to

---

<sup>15</sup> The abuse of dominance in terms of excessive or exploitative prices is closely related to this category of market power.

<sup>16</sup> See OFT and Competition Commission merger guidelines, *supra* note 8.

<sup>17</sup> See J. Pearce Azevedo and M. Walker, “Dominance: Meaning and Measurement”, (2002) 7 *European Competition Policy Review*, at p.365. This has been recently recognised by the European Commission in its Guidelines on the Application of Article 81(3) of the Treaty where it states that “market power is the ability to maintain prices above competitive levels for a significant period of time or to maintain output in terms of product quantities, product quality and variety or innovation below competitive levels for a significant period of time”, at para. 25.

restrict output. Such allegations are at the bottom of most antitrust cases in which one firm or group of firms is claimed to have harmed competition by foreclosing or excluding its competitors. We denote this power as “exclusionary” [...] market power”.<sup>18</sup>

This form of market power is already explicitly taken into account by a number of competition authorities, including the OFT which states that “[a dominant firm] can also use its market power to engage in anti-competitive conduct and *exclude or deter competitors* from the market”.<sup>19</sup> Examples of such exclusionary behaviour include predatory pricing,<sup>20</sup> certain forms of loyalty rebates, refusal to supply, and margin squeeze.

In the context of Article 81(3) EC, the Commission has itself recognized that:

“The creation, maintenance or strengthening of market power can [...] also result from a restriction of competition between any one of the parties and third parties [to an agreement], e.g. because the agreement leads to foreclosure of competitors or because it raises competitors' costs, limiting their capacity to compete effectively with the contracting parties.”<sup>21</sup>

While the Commission recognizes this type of behaviour as an abuse concept under Article 82, it has not clarified the analytical framework that it applies to such cases. In fact, the Commission has at times been accused of protecting competitors, instead of protecting competition and consumers.<sup>22</sup>

### C. Levels of dominance

The economic approach to defining dominance does not preclude drawing distinctions between different levels/degrees of dominance. In fact, one firm may be able to price well above the competitive level for a long time, while another firm may only be able to price just above for a short period of time.<sup>23</sup> From an economic perspective there is no difficulty with such a sliding scale. As noted above, market power should be understood as a continuum, rather than as a zero-one state. Accordingly, a dominant firm can be viewed as one with substantial market power and there is no logical difficulty with the fact that there are different levels of “substantial”.

---

<sup>18</sup> T.G. Krattenmaker, R.H. Lande, and S.C. Salop, “Monopoly Power and Market Power in Antitrust Law” (1987), 76, *Georgetown Law Journal*, 241 at p.28.

<sup>19</sup> See “The Chapter II Prohibition”, OFT 402, 1999 at para. 3.9.

<sup>20</sup> It can be argued that a dominant position is not necessary for a strategy of predation; in fact, a position of dominance is the end goal of predation, and not the starting point. If a firm were already dominant, there is arguably little need to predate.

<sup>21</sup> See Communication from the Commission - Guidelines on the application of Article 81(3), supra note 14 at para. 26.

<sup>22</sup> See R. Whish, supra note 2 at p. 20.

<sup>23</sup> See T. Krattenmaker, K. Lande and S. Salop supra note 18 at p.247.

A firm enjoying a quasi monopoly could thus be found in a position of “super-dominance”. This concept was for the first time referred to by Advocate General Fennelly in the *Compagnie Maritime Belge* case:

“To my mind, Article 86 [now Article 82] cannot be interpreted as permitting monopolists or quasi-monopolists to exploit the very significant market power which their superdominance confers so as to preclude the emergence either of a new or additional competitor. Where an undertaking, or group of undertakings [...] enjoys a position of such overwhelming dominance verging on monopoly, comparable to that which existed in the present case at the moment when G & C entered the relevant market, it would not be consonant with the particularly onerous special obligation affecting such a dominant undertaking not to impair further the structure of the feeble existing competition for them to react, even to aggressive price competition from a new entrant, with a policy of targeted, selective price cuts designed to eliminate that competitor”.<sup>24</sup>

The rationale behind “superdominance” is that if a firm with 50 per cent of a market is dominant, then a firm with 90 per cent – other things being equal – is likely to be even more dominant.<sup>25</sup> So far, this concept has, however, never been explicitly endorsed by the Community courts. Rather, the Courts have only expressed discreet support for the idea. In *Tetra Pak II*, for instance, the Court of First Instance (“CFI”) and the ECJ implied that a dominant position could be easily identified where the undertaking under scrutiny enjoyed a quasi monopoly.<sup>26</sup> Similarly, but without being more explicit, the Commission expressed this view in the *1998 Football World Cup*,<sup>27</sup> as well as in the *Microsoft* decisions where it held:

---

<sup>24</sup> See Opinion of Advocate General Fennelly delivered on 29 October 1998 in *Compagnie maritime belge transports SA* (C-395/96 P), *Compagnie maritime belge SA* (C-395/96 P) and *Dafra-Lines A/S* (C-396/96 P) v *Commission*, Joined cases C-395/96 P and C-396/96 P, [2000] E.C.R. I-1365 at para. 137.

<sup>25</sup> The legal logic is also that the special responsibility of super dominant firms is higher than that of dominant firms.

<sup>26</sup> See Case T-83/91, *Tetra Pak Rausing v. Commission*, [1994] E.C.R. II-755 at para. 115: “The actual scope of the special responsibility imposed on an undertaking in a dominant position must therefore be considered in the light of the specific circumstances of each case, reflecting a weakened competitive situation, as an analysis of the case-law confirms”. See Case C-333/94, *Tetra Pak International SA v Commission*, [1996] E.C.R. I-5951 at para. 31: “Accordingly, the Court of First Instance was right to accept the application of Article 86 [now Article 82] of the Treaty in this case, given that the quasi-monopoly enjoyed by Tetra Pak on the aseptic markets and its leading position on the distinct, though closely associated, non-aseptic markets placed it in a situation comparable to that of holding a dominant position on the markets in question as a whole.”

<sup>27</sup> Commission decision of 20 July 1999, *1998 Football World Cup*, (2000) O.J. L 5 at paras. 86-87: “The scope of the parties' responsibility must therefore be considered in relation to the degree of dominance held by the parties and to any special characteristics of the market which might affect the competitive situation. [...] the CFO was, as a *de facto* monopolist, under a *prima facie* obligation to ensure that entry tickets sold in 1996 and 1997 for finals matches were made available to the general public under non-discriminatory arrangements throughout the EEA, even though demand from consumers outside France for certain ticket products may have been relatively small as against the demand from the general public in France.”

“Microsoft, with its market shares of over 90%, occupies almost the whole market. It therefore approaches a position of complete monopoly, and can be said to hold an overwhelmingly dominant position”<sup>28</sup>

However, absent any clear statement by the Court and the Commission on the concept of super dominance, it would be indeed helpful if the Commission could clarify this issue.<sup>29</sup>

#### D. Market definition

There are serious problems with market definition in Article 82 cases. A first problem concerns the substantive test for the identification of relevant markets. The Commission's Guidelines on the Definition of the Relevant Market made it clear that the standard economic approach to defining a relevant market is the SSNIP test (or Hypothetical Monopolist test).<sup>30</sup> However, while this test is well suited to merger cases, the test seems poorly suited to dominance cases. Broadly speaking, the correct benchmark for Article 82 cases is the price which would prevail in the absence of any anti-competitive behaviour. But this varies with the particular allegation. For instance, if the allegation is one of excessive pricing, then the benchmark is the price in the absence of the alleged excessive pricing. However, this approach amounts to circular reasoning, because it is impossible to form a view on this benchmark without first forming a view on whether the prevailing prices are excessive. If the allegation is unfounded, then the correct benchmark is the current price. If the allegation is founded, then the correct benchmark is a lower price.<sup>31</sup> But without knowing whether the allegation is unfounded or not, one cannot know what the benchmark is. And if it is already known whether the allegation is unfounded or not, why is there a need for market definition? This implies that in many Article 82 cases market definition may not be as useful as generally believed.<sup>32</sup> However, as a matter of

---

<sup>28</sup> See Commission decision of 24 March 2004, *Microsoft*, not yet published at para. 435.

<sup>29</sup> In the UK, however, the Competition Appeal Tribunal referred to superdominance in its *Napp* judgment.

<sup>30</sup> See Commission Notice on the Definition of the Relevant Market for the Purposes of Community Competition Law, (1997) O.J. C 372 1 at paras. 17-18.

<sup>31</sup> Otherwise, the analysis will suffer the pitfalls known under the name of the *Cellophane Fallacy*. Implementing the SSNIP test from the monopoly price would lead to defining the relevant market too widely, thereby erroneously reaching the conclusion that the firm under scrutiny does not enjoy a dominant position. This is acknowledged in the Commission's Guidelines, *supra* note 7 at para. 19: “Generally, and in particular for the analysis of merger cases, the price to take into account will be the prevailing market price. This might not be the case where the prevailing price has been determined in the absence of sufficient competition. In particular for investigation of abuses of dominant positions, the fact that the prevailing price might already have been substantially increased will be taken into account”. The Commission, however, remains silent on the precise manner in which the cellophane fallacy will be taken into account.

<sup>32</sup> See S. Baker and L. Wu, “Applying the Market Definition Guidelines of the European Commission”, (1998) 19 *E.C.L.R.* 277; D. Harbord and G. Von Graevenitz, “Market Definition in Oligopolistic and Vertically Related Markets: Some Anomalies”, (2000) 3 *E.C.L.R.* 151 at note 6; F. M. Fisher, “Diagnosing Monopoly”, (1979) 19, *Quarterly Review of Economics and Business*, 7 at p.16; F. Fishwick, “The definition of the relevant market in the competition policy of the EEC”, (1993) 1 *Revue d'économie industrielle*, 63.

law, the ECJ made clear in *Continental Can* that market definition was essential for the assessment of dominance within Article 82 proceedings.<sup>33</sup>

There are, however, a number of ways of dealing with the problem of identifying the appropriate price benchmark for the SSNIP test:

- Price concentration studies. If data is available covering a number of different geographic areas, and concentration levels and market shares vary across these areas (with minimal differences in all other respects), then the relationship between price and concentration / market shares across the areas can be informative. If a firm is accused of being dominant because it has 60% of the market for widgets, then evidence that the price of widgets does not vary with concentration across the regions is useful as it suggests that widgets is not a relevant market, which in turn suggests that the 60% figure does not imply dominance.
- Inferences on market definition from behaviour. The analysis of behaviour by an allegedly dominant firm may provide information about market definition. If an effects analysis shows that the firm was able to price excessively, then this implies the firm is dominant, which in turn is likely to imply a particular market definition. But in that respect, defining the relevant market prior to the assessment of the alleged behaviour has no purpose.<sup>34</sup>
- Resort to a “traditional” characteristics approach to market definition.<sup>35</sup> Although such an approach has (rightly) gone out of fashion in borderline cases, there are situations when it can provide “upper bound” or “lower bound” benchmarks. For example, the traditional market definition approach may allow the investigator to dismiss the allegation immediately if the allegedly dominant firm has a very small market share of all plausible markets. Equally, if the firm has a very large share of all plausible markets, this suggests that the firm may well be dominant.

All three methods have some merit, and are likely to support each other, rather than leading to different conclusions. The choice as to which is most appropriate in a given case is likely to depend on the precise circumstances. For example, price-concentration analysis is particularly useful if there are comparable “benchmarks”, but less appropriate if the various areas are characterised by different demand levels or costs. Equally, the

---

<sup>33</sup> See Case C-6/72, *Europemballage Corporation and Continental Can Company Inc. v Commission*, [1973] E.C.R. 215 at para. 32: “For the appraisal of SLW’s dominant position and the consequences of the disputed merger, the definition of the relevant market is of essential significance, for the possibilities of competition can only be judged in relation to those characteristics of the products in question by virtue of which those products are particularly apt to satisfy an inelastic need and are only to a limited extent interchangeable with other products”.

<sup>34</sup> See D. Harbord and G. Von Graevenitz, *supra* note 32 at p.152.

<sup>35</sup> The traditional approach focuses on the review of, among others, products characteristics, prices and intended use from the consumer's viewpoint. An example of this approach can be found in the Block Exemption Regulation 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, (1999) O.J. L 336/21.



traditional approach is useful if it leads to clear-cut outcomes, but is less reliable in borderline cases.

A second problem relates to the market definition practice of the European Commission under Article 82 EC. There has indeed been a great deal of criticism of the fact that the Commission often defined markets very narrowly with a consequence that the firm under scrutiny was inevitably found in a dominant position.<sup>36</sup> This has been observed, for instance, in the *United Brands* and *Hugin* decisions, or in the *Michelin I* case.<sup>37</sup> This risk is further reinforced by the fact that, since the adoption of the Guidelines on the definition of the relevant market, the Commission has manifestly not applied the SSNIP test but rather preferred to rely on a qualitative assessment of substitutability through the identification of a cluster of indicators.<sup>38</sup>

### III. Factors for Establishing Dominance

Traditionally, the EC Courts and the Commission have found dominance on the basis of a review of market shares and an assessment of additional “factors”. There is, however, much uncertainty as to the value of market shares as an indicator of dominance, as well as to the relationship between market shares and the “other” factors. Such lack of a clear analytical framework is detrimental to the rigour of the analysis conducted to assess dominance. In particular, there is a risk that the analysis of factors indicative of dominance is reduced to a “checklist” approach, where a number of factors are examined in turn, in no particular order and without it being clear how much weight each individual factor carries, to conclude, on the basis of a plurality of factors being met, that the undertaking under investigation is dominant.

Such a simplistic approach must be firmly rejected. A finding of dominance requires a careful assessment of market conditions, in what must necessarily be a case-by-case analysis. In this analysis, market shares, while being a useful first indicator, cannot by themselves be decisive. The case-law has, to a certain extent, already recognized this. Any advance in this respect is, however, clearly predicated on the Commission leading the way to define a consistent analytical framework for the assessment of dominance.

#### A. The treatment of market shares in the case-law and the Commission’s decisional-practice

Market shares are undoubtedly a useful preliminary tool in assessing market power. Market shares alone, however, cannot be sufficient for a finding of dominance. Market shares are a poor tool for measuring *e.g.* the constraints posed by potential competition,

---

<sup>36</sup> See, for instance, M. Utton, *Market Dominance and Antitrust Policy*, Edward Elgar, Cheltenham UK, 2003 at p.79.

<sup>37</sup> Id. and V. Korah, *EC Competition Law and Practice*, 8<sup>th</sup> ed, Hart Publishing, Oxford-Portland Oregon, 2004 at pp.99-101.

<sup>38</sup> This tendency can be observed, for instance, in the *Microsoft* decision, *supra* note 28.

for adequately ascertaining the conditions of competition in innovative markets, or for properly taking into account the fact that some bidding markets may be characterized by intense competition despite the presence of large market shares, to name but a few examples.

Market shares are an imperfect proxy for measuring market power, and on their own cannot justify a finding of dominance.<sup>39</sup> If it is accepted that high market shares alone cannot be determinative for a finding of market power, it follows that the need to take into consideration additional factors (barriers to entry, buyer power) will apply regardless of whether market shares are very high – even close to a monopoly – or not.

In *Hoffmann-La Roche*, the ECJ had this to say about market shares:

“[...] although the importance of the market shares may vary from one market to another the view may legitimately be taken that very large shares are in themselves, and save in exceptional circumstances, evidence of the existence of a dominant position.

An undertaking which has a very large market share and holds it for some time, by means of the volume of production and the scale of the supply which it stands for – without those having much smaller market shares being able to meet rapidly the demand from those who would like to break away from the undertaking which has the largest market share – is by virtue of that share in a position of strength which makes it an unavoidable trading partner and which, already because of this secures for it, at the very least during relatively long periods, that freedom of action which is the special feature of a dominant position”.<sup>40</sup>

While the ECJ does grant significant evidentiary value to high market shares, at the same time it shows an understanding of basic economic concepts. Market shares in themselves are meaningless without additional indicators that will reflect on the company's real position in the marketplace (*e.g.*, position of strength over a relatively long period of time; existing barriers to entry or to expansion that prevent competition from meeting demand in the event of supra-competitive prices, *etc.*).

---

<sup>39</sup> For instance, if entry and exit were costless and very easy, then even a monopolist might not be able to raise prices above the competitive level because the mere threat of entry would keep prices low. Similarly, market shares are often only weak indicators of market power in bidding markets. In bidding markets buyers offer a number of firms the chance to be their preferred supplier by bidding the lowest price. Suppliers therefore bid based on their own costs and on their expectations of what others will bid. In markets of this type, firms that have previously won only a modest number of contracts or perhaps have never previously won a contract – as would be the case if the firm were a new entrant – can affect the price at which contracts are awarded. What matters is not market share but the ability to submit a credible bid. Even a firm with a very low market share may still have a major effect on the bidding behaviour of other firms in the market as long as they bid credibly and aggressively. Accordingly, current market shares can provide a misleading picture as to the level of current competition. Highly variable market shares indicate that a high current market share may only be transient and suggest the existence of significant competition between firms, thus implying relatively little market power. Finally, the high market share of a firm may just reflect superior efficiency.

<sup>40</sup> Case C-85/76, *Hoffmann-La Roche v. Commission*, *supra* note 1 at para. 41.

This nuanced approach to the concept of dominance was however revisited in subsequent case-law, principally in *AKZO*. In *AKZO*, the ECJ only partly refers to its own *Hoffmann-La Roche* ruling, to extract the conclusion that

“with regard to market shares the Court has held that very large market shares are in themselves, and save in exceptional circumstances, evidence of the existence of a dominant position [...] That is the situation where there is a market share of 50% such as that found to exist in this case”.<sup>41</sup>

*AKZO* thus appears to lead to a shift from the consideration of market shares as one among other indicators of dominance - albeit an important one - to over-reliance on market shares, which can on their own and save exceptional circumstances be sufficient for a finding of dominance. This narrow reading of *AKZO* is not in line with the much more prudent ruling in *Hoffmann-La Roche*. The problem however remains that, if a too generous interpretation of *AKZO* was promoted, companies may find themselves in a position of *per se* dominance due to their relatively high market shares, irrespective of the actual competitive market conditions they are facing.

The Commission itself appears to – rightly – have gone beyond a literal reading of *AKZO*, and will normally consider other parameters in its assessment of whether a company is in a dominant position. The recent *Microsoft* Decision<sup>42</sup> provides a good example of the Commission going beyond the mere review of market shares and attempting to determine on the basis of the particular circumstances of the markets under review whether *Microsoft* was in a position of dominance or not. Nevertheless, the fact that the Commission repeats in that case the mantra that very large market shares in excess of 50% “are considered in themselves, and but for exceptional circumstances, evidence of the existence of a dominant position”<sup>43</sup> does raise a risk that the Commission will not be held to highest standard of evidence in the way it treats the additional factors of dominance, since it itself considers that it may not be required to conduct such an analysis in the first place.

## B. Market shares and the burden of proof

The importance given to market shares in assessing dominance is closely connected to the issue of who bears the burden of proof regarding the existence of market power. The case-law referred to above appears to hinge on the notion of very large market shares. Again, a literal reading of the case-law would seem to imply that, in cases where very large market shares are involved, the onus of rebutting the initial presumption of dominance based on a market share of 50% or more would lie with the company alleged to be dominant, and not with the Commission. In our view, this shift in the burden of proof based on the sole finding of a “very large” market share would be impracticable,

<sup>41</sup> Case C-62/86, *AKZO v. Commission*, [1991] E.C.R. I-3359, at para. 60.

<sup>42</sup> Commission decision *Microsoft*, supra note 28 at paras. 428-541. This paper argues that the framework for the analysis of dominance as set out by the Commission in its *Microsoft* Decision was the correct one. It does not take a view as to the correctness of the Commission’s findings in that case.

<sup>43</sup> *Id.* at para. 435.

and cannot be justified on the basis of a coherent division of the responsibilities between, on the one hand, the public authority responsible for conducting the investigation and, on the other hand, the company under investigation. If market shares are by definition an imperfect proxy for a finding of market power, any shift of the burden of proof at that early a stage in the analysis from the Commission to the company subject to an Article 82 EC investigation can simply not be sustained.

Again, although the Commission does not end its assessment with the finding of a very large market share, the impression is created in most cases that the rest of the analysis is apparently confined to looking for exceptional circumstances that would disprove the presumption obtained from the sole analysis of market shares, rather than the thorough analysis of market conditions which would be required to substantiate a finding of dominance.

### C. Assessment of market shares in practice

A number of additional points need also to be mentioned when considering market shares.

While low market shares alone cannot in themselves suffice to eliminate concerns about the existence of dominance, it is suggested that, at the very least, the fact that say 60% or more of the relevant market remains open to competition should – unless there is strong evidence to the contrary – be *prima facie* indicative of the absence of market power.<sup>44</sup> A *de minimis* rule of this kind has, for instance, been proposed by the OFT in its “Assessment of Market Power” guidelines.<sup>45</sup>

It is undisputed that market shares cannot be viewed in isolation. Earlier case-law and consistent Commission practice confirm that the market shares of a company need at the very least to be assessed in relation to the market shares of competitors active in the relevant product/geographic markets.

The reference to market shares cannot be a static exercise, but should be appraised over a timeframe that is sufficiently indicative for the market shares to prove meaningful.<sup>46</sup>

---

<sup>44</sup> In *Hoffman-La Roche*, the ECJ annulled the Commission’s decision that Roche was dominant in the vitamin B3 market as its share of this market amounted to 43% and there were no additional factors, which contributed to establish a finding of dominance. However, in its *Virgin/British Airways*, BA was held dominant in the UK air travel agency services market with a market share of 39.7%. This was, however, the first time that a firm with a market share below 40% was found to be dominant.

<sup>45</sup> See Section 2.12 of the guidelines, *supra* note 8 (“The OFT considers that it is unlikely that an undertaking will be individually dominant if its share of the relevant market is below 40 per cent, although dominance could be established below that figure if other relevant factors (such as the weak position of competitors in that market and high entry barriers) provided strong evidence of dominance”).

<sup>46</sup> *Id.* at 4.3 (“The history of the market shares of all undertakings within the relevant market is often more informative than considering market shares at a single point in time, partly because such a snapshot might not reveal the dynamic nature of a market. For example, volatile market shares might indicate that undertakings constantly innovate to get ahead of each other, which is consistent with

While what constitutes a reasonable timeframe needs to be addressed on a case-by-case basis, it is suggested that any period less than 3-5 years is unlikely to be sufficient for market shares to be used even as an initial indicator of market power.

Despite some suggestions to the contrary by both the Commission and EC Courts,<sup>47</sup> it is argued that a constant decline of market shares in the company that is alleged to be dominant be factored in when determining whether a company is really capable of exerting market power.<sup>48</sup>

D. The “unavoidable trading partner” concept

Much has been made by some of the use of the concept of “unavoidable trading partner” in recent Court judgments and Commission decisions<sup>49</sup>. It should be recalled that, as such, this concept is not new as the ECJ already mentioned it in the above quoted passage of its *Hoffmann-La Roche* judgment. In our view, the concept as such adds little, and is in fact equivalent to asserting that a company has market power over its customers, which is part of the legal definition of dominance. At most, the consideration that a company may be an “unavoidable trading partner” will assist the Commission in identifying the relevant parameters – outside market shares – that are relevant for a finding of dominance in the particular industry under examination (e.g., barriers to entry linked to a must stock brand, barriers to entry raised by the control of essential assets, etc.), i.e. the factors that make customers dependent upon the allegedly dominant player.

E. The need to assess the existence of barriers to entry and to expansion

As mentioned above, both the Commission and EC Courts have referred in their decision-making to a number of additional factors that may be indicative of dominance. So far, however, the analytical framework in which these factors must be assessed has been missing. As suggested by Professor Whish among others, these factors have to be seen as tools for determining whether the conditions prevailing on the market give rise to barriers to entry or barriers to expansion, thus allowing the allegedly dominant undertaking to behave to an appreciable extent independently of its competitors, customers and ultimately of consumers (or of suppliers in monopsony cases).<sup>50</sup> If anyone can quickly enter and exit the market at will, even a 100% market share is irrelevant for an assessment of dominance.

---

effective competition. Evidence that undertakings with low market shares have grown rapidly to attain relatively large market shares might suggest that barriers to expansion are low, particularly when such growth is observed for recent entrants”).

<sup>47</sup> See Case T-219/99, *British Airways v. Commission*, not yet reported, para. 224 and para. 298; see also Commission decision of 14 July 1999, *Virgin/British Airways*, (2000) O.J. L30/1, para. 107.

<sup>48</sup> It is however recognized that declining market share might also be a consequence of abusive behaviour, e.g. in an investigation on excessive pricing.

<sup>49</sup> See recently CFI, *British Airways v. Commission*, supra note 47 at para. 217 and Commission decision of 20 June 2001, *Michelin*, (2002) O.J. L 143/1, at paras. 200-208.

<sup>50</sup> See R. Whish, supra note 2.

Under the *Hoffmann-La Roche* and *AKZO* terminology, one may think that barriers to entry/expansion<sup>51</sup> are present on each and every market, since it would only be in “exceptional circumstances” that a company enjoying high market shares may not be in a position to exert market power<sup>52</sup>. However, it is unlikely that a company with high market shares will have the possibility of sustaining supra-competitive prices in the long run if barriers to entry are low, because any decrease in output or any price increase could be subject to competitive reaction by the remaining (actual and/or potential) players on the relevant market. On such basis, should a fully-fledged analysis of market conditions reveal that there are no such barriers to entry, the fact that a company holds a large market share would not be sufficient for a finding of dominance. In those cases, the high market shares could be simply indicative of a “superior skill, foresight and industry” of the company subject to an investigation,<sup>53</sup> or of the existence of external factors such as historic trends that may not be sustainable in the near future.

It is worth reiterating that a determination of whether or not there are barriers to entry requires a full analysis of the conditions of competition prevailing on the relevant market at a particular point in time. The fact that one or more of the factors listed below are present, suggesting the existence of an entry barrier, should not relieve the regulatory authorities of their duty to make a full determination of whether the allegedly dominant entity can really exercise market power. At the very least, any reference to the indicators detailed below should take into consideration whether the characteristics under examination are exclusive to the company that allegedly has market power, or whether these characteristics are shared by other players active on the relevant markets. While factually correct, statements such as those contained in some Commission decisions<sup>54</sup> noting that “the existence of a dominant position may depend upon a combination of factors, where no single one is necessarily decisive” are unfortunately of little guidance to companies and practitioners. Again, the *Microsoft* Decision is a good example of a recent attempt from the Commission to shift from a pure “checklist” approach of a number of unweighted factors and delve into an analysis of the particular features of the industry prior to reaching a finding of dominance.<sup>55</sup>

In looking at the factors identified so far, we limit our analysis of past Commission and EC Court practice to some of the most prominent cases that highlight the EC position with regard to some of the key factors (e.g., *Hoffmann-La Roche*, *United Brands*, *Michelin I* and *II*) even though it is clear that for each of the factors the wealth of cases invoking them either directly or indirectly is much broader.

---

<sup>51</sup> Throughout the remainder of this section, the term “barriers to entry” will be understood as encompassing also barriers to expansion, unless otherwise specified.

<sup>52</sup> Which is noteworthy since some economists would argue that true barriers to entry are in fact very rare.

<sup>53</sup> The language is borrowed from Judge Hand in *United States v. Aluminum Co. of America*, 148 F. 2d 416 (1945).

<sup>54</sup> See e.g., Commission decision of 13 December 2000, *Soda ash-Solvay*, (2003) O.J. L10/10, para. 128.

<sup>55</sup> As stated above, this paper takes no view on the assessment actually carried out by the Commission in *Microsoft*.

1. Legal barriers to entry

Legal/statutory barriers are relevant for determining whether a company is dominant on a given market. Undertakings enjoying exclusive rights to provide a given product or service (i.e., statutory monopolies) will by definition enjoy a dominant position as no other firm can enter in the market to challenge them. The same can be said of firms that enjoy intellectual property rights, which prevents other firms from producing a given product or service, unless there are alternative technologies, which allow other firms to produce the product or service in question (see below, Section 5.4). Thus, any detailed analysis of barriers to entry will require an understanding of the statutory/legal provisions under which a company that is allegedly dominant operates.

The existence of high market shares, if they are found in a market that has only been recently open to competition, may not be sufficiently reliable as an indicator of market power. Indeed, these market shares typically go down once competitors have entered the market. Thus, a position of substantial market power soon after liberalization does not necessarily mean that it will be maintained for a long time. On the other hand, legal barriers such as those arising from a restricted number of licenses being granted by government to operate on the relevant market, or by the requested adherence to technical standards that can only be complied with by one or a few companies that are driving the standard-setting process may provide some initial indication of the existence of market power.<sup>56</sup>

2. Sunk costs and barriers to expansion

Sunk costs are costs that must be incurred in order to compete on a given market, and that are not recoverable upon exit.<sup>57</sup> In *United Brands*,<sup>58</sup> the ECJ noted that “the particular barriers to competitors entering the market are the exceptionally large capital investments required [...], the introduction of an essential system of logistics [...], economies of scale from which newcomers to the market cannot derive any immediate benefit and the actual

---

<sup>56</sup> For these and other illustrations, see OFT Guidelines, “Assessment of Market Power” supra note 8 as well as “Assessment of Market Power, Draft Competition Law Guidelines for Consultation” (OFT 415a, April 2004).

<sup>57</sup> An important distinction can be made between *exogenous* and *endogenous* sunk costs. Exogenous sunk costs are those which any firm must incur if it is to enter the market. For example, exogenous sunk costs are those associated with set-up costs such as the acquisition of a plant with minimum efficient scale. In contrast, endogenous sunk costs are not predetermined in the same way. Rather, the level of endogenous sunk costs incurred is determined by the firms themselves. For example, the amounts that a firm is prepared to spend on research and development or on advertising are not usually predetermined but are commercial decisions for the particular firm to make. The level of expenditure a firm will undertake in incurring endogenous sunk costs will typically depend on the effect that such spending has on consumer demand for its products. Where entry costs are endogenous, there arises the possibility that competition between firms will lead to a competitive escalation in such expenditures. Under these circumstances, such escalation can imply that some industries become strategically concentrated. This can lead to firms having high market shares even though they are engaged in fierce competition with their rivals.

<sup>58</sup> See Case C-27/76, *United Brands*, supra note 1 at para. 122.

cost of entry made up *inter alia* of all the general expenses incurred in penetrating the market such as the setting up of an adequate commercial network, the mounting of very large-scale advertising campaigns, all those financial risks, the costs of which are irrecoverable if the attempt fails". All this led to practical and financial obstacles to entry that placed United Brands in a dominant position.

While sunk costs can indisputably be a factor in determining the existence of barriers to entry, the fact that an industry is characterized by large sunk costs does not in itself automatically preclude the possibility of entry or of aggressive competition on the marketplace. This possibility may arise when there are no barriers to expansion of other operators already on the market. Indeed, barriers to entry relate to the ability of firms *outside* a particular market nonetheless to impose a constraint on the potential for exercising market power *within* the market. Barriers to *expansion*, on the other hand, relate to the ability of firms already operating in the market to impose a constraint on the potential for a firm or firms to exercise market power within the market. A barrier to expansion is something that stops a firm already in a market from being able quickly and cheaply to increase its output. Thus a firm that is capacity constrained and would have to incur significant sunk costs to expand its output faces a barrier to expansion, whereas one that currently has spare capacity does not face such a barrier to expansion (up to the point at which it is using all its capacity). Equally, a firm that is currently producing at full capacity may not face significant barriers to expansion if it can increase its capacity quickly and relatively cheaply (in particular, without incurring significant sunk costs). If rival firms in a market do not face barriers to expansion, then they are likely to be able to respond to a price rise imposed by another firm by undercutting the price rise and selling more output than previously, thus undermining the attempt by the original firm to raise prices profitably.

Barriers to expansion can be low even though barriers to entry are high. A failure to take account of barriers to expansion might lead to the erroneous conclusion that a firm with a high market share has market power because there are high barriers to entry into the market, when in fact low barriers to expansion by firms already in the market mean that the firm with a high market share has no market power.

In the same way that sunk costs are key to the analysis of barriers to entry, they are key to the analysis of barriers to expansion. If a firm would need to incur significant sunk costs to expand its output, then it probably faces significant barriers to expansion. However, it is quite possible that there could be significant sunk costs to entering a market, but low sunk costs to expanding output, once in a market. Two examples should make this clear. When branding matters, barriers to entry can be high but barriers to expansion low. Firms often need to incur significant sunk costs (usually of advertising) to create a brand and this may be a pre-requisite for entering a market. However, once the firm has established its brand and is in the market, expanding sales may not require significant sunk costs. A second example is that when investment is very "lumpy",<sup>59</sup> it may be

---

<sup>59</sup> Investment is said to be "lumpy" when the investment necessary to produce one unit of a good is very similar to the investment needed to produce many more units. For instance, if a firm needs to buy a very expensive piece of machinery before it can start producing any units, but this machine will then be



necessary to incur large sunk costs to enter a market, but then the costs of expanding output to full capacity may be very low. Of course, once such a firm reaches full capacity, the lumpiness of investment means that it then faces high barriers to further expansion.

Excess capacity can be relevant for a finding of dominance. If other firms have excess capacity, this means they are likely to have low barriers to expansion and so are able to undermine any attempt by a large firm to exert market power by restricting output. This was noted by the Court in *Hoffmann-La Roche*: “the existence of considerable unused manufacturing capacity creates potential competition between established manufacturers”.<sup>60</sup>

### 3. Economies of scale/scope/network effects

In the presence of large economies of scale and economies of scope, a potential entrant may be deterred or delayed for a substantial period of time from entering the market due to the perceived difficulty of competing successfully against the incumbent who has already attracted such scale/scope economies (e.g., due to the need to reach a minimum viable scale of production relative to the size of the market for entry to be profitable). Court cases like *United Brands* referred to above, or Commission decisions like *BPB Industries plc.*<sup>61</sup> expressly refer to the large economies of scale from which the companies benefited, as a factor relevant for a finding of dominance.

The same considerations apply to network effects,<sup>62</sup> for instance in those cases in which well-established players have reached the critical mass that is required for customers to perceive the network as a necessary asset.<sup>63</sup>

Any finding of market power on the basis of economies of scale/scope and network effects will need to take into account whether it may still be profitable for new entrants to operate efficiently and thus pose competition constraints on the incumbent player on the basis of a smaller scale of production.

### 4. Superior technology

In ECJ cases like *United Brands*,<sup>64</sup> as well as in past and more recent Commission decisions like *Eurofix-Bauco v. Hilti*<sup>65</sup> and *Michelin II*,<sup>66</sup> account has been taken of the

---

able to produce, say, a million units, then investment is lumpy. If the size of the “lumps” is large relative to the size of the total market, then one should expect to see relatively concentrated markets.

<sup>60</sup> Case-85/76, *Hoffmann-La Roche v. Commission*, supra note 1 at para. 48.

<sup>61</sup> Commission decision of 5 December 1988, *BPB Industries plc.*, (1989) O.J. L10/50, para. 116.

<sup>62</sup> See OFT guidelines, supra note 8, at para. 5.21 (“Network effects occur where users’ valuations of the network increase as more users join the network. ... If customers benefit from being on the same network (e.g. due to incompatibility with other networks), an incumbent with a well established network might have an advantage over a potential entrant that is denied access to the established network and so has to establish its own rival network”).

<sup>63</sup> For a recent Commission decision discussing the importance of direct and indirect network effects in the assessment of dominance, see Commission decision *Microsoft*, supra note 28.

<sup>64</sup> Case C-27/76, *United Brands*, supra note 1 at paras. 82-84.

<sup>65</sup> Commission decision of 22 December 1987, *Eurofix-Bauco v. Hilti*, (1988) O.J. L65/19, para. 69.

“indisputable technological lead” of the allegedly dominant undertakings, where such lead was normally the result of extensive investments derived from the company’s superior financial resources. Without more, the fact of a company having developed, through its internal skills, a better technology than that of its rivals should not be sufficient in itself for a finding of dominance. This will be particularly the case when competitors could have replicated such allegedly superior technology, and most certainly in industries where innovation is not critical or where companies can effectively compete on the basis of mature technology. In general, any finding of market power on the basis of superior technology should be treated with caution, as such findings may send the wrong signal to industry that a company is being penalized for its superior skills.<sup>67</sup>

In our view, the same reasoning applies to intellectual property rights, which generally aim at rewarding companies for their efforts to innovate. Any reference to the patents held by a company as a factor conducive to market power should have previously taken due account of alternative paths – including teaming efforts – available for other companies active in the relevant markets to compete on an equal footing without necessarily infringing the company’s patent rights.<sup>68</sup> The same reasoning will apply to other IP rights, namely copyrights and trademarks. In our view, only in specific circumstances – *e.g.*, markets characterized by the importance of product differentiation and where strong brand recognition is critical for success – should the existence of trademarks be afforded any real weight in a finding of market power.

##### 5. Control of essential assets/vertical integration/branding

The fact that an entity has access to assets that, while important, are not indispensable and can be replicated;<sup>69</sup> that a company is vertically integrated (*see e.g.*, ECJ *United Brands* judgment<sup>70</sup> or the *Michelin II* Commission Decision<sup>71</sup>); or that a company has been able to build a reputation on the basis of projecting a strong image (*see e.g.*, ECJ *United Brands* judgment<sup>72</sup>) should not, on their own, be regarded as decisive for a finding of market power. Doing otherwise may lead to penalizing companies for their greater skills and foresight in meeting the conditions necessary for successful competition.

---

<sup>66</sup> Commission decision, *Michelin*, supra note 49 at paras. 183-184.

<sup>67</sup> The claim that a finding of dominance as such does not penalize a company since only abuses are prohibited is a hollow one, since companies found to be dominant will be prohibited to continue certain practices even where those practices are prevalent in the industry.

<sup>68</sup> See, OFT guidelines, supra note 8 at para. 5.13 (“Intellectual property rights (IPRs) can be entry barriers, although this is not always the case. In particular, when an IPR does not prevent others from competing with the IPR holder in the relevant market, it would not normally be a barrier to entry. In those cases where IPRs do constitute a barrier to entry, it does not always imply that competition is reduced. Although an IPR may constitute an entry barrier in the short term, in the long term a rival undertaking may be able to overcome it by its own innovation. The short term profit which an IPR can provide acts as an incentive to innovate and can thus stimulate competition in innovation”).

<sup>69</sup> The issue of essential facilities is discussed in other sections.

<sup>70</sup> Case C-27/76, *United Brands*, supra note 1 at paras. 69-81.

<sup>71</sup> Commission decision, *Michelin*, supra note 49 at paras. 191-195.

<sup>72</sup> Case C-27/76, *United Brands*, supra note 1 at paras. 91-93.

6. Portfolio power/product range

The Commission and the ECJ have considered product ranges in a vast number of cases. Mention has been made of “the fact that AKZO offered a range of products wider than that of its main rivals”,<sup>73</sup> of Michelin’s “special extent of its range of products” in *Michelin I*,<sup>74</sup> and of the fact that “the Michelin brand is in a position to offer a wide range of different tyre products such that an ever increasing number of customer groups is reached”.<sup>75</sup> In the *Tetra Pak II* Decision,<sup>76</sup> the Commission referred to the “diversity of [Tetra Pak’s] products and geographical locations, which makes it less dependent on various fluctuations and allows it, if necessary, to make financial sacrifices on one or other of its products without affecting the overall profitability of its operations”.

In general, the fact that a company has a broad range of product offerings on the market should not lead to a finding of dominance. Such a finding should only be made in those circumstances where it can be shown that a deep product range inevitably leads to barriers to entry, for instance due to significant cost savings reaped by the allegedly dominant entity on the relevant markets due to its greater portfolio, or due to measurable advantages relative to its competitors such as discounts across the board that cannot be matched by its competitors. In particular, it should not be enough to merely assert that a company’s broad product range allows the company, for instance, to subsidize certain predatory activities. On the contrary, it is necessary to show that such use of a broad range of products is actually possible and likely. The mere existence of a deeper portfolio than that of competitors should not be sufficient to claim that a company is in a position of market power, even in cases where the allegedly dominant entity is the first – but not only – supplier of choice.

7. Overall strength (financial power, profitability)

In *Hoffmann-La Roche*,<sup>77</sup> the ECJ held that the fact that Hoffmann-La Roche was the world’s largest manufacturer, that it was at the head of the largest pharmaceuticals group in the world, and that it had the largest turnover, had no bearing on the finding of dominance. However, other cases do afford importance to the overall size and weight of a company. For instance, in *Michelin I*<sup>78</sup> the ECJ referred to “the advantages which [Michelin] may derive from belonging to groups of undertakings operating throughout Europe or even the world. Amongst those advantages was the lead which the Michelin group has over its competitors in the matters of investment and research and the special extent of its range of products [...]”. In *BPB Industries*,<sup>79</sup> the Commission considered that it was necessary to consider “not only the position of BPB in the market but also its technological and financial resources [...]”.

---

<sup>73</sup> Case C-62/86, *AKZO v. Commission*, supra note 41 at para. 58.

<sup>74</sup> Case 322/81, *NV Nederlandsche Industrie Michelin v. Commission*, [1983] E.C.R. 3461, at para. 55.

<sup>75</sup> Commission decision, *Michelin*, supra note 49 at para. 184.

<sup>76</sup> Commission decision, *Tetra Pak II*, (1992) O.J. L 72/1, para. 101.

<sup>77</sup> Case 85/76, *Hoffmann-La Roche v. Commission*, supra note 1 at para. 47.

<sup>78</sup> Case 322/81, *NV Nederlandsche Banden Industrie Michelin v. Commission*, supra note 74 at para. 55;

See also Commission decision, *Michelin*, supra note 49 at paras. 182-183.

<sup>79</sup> Commission decision of 5 December 1988, *BPB Industries*, (1989) O.J. L10/50, para. 115.

Any considerations that do not pertain directly to the relevant market under review should not be factored in to any analysis of market power. Despite some Commission and EC Courts' practice suggesting the contrary, it is argued that the same reasoning should apply to "deep pockets" claims or to claims about the alleged favoured access of the supposedly dominant entity to capital markets. Large multinational groups are in many instances publicly-traded companies, and are directly responsible *vis à vis* their shareholders – as well as *vis à vis* their creditors – for any conduct aimed at preserving an inefficient business unit to the detriment of the most profitable segments of the company's range of activities. While capital markets do not always exercise as tight a control as one would hope on large multinationals, the fact remains that -- again -- it would be necessary to demonstrate that subsidization across activities is possible and likely. Moreover, evidence would then need to be adduced to show that specific capital markets deficiencies would deny competitors access to comparable funds.

#### 8. Behavioural factors

The conduct of an undertaking in the market normally relates to the issue of abuse, not to the assessment of market power. However, both the ECJ and the Commission have also taken behavioural factors into account when dealing with dominance. In *United Brands*,<sup>80</sup> the ECJ ruled that in order to find out whether an undertaking is in a dominant position, "it may be advisable to take account if need be of the facts put forward as acts amounting to abuses without necessarily having to acknowledge that they are abuses". In both *Michelin* cases the Commission relied on Michelin's allegedly abusive practices as indicators of market power, noting that "as is often the case in situations such as that being examined here, the finding of a dominant position is supported inter alia by the evidence relating to the abuse of that position".<sup>81</sup>

A reference in the context of dominance to behavioural conduct should be limited to those instances where it can be shown that the conduct of an undertaking would not be feasible and profitable for a firm without market power. Even in those cases, it is argued that behavioural factors should only be relied upon as a complement, not a substitute, to a proper analysis of market conditions that also point to the existence of high entry barriers. The consideration of the undertaking's behaviour beyond these rather exceptional cases would inevitably lead to the risk of running circular arguments: due to its conduct a company is found to be dominant; and dominance and the "special responsibility" inherent to dominant undertakings in turn lead to the conduct itself being catalogued as anticompetitive.

---

<sup>80</sup> Case C-27/76, *United Brands*, supra note 1 at paras. 67-68.

<sup>81</sup> Commission decision of 7 October 1981, *NV Nederlandsche Banden-Industrie Michelin*, (1981) O.J. L353/33, para. 35, *see also* Commission decision of 20 June 2001, *Michelin*, (2002) O.J. L 143/1, paras. 198-199.

9. Previous findings of dominance

Previous findings of dominance do not directly relate to the issue of whether at the time of the investigation potential entrants or existing players may be deterred by barriers to entry. Past findings of dominance cannot be substituted for a proper current analysis of the facts. As noted by the CFI in *Coca-Cola*,<sup>82</sup> a finding of dominance is the result of an analysis of the structure of the market and the conditions of competition prevailing at the time in which the Commission adopts each decision. Thus, in the course of each Article 82 EC decision, the Commission “must define the relevant market again and make a fresh analysis of the conditions of competition which will not necessarily be based on the same considerations as those underlying the previous finding of a dominant position”.

F. Buyer power

Any assessment of market power must necessarily take into account the issue of countervailing buyer power. In *Italian Flat Glass*,<sup>83</sup> the CFI reproached the Commission for not having “even attempted to gather the information necessary to weigh up the economic power of the three [allegedly collectively dominant] producers against that of Fiat, which could cancel each other out”.

The issue of dominance cannot be properly dissociated from an analysis of the extent to which buyers interact in practice with suppliers, and the extent to which customers can counteract supra-competitive prices imposed upon them by the allegedly dominant supplier. Even companies with large market shares in industries with high entry barriers may still lack market power, for instance in cases where any decrease in output/price increase could be immediately avoided by buyers strategically scaling back their purchases. The existence of buyer power may also be substantiated in instances in which one or a limited number of buyers are an essential outlet for the manufacturer’s product, as well as in those cases in which buyers can themselves enter or sponsor entry into the market.

**IV. Collective Dominance**

Economic theory teaches that market power can be enjoyed by a single firm, but can also be jointly enjoyed by two or more firms. A classic way of jointly exercising market power is the formation of a cartel. However, absent any cartel or agreement, certain market conditions can in themselves induce independent firms to jointly exercise their market power. This may in particular happen on oligopolistic markets where prices rise and output decreases as a result of individual decisions taken by the operators, which do however take account of their interdependence in the framework of repeated interaction.

---

<sup>82</sup> Case T-125/97 and T-127/97, *The Coca-Cola Company and Coca-Cola Enterprises Inc. v. Commission*, [2000] E.C.R. II-1733, paras. 81 and 82.

<sup>83</sup> Cases T-69/89, T-77/89 and T-78/89, *Società Italiana Vetro SpA, Fabbrica Pisana SpA and PPG Vernante Pennitalia SpA v Commission*, [1992] E.C.R. II-1403, para. 366.

This in turn leads to losses in allocative efficiency similar to those resulting from a cartel without, however, any collusive *agreement* being entered into.<sup>84</sup> This issue, often referred to as the “oligopoly problem” has given rise to substantial practical difficulties in both the EC and the US.<sup>85</sup>

As regards EC competition law, the concern for such market structures is not recent. In *Dyestuff*<sup>86</sup> and *Woodpulp*,<sup>87</sup> the ECJ held that such practices could not be caught under the concept of “concerted practice” pursuant to Article 81 EC. The question subsequently arose whether the application of Article 82 EC to the abuse of a dominant position held by “one or more undertakings” could provide a basis for initiating legal action towards such market outcomes. Under the influence of the Commission, both the CFI and the ECJ upheld a “collective dominance” doctrine whereby anticompetitive oligopolistic outcomes could constitute an infringement of Article 82 EC (A).<sup>88</sup> However, the Community Courts and the legislator have further stretched this concept so as to apply it to a number of market configurations which are distinct from oligopolistic coordination settings (B). These judgments and decisions raise important concerns (C).

A. Collective dominance and oligopolistic anticompetitive coordination

In *Compagnie Maritime Belge*, the ECJ explicitly held that the concept of collective dominance under Article 82 EC encompassed anticompetitive oligopolistic interdependence situations:

“[...] the existence of an agreement or of other links in law is not indispensable to a finding of a collective dominant position; such a finding may be based on other connecting factors and would depend on an economic assessment and, in particular, on an assessment of the structure of the market in question (emphasis added).”<sup>89</sup>

Prior to this case, it was not clear whether oligopolistic interdependence in itself could be brought within the ambit of Article 82 EC because the Court required the evidence of “economic links”, which seemed to require more than just oligopolistic interdependence.

---

<sup>84</sup> It may also lead to losses in productive efficiency since firms in such oligopolies do not compete anymore and may not seek to achieve economies on the cost side, etc.

<sup>85</sup> See V. Korah, “Gencor v. Commission: Collective Dominance”, (1999) 6 *E.C.L.R.* 337.

<sup>86</sup> See Case 48/69, *ICI v. Commission* (Dyestuff), [1972] E.C.R. 619.

<sup>87</sup> See Cases, C-89, 104, 114, 116, 117, 125-129/85, *Ahlström Oy v. Commission* (Woodpulp), [1993] E.C.R. I-1307

<sup>88</sup> Lawyers and economists often refer to a similar concept under the name of “joint dominance”. To date, however, the case-law of the ECJ only refers to the concept of “collective dominance”, which will thus be used for the purpose of the present study.

<sup>89</sup> See Cases C-365 & 396/96P *Compagnie Maritime Belge Transports SA v Commission*, [2000] E.C.R. I-1365 at para. 45. There is in addition a rich body of case-law adopted in relation to merger control. The case-law adopted on the basis of merger control extensively refers to Article 82 EC in support of its substantive findings. In *Gencor*, the reference to Article 82 made it clear that oligopolistic interdependence fell within the scope of Article 82 EC. See Case T-102/96, *Gencor v. Commission* [1999] E.C.R. II-753.

The reference to “connecting factors” and to the “economic assessment and, in particular, on an assessment of the structure of the market in question” clarified this point.<sup>90</sup>

In the same judgment, the ECJ clarified the test for a finding of collective dominance:

“It follows that the expression one or more undertakings in Article 86 of the Treaty implies that a dominant position may be held by two or more economic entities legally independent of each other, provided that from an economic point of view they present themselves or act together on a particular market as a collective entity. [...] So, for the purposes of analysis under Article 86 [now Article 82] of the Treaty, it is necessary to consider whether the undertakings concerned together constitute a collective entity vis-à-vis their competitors, their trading partners and consumers on a particular market. It is only where that question is answered in the affirmative that it is appropriate to consider whether that collective entity actually holds a dominant position and whether its conduct constitutes abuse (emphasis added).”<sup>91</sup>

Two steps are thus necessary in order to find a collective dominant position.<sup>92</sup> First, the firms must present themselves or act as a “collective entity”. The finding of a collective entity is itself subject to the implementation of a threefold test that was laid down by the CFI in *Airtours* whereby there must exist (i) a certain amount of transparency; (ii) a retaliatory mechanism; and (iii) the absence of reaction by current and potential competitors as well as customers.<sup>93</sup> Second, the identified collective entity must enjoy a dominant position. Classically, the assessment of dominance is made with reliance on market shares as well as the other parameters that were outlined above.

In response to a number of difficulties that appeared in latter cases, the CFI recently elaborated on the test. Among these, was the question whether the existence of competition between the members of an oligopoly ran counter to the finding of a collective entity and thus to the finding of collective dominance under Article 82 EC.<sup>94</sup> The Commission seems to consider that it can find collective dominance even if there is a

---

<sup>90</sup> Case *Compagnie Maritime Belge* at para. 45.

<sup>91</sup> This has been repeated by the CFI in the *TACA* ruling, see Joined cases T-191/98, T-212/98 to T-214/98, *Atlantic Container Line AB and Others v. Commission*, not yet reported.

<sup>92</sup> See on this, M. Jephcott and C. Withers, “Where to now for EC oligopoly control?”, 22 *E.C.L.R.* 301; P. Nihoul et P. Rodford, *EC Electronic Communications Law*, Oxford University Press, 2004 at para. 3.341; M. Clough, “Collective Dominance – the Contribution of the Community Courts”, in *Essays for Judge David Edwards*, Hart Publishing, 2003 at p.174.

<sup>93</sup> See Case T-342/99 *Airtours plc v Commission* [2002] E.C.R. II-2585 at para. 62: “[...] three conditions are necessary for a finding of collective dominance as defined: First, each member of the dominant oligopoly must have the ability to know how the other members are behaving in order to monitor whether or not they are adopting the common policy [...]; Second, the situation of tacit coordination must be sustainable over time, that is to say, there must be an incentive not to depart from the common policy on the market. [...]; Third, to prove the existence of a collective dominant position to the requisite legal standard, the Commission must also establish that the foreseeable reaction of current and future competitors, as well as of consumers, would not jeopardise the results expected from the common policy.”

<sup>94</sup> For a discussion of this, see S. Preece, “Compagnie Maritime Belge: Missing the Boat?” (2000) 8 *E.C.L.R.* 388. See also J. Temple Lang, “Oligopolies and Joint Dominance in Community Antitrust Law”, (2001), *Fordham Corp L. Institute* (B. Hawk, ed.), 269.

possible degree of competition between the parties.<sup>95</sup> This view was recently confirmed in *TACA* where the CFI held that:

“there can be no requirement, for the purpose of establishing the existence of such a dominant position, that the elimination of effective competition must result in the elimination of all competition between the undertakings concerned”<sup>96</sup>

B. Other settings in which collective dominant positions may be identified

Besides oligopolistic markets, the concept of collective dominance has also developed in different settings which are examined in the paragraphs that follow.

1. Collective dominance as the cumulative effect of individual dominant positions on distinct markets

Initially, the concept of collective dominance seemed to apply only where one relevant market was concerned. This is apparent in the (often overlooked) wording of the CFI in *Flat Glass* where the Court held:

“[...] There is nothing, in principle, to prevent two or more independent economic entities from being, on a specific market, united by such economic links that, by virtue of that fact, together they hold a dominant position vis-à-vis the other operators on the same market (emphasis added).”<sup>97</sup>

Subsequently, the concept of collective dominance was extended to situations where several undertakings enjoyed a dominant position respectively on different markets.<sup>98</sup> The reason for this extension is of a legal nature. Indeed, Article 82 EC requires, for a finding of a dominant position, that there is a dominant position “within the common market or in a substantial part of it”. In *Almelo* and *La Crespelle*, several firms of regional/local importance each enjoyed a dominant position on a number of distinct and narrow geographic markets.<sup>99</sup> Taken one by one, the dominant position of each firm did not seem to affect a substantial part of the common market. However, in a fashion similar to the cumulative effect doctrine under Article 81 EC, the Court considered that it was possible

---

<sup>95</sup> See Commission decision of 16 September 1998, *Trans-Atlantic Conference Agreement*, (1999) O.J. L 95 pp.1-112 at para. 522. This position was also expressed in the Commission Notice on the Application of Competition Rules to Access Agreements in the Telecommunications Sector, (1998) O.J. C 265 of 22 at para. 79.

<sup>96</sup> See *TACA*, supra note 91 at para. 653.

<sup>97</sup> See Cases T-68/89, 77/89 and 78/89, *SIV and others v. Commission* [1992] E.C.R. II-1403 at para. 358.

<sup>98</sup> As J. Temple Lang observes, “joint dominance in one market is not the same as a series of national, (or other) markets in each of which there is one sole dominant undertaking”, see J. Temple Lang, supra note 94 at p.318. The author points out, referring to *Bodson*, that there can be joint dominance situations, (...) “even if the number of companies involved is quite large, and would not otherwise be thought as constituting an oligopoly”, at p.300.

<sup>99</sup> Case C-393/92, *Gemeente Almelo and others v. Energiebedrijf IJsselmij*, [1994] E.C.R. I-1477; Case C-383/93, *Centre d'insémination de la Crespelle v. Coopérative de la Mayenne*, [1994] E.C.R. I-5077



to aggregate individual dominant positions on different markets under the concept of collective dominance, so that a substantial part of the common market was affected.<sup>100</sup>

This case-law raises important legal questions. First, there is a great deal of uncertainty because the Commission never itself enforced Article 82 EC in situations of this kind. These cases were raised through the Article 234 EC preliminary reference mechanism. Second, most of these cases could potentially have been dealt with under national law.<sup>101</sup> It would thus be welcome if the Commission could clarify its position on this issue and state whether there is a “cumulative effect” doctrine under Article 82 when several small companies each hold a single dominant position on neighbouring geographic markets. In addition, the Commission should strive to explain why such situations of arguably a minor geographic importance should not be left to national law.

## 2. Collective dominance short of the single economic entity doctrine

A further setting where collective dominance situations have been found consists in undertakings related to the same group that operate at different levels within the supply chain (and thus on different markets<sup>102</sup>), but that are not sufficiently integrated to form a single economic entity and thus be found individually dominant. This situation, often referred to as “vertical collective dominance”, arose in the *Irish Sugar* case. In that decision, the Commission was attempting to put an end to a series of abuses entered into by a supplier and its distributor. The latter was under the control of the former but did not reach the case-law standard necessary to a finding of a single economic entity.<sup>103</sup> Thus they formed two distinct economic units. Only a part of the anticompetitive practices could have been brought to an end pursuant to Article 81 EC because there remained anticompetitive practices that were purely unilateral to the distributor. These practices could not be caught under Article 82 EC either, because there was no evidence that the distributor held an individual dominant position. The Commission thus linked the practices of the distributor to the dominant position of the supplier by relying on the concept of collective dominance. In that situation the collective dominance concept offers a convenient device for the Commission to overcome legal obstacles.

The *Irish Sugar* judgement, although an isolated judgement, is problematic in several respects. It could indeed extend the “special responsibility” bearing on dominant undertakings not to impair competition, to their distributors and trading partners.<sup>104</sup> While in *Irish Sugar* a number of factual elements suggested that the producer held a significant control (through close management relationships) over the distributor, it remains to be seen whether, in a case where control would not be so strong, undertakings could be

---

<sup>100</sup> This hypothesis is explicitly pointed out by P. Nihoul and P. Rodford, *supra* note 92 at para. 3.327 and following.

<sup>101</sup> See P. Nihoul and P. Rodford, *supra* note 92 at para. 3.331.

<sup>102</sup> See J. Temple Lang *supra* note 94 at p.382.

<sup>103</sup> See Case 73/95, *Viho v. Commission*, [1996] E.C.R. I-5457.

<sup>104</sup> See G. Monti, “The Scope of Collective Dominance under Article 82 EC” (2001) 38, *C.M.L.R.* 131 at p.143.

considered jointly dominant.<sup>105</sup> Absent any enforcement after the *Irish Sugar* case, there is some uncertainty whether the Commission will actively scrutinise the trading partners of dominant companies or whether it only intends to do so in very specific instances, such as the ones at stake in the case.

### 3. Collective dominance and legislative/regulatory measures

A number of plaintiffs have also tried to invoke the collective dominance concept in order to challenge national laws on the basis of Article 82 and 10 EC. In all these cases, the ECJ rebutted the claims. In *Spediporto*, *Bassano* and *Sodemare*, the Court considered that the national laws at hand could not lead to a collective dominant position, because the undertakings were not linked sufficiently so that there was no competition at all between them.<sup>106</sup> The standard for holding that national legislation may create collective dominant positions is thus that the undertakings be sufficiently linked between themselves that they adopt the same conduct on the market, i.e. that they do not compete with each other.

In spite of the negative stance of the Court, a number of authors nonetheless argue that State liability cannot be excluded in theory.<sup>107</sup> Some even call the Commission to bring enforcement proceedings against Member States that would, through legislation, create or strengthen a market structure that is conducive to anticompetitive behaviour (e.g. a collective dominant position that could lead to potential abuses). A clarification on this issue by the Commission would therefore be welcome.

### 4. Collective dominance in sector-specific legislation

The concept of collective dominance has not only been applied in the context of EC competition law, but has also been given recognition in the context of sector-specific legislation. For instance, Article 15 of the Framework Directive on electronic communications provides:

“An undertaking shall be deemed to have significant market power if, either individually or *jointly with others*, it enjoys a position equivalent to dominance, that is to say a

---

<sup>105</sup> See V. Korah, *Introductory Guide to EC Competition Law and Practice*, supra note 37 at 2.2.1 and 3.2.5.

<sup>106</sup> See Case C-96/94, *Centro Servizi Spediporto v. Spedizioni Marittima del Golfo*, [1995] E.C.R. I-2883 at para. 34: “National legislation which provides for the fixing of road-haulage tariffs by the public authorities cannot be regarded as placing economic agents in a collective dominant position characterized by the absence of competition between them”; Case C-140/94, *DIP and others v. Comune di Bassano del Grappa and others*, [1995] E.C.R. I-3257, at para. 27: “National rules which require a licence to be obtained before a new shop can be opened and limit the number of shops in the municipality in order to achieve a balance between supply and demand cannot be considered to put individual traders in dominant positions or all the traders established in a municipality in a collective dominant position, a salient feature of which would be that traders did not compete against one another (emphasis added)”; Case C-70/95, *Sodemare and others v. Regione Lombardia*, [1997] E.C.R. I-3395.

<sup>107</sup> See G. Monti, supra note 104 at p.153; S. Stroux, “Is EC Oligopoly Control Outgrowing Its Infancy?” (2000) 23 *World Competition* 3 at p.22.

position of economic strength affording it the power to behave to an appreciable extent independently of competitors, customers and ultimately consumers”.<sup>108</sup>

The Framework Directive provides a number of non exhaustive criteria for assisting the regulators in the assessment of collective dominance.<sup>109</sup> While research had suggested that the risk of collective dominance in electronic communications industries was rather low, the Commission has recently approved National Regulatory Authorities' findings of joint dominance situations on the mobile communications markets.<sup>110</sup> At any rate, the regulatory schemes adopted pursuant to the Framework Directive seem to be adequately equipped to deal with potential anticompetitive parallel behaviour.

### C. Areas of concern

#### 1. Low level of enforcement of collective dominance under article 82 EC

A distinctive feature of collective dominance under Article 82 EC is its low level of enforcement. The Commission has been extremely cautious in launching Article 82 proceedings on the basis of the collective dominance doctrine. Rather, the Commission seems to have focused the enforcement of the doctrine in different fields, i.e. merger control and sector-specific legislation.

In addition, among the few collective dominance decisions adopted by the Commission, there has been so far no Article 82 EC case where oligopolistic interdependence was held to constitute a sufficient connecting element required for a collective dominant position.<sup>111</sup> In most cases, the Commission was able to evidence close links between the companies and the Commission's reliance on the collective dominance concept might be explained by the willingness to circumvent Article 81(3) exemptions or immunity from

---

<sup>108</sup> See Article 15 of the Framework Directive, *supra* note 12.

<sup>109</sup> See Annex II of the Framework Directive, *supra* note 12. These criteria are, among others, the maturity of markets, stagnant or moderate growth on the demand side, low elasticity of demand, homogeneous product, similar cost structures, similar market shares, lack of technical innovation, mature technology, absence of excess capacity, high barriers to entry, lack of countervailing buying power, lack of potential competition, various kinds of informal or other links between the undertakings concerned, retaliatory mechanisms, lack or reduced scope for price competition.

<sup>110</sup> See M. Armstrong, “The Theory of Access Pricing and Interconnection” in M. Cave, S. Majumdar and I. Vogelsang (eds) *Handbook of Telecommunications Economics*, V.I: Structure, Regulation and Competition, North Holland, 2002, pp.297-386. However, ComReg's (the Irish Telecommunications Regulator) recently found that Vodafone and O2 were jointly enjoying a dominant position in the wholesale market for access and call origination in Ireland (they collectively achieved a 94% market share). The regulator accordingly imposed remedies on the two operators (they will have, among others, to provide network access following a reasonable request by an access seeker). This decision was approved by the Commission. See Commission decision of 20 January 2005, *Access and Call Origination on Public Mobile Telephone Networks in Ireland*, not yet published. See also for a similar finding by the French Competition Authority: Avis du 14 octobre 2004 relatif à une demande d'avis présentée par l'Autorité de Régulation des Télécommunications en application de l'article L. 37-1 du code des postes et communications électroniques.

<sup>111</sup> See H. Haupt, “Collective Dominance Under Article 82 EC and EC Merger Control in the Light of the *Airtours* Judgment”, (2002) 9 *E.C.L.R.*, 434 at p.438; See also M. Clough, *supra* note 92.

finer.<sup>112</sup> For the sake of legal certainty, the Commission should clarify whether it intends to enforce Article 82 EC where only connecting factors in the form of pure oligopolistic interdependence exist. This would additionally provide useful guidance to MS competition authorities and courts which might (have) engage(d) in action against anticompetitive oligopolies on the basis of Article 82-like provisions.<sup>113</sup>

## 2. The test for collective dominance in oligopolistic settings

The two step approach suggested by the EC Courts requires to establish (i) that the firms at stake present themselves or act as a “collective entity” and (ii) that they enjoy a dominant position.

### (i) The existence of a collective entity

Pursuant to the case-law, a collective entity may be found either when some “economic links” exist between the undertakings or when some “correlating factors” lead them to behave as a common entity. While the concept of economic links does not only cover oligopoly and can help finding collective dominance in other market configurations (i.e. *Almelo*, *Irish Sugar* etc.), the concept of correlating factors seems to exclusively target situations of oligopolistic interaction.

It is in relation to the latter concept that the legal certainty is less satisfactory. In *Airtours*, the CFI refined the legal test for tackling oligopolistic interdependence in the sense of tacit co-ordination under the European Merger Control Regulation (“EMCR”). In *Laurent Piau*, the CFI recently made clear that this test was also applicable in Article 82 proceedings.<sup>114</sup> However, merger control has a number of features that make it different from Article 82 EC proceedings and it can be questioned whether the test should be enforced in a similar fashion or should be the same.<sup>115</sup>

A first issue concerns the onus of proof lying on the Commission. In the context of the EMCR, the *Airtours* conditions aim at predicting a risk of future tacit co-ordination. In contrast, the approach under Article 82 EC aims at showing that parallel pricing has actually occurred because of market features that were conducive to tacit collusion. Truly, there is a risk of adoption of a flawed decision under the EMCR. However, under Article 82 EC, a risk also exists that a parallel price increase, for instance, be sanctioned where it does not result from tacit co-ordination (when, for instance, price competition was constrained because of national legislation or because the price increase was caused

---

<sup>112</sup> See T. Soames, “An Analysis of the Principles of Concerted Practice and Collective Dominance: A Distinction without a Difference?” (1996) 1 *E.C.L.R.*, 24.

<sup>113</sup> For instance, on the basis of complex monopoly-style investigations in the UK.

<sup>114</sup> See Case T-193/02, *Laurent Piau v. Commission*, at §111 not yet published; R. Whish, *Competition Law*, 4<sup>th</sup> Ed., (2001) Butterworths, at p.479; J. Temple Lang supra note 94; J. Faull and A. Nikpay, *The EC Law of Competition*, Oxford University Press, 1999; P. Nihoul and P. Rodford supra note 92; M. Clough supra note 92 at p.174. See, also in *TACA*, the references to *Gencor* and *Airtours* at para. 652.

<sup>115</sup> See, for a good presentation of these, J. Temple Lang supra note 94 at p.314.

by underlying cost increases).<sup>116</sup> For this reason, while one should tolerate a margin of appreciation under the EMCR given the predictive nature of the assessment, the standard of proof under Article 82 should be more stringent. Because information not available to the Commission in merger proceedings is available under *ex post* enforcement, it seems reasonable to require the Commission to establish with much caution the existence of tacit co-ordination.

This is particularly true with respect to the substantive conditions laid down in *Airtours*. As far as the second condition is concerned, the CFI specifically noted in *Airtours* that the Commission did not have to bring evidence of the existence of a *specific* retaliatory mechanism. Rather it just had to show that a potential retaliatory mechanism might give incentives to firms not to deviate.<sup>117</sup> The backward looking nature of Article 82 allows a better assessment of whether the collective action is the direct consequence of the existence of a retaliatory mechanism. Therefore, the Commission should be required, unlike under the EMCR test, to show that a specific retaliatory mechanism existed and exerted a deterrent effect that led the oligopolists to stick to a common line of action.

Equally, the transposition of the third *Airtours* condition within Article 82 proceedings could be debated. Under this condition, the Commission should prove that the “foreseeable” reaction of current and potential competitors as well as consumers would not jeopardise the expected results of the common policy. However, if an anticompetitive effect resulting from an abusive practice has been observed, it probably implies that potential competition was not sufficient and that the jointly dominant undertakings could actually behave independently of their competitors, actual and potential, as well as consumers.<sup>118</sup> Nevertheless, this does not mean that the Commission should not analyse the question of potential competition within Article 82 proceedings.<sup>119</sup> On the contrary, the Commission should strive to prove that the undertakings could effectively implement tacit coordination because of the absence of curtailing power from their customers as well as actual and potential competitors. A clarification on this issue would be welcome.

Another related issue concerns the degree to which – in support of its finding of a collective entity - the Commission should produce evidence that competition between the oligopolists is hampered. In *Airtours*, the CFI held:

“The evidence must concern, in particular, factors playing a significant role in the assessment of whether a situation of collective dominance exists, such as, for example, the lack of effective competition between the operators alleged to be members of the

---

<sup>116</sup> It should be observed that parallel pricing is consistent with competition as well as with collusion. For instance, if all firms used the same inputs, then a cost increase in an input should feed through to all the firms raising their prices. As a matter of economics, the more competitive the market, the more the cost increase would be passed on.

<sup>117</sup> This has been criticized by A. Nikpay and F. Houwen in “Tour de Force or a Little Local Turbulence? A Heretical View on the *Airtours* Judgment” (2003) 24 *E.C.L.R.*, 193 at p.199.

<sup>118</sup> See *Id.*, who have criticised excessive reliance on this condition in the field of the EMCR. *A fortiori*, their line of reasoning could be extended to the backwards assessment under Article 82 EC.

<sup>119</sup> See G. Monti, *supra* note 104 at p.138.

dominant oligopoly and the weakness of any competitive pressure that might be exerted by other operators.”<sup>120</sup>

Recently, in *TACA*, the CFI held that:

“there can be no requirement, for the purpose of establishing the existence of such a dominant position, that the elimination of effective competition must result in the elimination of all competition between the undertakings concerned”<sup>121</sup>

The ruling is unclear because it does not say how much competition between the oligopolists should be hampered to lead to a finding of collective dominance. There could be, for instance, a risk that even where operators would compete on a number of parameters, they could be found to enjoy a collective dominant position.<sup>122</sup> This is quite problematic. In certain industries, operators might not compete on price but they fiercely compete on a wide range of other parameters (quality, innovation, commercial services etc.) which should limit findings of a “collective entity”. For instance, in the oil sector, or the tobacco sector, price competition is to a large extent constrained by the cost of raw material, the homogeneity of products or by public taxation. This does not preclude operators from competing fiercely on these markets. It is thus submitted that the Commission should not give enforcement priority to those markets, but rather focus on markets where there is a lack of effective competition on a large range of parameters.

(ii) Assessment of dominance

It is not obvious whether the assessment of collective dominance should be carried out in a similar fashion to that of individual dominance.<sup>123</sup> In particular, reliance on market shares may not be as decisive in oligopolistic markets as it is with regards to the assessment of a single firm’s market power. While an undertaking may be presumed to enjoy an individual dominant position if it has a very large market share, the finding of a collective dominant position may not be reached even in the presence of a very large market share. For instance, if the collective entity enjoys a 70% market share, but there is important product differentiation, a lack of transparency, the ability to exercise collective market power might not be realistic. This is why there should not be any presumption of collective dominance on the basis of the identification of a high collective market share in an oligopolistic market.

---

<sup>120</sup> See *Airtours* supra note 93 at para. 63.

<sup>121</sup> See *TACA* supra note 91 at para. 653.

<sup>122</sup> See J. Temple Lang supra note 94 at p.315.

<sup>123</sup> See G. Monti, supra note 104.

**V. Policy Recommendations**

- (i) As a matter of policy, the Commission should be encouraged to explicitly clarify that dominance within the meaning of Article 82 EC amounts to substantial market power;
- (ii) The Commission should clarify how it proposes to take account of the “cellophane fallacy”;
- (iii) Absent any clear statement by the Court and the Commission on the concept of super dominance, it would be helpful if the Commission could clarify its approach to this issue;
- (iv) Factors outside a relevant market (e.g. a wide product portfolio or financial power) should only be relied upon in an assessment of dominance, if their bearing on competition within the market has been adequately demonstrated;
- (v) For the sake of legal certainty, the Commission should clarify whether it intends to enforce Article 82 EC where only connecting factors in the form pure oligopolistic interdependence exist;
- (vi) The standard of proof of a collective dominant position under Article 82 EC should be more stringent than under the EMCR;
- (vii) If collective dominance is to be enforced under Article 82 proceedings, the Commission should not give enforcement priority to markets where there is some form of competition between the oligopolists, but rather focus on markets where there is a lack of effective competition on a large range of parameters.

# The Concept of an Exclusionary Abuse under Article 82 EC

John Temple Lang and Robert O'Donoghue\*

## I. Introduction

One of the most topical and complex issues in antitrust law concerns the definition of anti-competitive unilateral conduct. The issue is current given the Commission's ongoing review of policy under Article 82 EC and an important recent judgment by the United States Supreme Court on the definition of unlawful monopolisation under Section 2 of the Sherman Act (*Trinko*).<sup>1</sup>

Broadly speaking, there are three types of abuse under Article 82 EC: exploitative abuses, exclusionary abuses, and reprisal abuses. The greatest controversy surrounds the definition of exclusionary abuses, which form the subject-matter of this paper. Distinguishing legitimate competition from exclusionary behaviour presents several difficulties. First, legitimate competition and exclusionary conduct are very similar in appearance. For example, low prices are the essence of competition but can sometimes be too low and exclusionary. Put differently, both legitimate competition and exclusionary conduct harm rivals, but, in the former case, such harm is an essential part of a properly-functioning competitive process. Second, the ways in which a firm can exclude competitors are myriad. Finally, economists have, until recently, largely ignored the assessment of unilateral practices, focusing instead on mergers and other forms of agreements. This has been particularly true in Europe. Moreover, much of the limited economic work on unilateral practices is theoretical rather than empirical.

The law in Europe on unilateral behaviour – Article 82 of the EC Treaty – has in particular been criticised as lacking clarity, consistency, and economic rigour. Among the

---

\* John Temple Lang is a Counsel based in the Brussels office of Cleary Gottlieb; Robert O'Donoghue is an Associate at Cleary Gottlieb in Brussels.

<sup>1</sup> *Verizon Communications Inc. v. Law Offices of Curtis v. Trinko*, LLP 540 U.S. 682, (2004). For a discussion of this case and its relevance to EC law, see D. Geradin, "Limiting the Scope of Article 82 of the EC Treaty: What can the EU learn from the U.S. Supreme Court's Judgment in *Trinko* in the wake of *Microsoft*, *IMS*, and *Deutsche Telekom*?", (2004) 41 *C.M.L.R.* 1519.



reasons suggested for this are as follows:<sup>2</sup> (1) The Commission has underestimated the risk of causing anticompetitive effects through inadequately considered statements and actions, in particular about pricing abuses;<sup>3</sup> (2) the only general statements about the application of Article 82 EC have been made by the Commission in specialised contexts, notably the telecommunications industry;<sup>4</sup> (3) legal commentaries on Article 82 EC have tended to stress its open-ended implications rather than the limiting principles, and to look at a series of specific situations rather than the general rules applicable; (4) the Community Courts analyse antitrust cases in detail only in appeals from the Commission which has led to judicial statements very closely tied to the facts of particular cases, rather than general principles; (5) there are few cases – European companies are less litigious than US companies, and may be less willing to sue dominant enterprises; and (6) the Commission is reluctant to initiate procedures in technical and complex cases without the help of a well-informed complainant.

The following sections review the current definition of exclusionary conduct under Article 82 EC and conclude that it is essentially vague (Section II). What then follows is an analysis of suggested alternative definitions of abusive behaviour (Section III). Each of these is evaluated in Section IV. Section V discusses in detail a number of other fundamental issues regarding the scope and interpretation of Article 82 EC. A brief conclusion is contained in Section VI.

## **II. The Current Definition of Exclusionary Abuses under Article 82 lacks any Meaningful Content**

### **A. The basic scope of Article 82 EC**

Article 82 prohibits “*any abuse by one or more undertakings of a dominant position within the common market ... in so far as it may affect trade between Member States...*” Only “abuse” is banned; creating or having a dominant position is not prohibited under Article 82 EC. There is no statutory definition of “abuse.” Article 82 merely lists four examples:

- (i) *Article 82(a) EC. Exploitation, or “directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions.”* This covers taking undue advantage of consumers by using market power to charge grossly excessive prices or impose unjustifiably onerous or unfair terms. It arguably applies only in cases where there are significant barriers to entry that cannot be overcome by investments in anticipation of monopoly rents. This provision is rarely applied by the EC Commission to regulate prices. It is occasionally invoked together with

---

<sup>2</sup> See J. Temple Lang, “Anticompetitive Non-Pricing Abuses Under European and National Antitrust Law,” in Hawk (ed.), (2003) *Fordham Corporate Law Institute* 235

<sup>3</sup> See J. Temple Lang and R. O’Donoghue, “Defining legitimate competition: how to clarify pricing abuses under Article 82 EC”, (2002) 26 *Fordham International Law Journal* 83.

<sup>4</sup> Aspects of Article 82, in particular in relation to essential facilities, are discussed briefly in the Notice on Access Agreements in the telecommunications sector, (1998) O.J. C-265/2 and in the Notice on EC competition rules on cross-border credit transfers, (1995) O.J. C-251/3, paras. 23-29.

Article 82(b), for instance, in price squeezing cases,<sup>5</sup> but in such cases the conditions of Article 82(b) must also be met;

- (ii) *Article 82(b) EC. Exclusionary conduct, or “limiting production, markets or technical development to the prejudice of consumers”.* Examples are foreclosure or handicapping of competitors, by which competition is reduced still further, and harm is caused to consumers. This is the most frequent and important category of abuse;
- (iii) *Article 82(c) EC. Discrimination, or “applying dissimilar conditions to equivalent transactions with other trading partners, thereby placing them at a competitive disadvantage”* This is not as far-reaching as the United States Robinson-Patman Act, since Article 82(c) EC requires dominance, competitive disadvantage, and absence of objective justification. It is often invoked for exclusionary abuses, but, as argued below, in such cases harm to consumers is necessary under Article 82(c) as it is expressly under Article 82(b);
- (iv) *Article 82(d) EC. Tying, or “making the conclusion of contracts subject to the acceptance by the other party of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts”* Tying is not a *per se* violation.

Some cases involve more than one kind of abuse, *e.g.*, both foreclosure of competitors and discrimination between customers with primary line injury. Simultaneous abuses may also reinforce or aggravate one another.

B. The current definition of abuse under Article 82 EC lacks precision and any real normative content

Neither the Commission’s decisional practice nor the case-law of the Community Courts provide a clear, consistent definition of exclusionary abuses. Further, no currently-applied definition has sufficient normative content to be applied *ex ante* as a normative rule by firms making pricing decisions or embarking on a given course of conduct. The concept of an abuse has been variously defined as follows:<sup>6</sup>

- (i) *“Normal competition.” “... [B]ehaviour ... which, through recourse to methods different from those governing normal competition in products or services on the basis of transactions of commercial operators, has the effect of hindering the*

---

<sup>5</sup> See *e.g.*, Commission decision of 21 May 2003, *Deutsche Telekom*, (2003) O.J. L 263/9, para. 199 (“The Commission concludes that DT is abusing its dominant position on the relevant markets for direct access to its fixed telephone network. Such abuse consists in charging unfair prices for wholesale access services to competitors and retail access services in the local network, and is thus caught by Article 82(a) of the EC Treaty.”).

<sup>6</sup> The Community Courts have added that abuse is “an objective concept,” implying that exclusionary intent is not an element in itself (although exclusionary intent can be relevant for pricing and other practices). See Case 85/76, *Hoffman-LaRoche*, [1979] E.C.R. 461, para. 91.

*maintenance of the degree of competition still existing in the market or the growth of that competition.” (Hoffman-La Roche ([1979] E.C.R. 461, para. 91.)*

- (ii) *“Competition on the merits.” “The Commission emphasizes that it does not consider an intention even by a dominant firm to prevail over its rivals as unlawful. A dominant firm is entitled to compete on the merits. Nor does the Commission suggest that large producers should be under an obligation to refrain from competing vigorously with smaller competitors or new entrants.” AKZO (OJ L 375, 31.12.1985, para. 81.)*
- (iii) *A “special responsibility.” “[D]ominant undertakings have a special responsibility not to allow their conduct to impair genuine undistorted competition on a market where competition is already restricted by the fact of their dominant position.” (Case T-191/98, Atlantic Container Lines judgment dated Sept. 30, 2003, para. 1460.)*
- (iv) *Exclusionary conduct without objective justification. “An undertaking in a dominant position cannot have recourse to means other than those within the scope of competition on the merits...” “without objective economic justification.” (Michelin II, para. 107, 110.)*

None of the above definitions encapsulates a normative concept capable of satisfying the basic requirements of the rule of law and legal certainty. “Normal competition” is a vague phrase, since it begs the question of what is “normal.” Conduct carried out by a dominant undertaking that is also routinely carried out by non-dominant firms should be presumed “normal” and efficiency-enhancing. And, yet, the Commission has rejected the notion that a common practice within an industry would necessarily constitute “normal competition.”<sup>7</sup>

“Competition on the merits,” and “genuine undistorted competition” are similarly vague. These terms have been defined as competition on the basis of “price, quality and functionality” of the product.<sup>8</sup> But this is unclear, and does not provide sufficient limiting principles. For example, all predatory pricing and loyalty discounts are competition based on “price”, but they are not always allowed. All tying is competition by adding functionality, but tying is not always allowed.

---

<sup>7</sup> See Commission decision of March 21 2004, *Microsoft*, not yet published, footnote 877 (citing Case 322/81, *Michelin v Commission*, [1983] E.C.R. 3461, paragraph 57 and Case T-111/96, *ITT Promedia v Commission* [1998] E.C.R. II-2937, para. 139.

<sup>8</sup> See, e.g., Comments by Mario Monti, European Commissioner for Competition to the speech given by Hew Pate, Assistant Attorney General, US Department of Justice, at the Conference “Antitrust in a Transatlantic context,” Brussels, June 7, 2004 (“I think we can both agree that in competition the best should win on the merits, but only on the merits. Whenever dominant companies can use their market power to win in a market for reasons that are not related to the price or quality of their products, then we should consider intervening.”). Available at : [http://europa.eu.int/comm/competition/speeches/text/sp2004\\_005\\_en.pdf](http://europa.eu.int/comm/competition/speeches/text/sp2004_005_en.pdf).

The term “*special responsibility*” fares no better. The Court of First Instance has held that this term “*means only that a dominant undertaking may be prohibited from conduct which is legitimate where it is carried out by non-dominant undertakings.*”<sup>9</sup> In other words, it simply encapsulates a general statement that conduct carried out by firms that are not dominant may be abusive when carried out by a dominant firm. Use of the term “*special responsibility*” does not indicate what type of conduct will be abusive when carried out by a dominant firm and does not explain why.

A further problem is that a practice may be regarded as not constituting “*normal competition*,” “*competition on the merits*,” and “*genuine undistorted competition*” in one situation, but not in others. A good example is unconditional price reductions. The rules established under the *AKZO* line of case-law state that, first, prices below average variable cost are presumed abusive, and, second, that prices above average variable cost but below average total cost may be regarded as abusive where there is evidence of exclusionary intent.<sup>10</sup> From this, one would reasonably assume that an unconditional price cut above average total cost is not abusive. And yet, in *CEWAL*, the Community Courts found that such prices could, in exceptional cases, constitute an abuse. While the Courts cited certain factors that may have tipped the balance in favour of the above-cost prices being treated as abusive in that case (*e.g.*, very high market share, evidence of specific exclusionary intent), it nonetheless indicated that the *AKZO* case-law was not exhaustive, *i.e.*, that unconditional price cuts could be unlawful in other circumstances. In other words, the terms “*normal competition*,” “*competition on the merits*,” and “*genuine undistorted competition*” are not merely vague, but also conclusory. That is, they are defined according to what the Commission, Community Courts, or national authorities happen to conclude is an abuse in each case. This is highly unsatisfactory.<sup>11</sup>

Another example of the ambiguous and vacuous nature of current definitions of exclusionary conduct concerns the area of loyalty discounts. In both *Michelin II* and *British Airways/Virgin*, the Court of First Instance has used the phrases “*fidelity-building*” or “*loyalty-inducing*” as the legal test to determine whether the dominant firm’s lower prices or better terms were abusive. These tests do not, however, distinguish between customers’ fidelity secured by abusive exclusionary behaviour and customers’ fidelity resulting from legitimate price competition. Further, the Court of First Instance’s test is at odds with the commonly-understood definition of “*competition on the merits*.” While the precise meaning of “*competition on the merits*” is not clear, it must at least mean that: (1) a purchaser must be free to choose the goods or services it wants based on available price (including the availability of any discounts or better terms), quality, and quantity; and that (2) a seller of goods or provider of services must be free to deal with purchasers willing to offer the best terms. In a system of undistorted competition, a customer must thus be free, and can be expected to choose, to deal with the supplier offering the best terms. The highest discount will, then, attract customers, and, in this

---

<sup>9</sup> See Case T-191/98, *Atlantic Container Lines* judgment, not yet reported, para. 1460.

<sup>10</sup> See Commission decision of 14 December 1985, *AKZO*, (1985) O.J. L374/1; Case C-62/86, *AKZO Chemie BV v. Commission*, [1991] E.C.R. I-3359.

<sup>11</sup> Similar criticisms have been made of Section 2 of the United States Sherman Act: See E. Elhauge, “Defining better monopolization standards,” (2003) 56 *Stanford Law Review*, 253.

legitimate sense, can be described as “*fidelity-building*”. This ambiguity in the legal test used for abuse has created significant legal uncertainty as to the scope of legitimate price competition, and thus creates disincentives for firms to engage in legitimate price competition.

### III. Proposed Alternative Definitions of Exclusionary Unilateral Conduct

Given the uncertain and vacuous nature of current definitions of exclusionary behaviour under Article 82 EC, lawyers and economists have made a number of proposals by way of clarification. Briefly, the following tests have gained most prominence: (1) the profit sacrifice test; (2) the equally-efficient competitor test; (3) the consumer welfare test; and (4) the “limiting production” test in Article 82(b) EC. The advantages and disadvantages of each of these tests is discussed below.

#### A. Profit sacrifice test

Recent antitrust case-law in the United States has endorsed a “profit sacrifice” test to some extent.<sup>12</sup> In particular, the United States Department of Justice has argued in recent leading antitrust cases that it is relevant to ask whether the conduct would make economic sense for the defendant but for its elimination or lessening of competition. In essence, the Department of Justice argues that “*conduct is not exclusionary or predatory unless it would not make no economic sense for the defendant but for its tendency to eliminate or lessen competition.*”<sup>13</sup> The Department of Justice adds that “sacrifice” entails a choice between a business strategy that would make no business sense outside the probability that the conduct would create or maintain monopoly power.<sup>14</sup>

Judicial acceptance of the Department of Justice’s proposed sacrifice test has been mixed. In *American Airlines*,<sup>15</sup> the Department (as plaintiff) argued that the appropriate inquiry in a predatory pricing case was whether incrementally-added capacity was money losing, even if the service provided by the incumbent airline as a whole remained profitable on the city pair as a whole. The 10<sup>th</sup> Circuit held that, even under the standard advanced by

---

<sup>12</sup> The profit sacrifice test was originally proposed by leading industrial economists in the early 1980s. See J. Ordover & R. Willig, “An economic definition of predation: pricing and product innovation,” (1981) 91 *Yale Law Journal* 8. The test was intended to provide an objective, transparent and economically based framework for assessing exclusionary unilateral behaviour. The economists defined exclusionary behaviour as a “*response to a rival that sacrifices part of the profit that could be earned under competitive circumstances were a rival to remain viable, in order to induce exit and gain consequent additional monopoly profits.*” (Id. at 9-10).

<sup>13</sup> Brief for the United States and Federal Trade Commission as Amici Curiae Supporting Petitioner, *Verizon Communications, Inc. v. Law Office of Curtis V. Trinko*, No. 02-682 (docketed U.S. Sup. Ct. Dec. 13, 2002), at 15.

<sup>14</sup> Id.

<sup>15</sup> *United States v. AMR Corp.*, 335 F.3d 1109 (10th Cir. 2003).

the Department, they had failed to demonstrate that the additions of capacity at issue were unprofitable.<sup>16</sup>

In *Trinko*,<sup>17</sup> the Department advocated (as *amicus curiae*) essentially the same sacrifice test for assessing unilateral refusals to deal. Although the Supreme Court majority opinion did not expressly refer to the sacrifice test, it justified past cases in which a duty to deal was imposed on the basis that the defendant was foregoing a more profitable course of conduct in refusing to deal. For example, in its discussion of *Aspen Skiing*, the Court attached importance to the fact that the defendant had refused to deal even when the requesting party offered a price that exceeded the retail price charged by the defendant downstream. It pointed to the defendant's willingness to forego short-term benefits through "[t]he unilateral termination of a voluntary (and thus presumably profitable) course of dealing," and its "unwillingness to renew the ticket even if compensated at retail price," as facts that suggested its "distinctly anticompetitive bent." As a result, the Department had indicated that "it plans to assert the sacrifice standard with renewed confidence" following *Trinko*.<sup>18</sup>

The profit sacrifice test has been criticised in important respects. The first set of criticisms are fundamental in nature. Certain commentators have argued that the test is flawed in two critical respects.<sup>19</sup> First, they argue that a number of types of conduct do not involve profit sacrifice, but have been clearly recognised as exclusionary. For example, filing a false or overbroad patent application may be cheaper than filing a correct and properly-defined one. The same point can be made about other forms of non-price predation (*e.g.*, falsely disparaging a rival), reprisal abuses, and anticompetitive forms of raising rivals' costs. A profit sacrifice test would therefore seem to wrongly exclude such abuses.

A second criticism is that a profit sacrifice test could capture a number of forms of highly desirable market activity. For example, in the area of intellectual property or substantial long-term investments in tangible property, investments would typically be unprofitable but for the prospect of later monopoly returns reaped by (lawfully) excluding competitors. A literal application of the sacrifice test might treat such investments as predatory despite the fact that, in general, they clearly benefit consumer welfare by offering a better market option.

The second set of criticisms are definitional. It is not clear, for example, whether the profit sacrifice requires a firm to opt for the *most* profitable course of action in order to avoid a finding of exclusionary conduct or whether it should be required to have passed on a *more* profitable alternative. It is also not clear what degree of sacrifice would be

---

<sup>16</sup> See R. Hewitt Pate, "The Common Law Approach and Improving Standards for Analyzing Single Firm Conduct," Fordham International Antitrust Conference, October 23, 2003, available at [http://www.usdoj.gov/atr/public/speeches/speech\\_pate.htm](http://www.usdoj.gov/atr/public/speeches/speech_pate.htm).

<sup>17</sup> Supra note 1.

<sup>18</sup> See "The Struggle For Standards," remarks by J. Bruce McDonald, Deputy Assistant Attorney General, Antitrust Division U.S. Department of Justice, presented at American Bar Association Section of Antitrust Law, Spring Meeting, available at <http://www.usdoj.gov/atr/public/speeches/203780.htm>.

<sup>19</sup> See E. Elhauge, supra note 11.

sufficient to establish exclusionary conduct or whether the rule is a strict one, i.e., any profit sacrifice is automatically abusive. Indeed, it is not even clear whether the sacrifice test is a single unified substantive standard for assessing all unilateral conduct or simply a more objective measure of the defendant's intent. As Vickers notes, "*while the sacrifice test might be useful in assessing willfulness or intent, it does not naturally yield a substantive standard of what behaviour is exclusionary...There is no escape from the fundamental question of what is exclusionary.*"<sup>20</sup> In other words, the sacrifice test may, at best, constitute a useful characterisation of certain types of abuses, but it is not, in itself, capable of identifying exclusionary conduct and clearly distinguishing it from legitimate conduct.

#### B. Equally-efficient competitor test

Exclusionary conduct has also been defined as conduct that would exclude an equally-efficient rival firm. This definition was originally proposed by Judge Posner in his seminal book, *Antitrust Law*. The latest edition offers the following definition of exclusionary conduct:<sup>21</sup>

"[T]he plaintiff must first prove that the defendant has monopoly power and second that the challenged practice is likely in the circumstances to exclude from the defendant's market an equally or more efficient competitor. The defendant can rebut by proving that although it is a monopolist and the challenged practice exclusionary, the practice is, on balance, efficient."

A more recent variant of this test, proposed by Professor Elhauge, is as follows:<sup>22</sup>

"The proper monopolization standard should instead focus on whether the alleged exclusionary conduct succeeds in furthering monopoly power (1) only if the monopolist has improved its own efficiency or (2) by impairing rival efficiency whether or not it enhances monopolist efficiency. Under this standard, which would permit the former conduct and prohibit the latter [...]."

The equally-efficient test certainly has some basis under Article 82 EC. For example, the *AKZO* predatory pricing rules are grounded in the economic insight that a profit-maximising dominant firm should be allowed to price down to the level of its average variable costs. This applies even if the dominant firm's costs are lower than those of rivals. Similarly, the test usually applied in margin squeeze cases – whether the dominant firm's own downstream arm could trade profitably if it had to pay the same input prices as third parties – relies on an equally-efficient competitor test.

At the same time, however, it is clear that the duties imposed on dominant firms under Article 82 EC are not limited to equally-efficient competitors. Under the *CEWAL* line of

---

<sup>20</sup> See J. Vickers, "Abuse of market power," Speech to the 31<sup>st</sup> conference of the European Association of research in industrial economics, Berlin, September 3, 2004.

<sup>21</sup> R. Posner, *Antitrust Law*, Second Edition (2001) (Chicago Press), p. 194-195.

<sup>22</sup> E. Elhauge, *supra* note 11 at 253.

case-law, unconditional price cuts that remain above the dominant firm's average total costs (and *a fortiori* average variable cost) may be abusive in certain circumstances. These rules reflect the economic view that the entry of less efficient firms may improve consumer welfare where the gains in lower prices outweigh higher costs.<sup>23</sup> This is said to be the case where rules against above-cost price cuts by a dominant firm result in the entry of firms that would not have entered absent such restrictions.<sup>24</sup> A similar point can be made in relation to restrictions on conditional above-cost prices by a dominant firm (e.g., loyalty rebates). In other words, there are a number of existing rules under Article 82 EC that, rightly or wrongly, seem to be based on the view that entrants who are less efficient (in the short-run) may improve consumer welfare overall. This in itself might suggest that the "equally-efficient rival" test cannot be unreservedly accepted under Article 82 EC.

An additional, but no less substantial, problem concerns the definition of an "equally-efficient firm" for purposes of competition law. In theory, the answer is simple: a firm with costs equal to (or lower than) the dominant firm. In practice, such comparisons can be extremely complex and the subject of disagreement among experts. For example, in the area of unconditional price cuts, there are substantial disputes over how to approach cost calculation and allocation. Unresolved issues include: (1) how to treat costs in industries with near-zero marginal costs; (2) how to apply cost tests in situations in which equally efficient firms have different ratios of fixed to variable costs; (3) what to do when, in declining industries, all firms have marginal costs that are below their variable costs; and (4) when an alleged predator strategically times low prices after it has made capital investments (and thus has low variable costs), but the rival is deciding whether to do the same.<sup>25</sup> Discussion of these issues is beyond the scope of the present section, but the issues are real and present significant issues in defining the concept of an "equally efficient firm."

Similarly, in the area of conditional above-cost pricing schemes (e.g., loyalty rebates), much of current uncertainty in the law stems from how to treat economies of scale for purposes of defining an "equally-efficient firm." The objection in such cases is usually that the dominant firm's large volume of past sales give it a scale advantage over rivals and that, by extending this advantage to marginal units and customers, the dominant firm can, in certain instances, offer prices at the margin that a rival only competing for the marginal units cannot match even if it is as efficient overall.<sup>26</sup> In simple terms, even if the rival is as efficient overall as the dominant firm, it may not be as efficient at serving

---

<sup>23</sup> M. Armstrong and J. Vickers, "Price discrimination, competition and regulation," 4 *Journal of Industrial Economics*, 334 (1993).

<sup>24</sup> *Id.*

<sup>25</sup> See E. Elhauge, "Why Above-Cost Price Cuts To Drive Out Entrants Are Not Predatory—and the Implications for Defining Costs and Market Power," 112 *Yale Law Journal*, 680, at 703-724 for a discussion of the competing views on these issues.

<sup>26</sup> See D. Ridyard "Exclusionary Pricing and Price Discrimination Abuses Under Article 82 – an Economic Analysis", (2000) 23 *E.C.L.R.* 286; Balto, and Averrit "Anticompetitive Aspects Of Market-Share Discounts and Other Incentives To Exclusive Dealing", 67 *Antitrust L.J.* 615; and Bulkley "The Role of Loyalty Discounts When Consumers Are Uncertain of the Value of Repeat Purchases", [1992] *International Journal of Industrial Organisation*, Vol. 10, 91-101.



certain marginal customers. While there is some merit in the view that only the most efficient firm should serve a customer, the Commission has taken the opposite approach in several cases. Whether this is correct or not is discussed elsewhere in this paper.

### C. Consumer welfare test

A third test seeks to shift the focus away from the relative efficiency of competitors toward an assessment of whether the dominant firm's practices are likely to have a material adverse effect on consumer welfare in the form of higher prices, less output, and reduced choice.<sup>27</sup> The consumer welfare test effectively merges the traditional distinction made under Article 82 EC between exclusionary and exploitative abuses: commentators argue that the only conduct that is truly exclusionary is that which has a material adverse effect on consumer welfare in the form of exploitation of market power. In other words, it has been suggested that there is only one type of anticompetitive unilateral action – that which is exploitative.<sup>28</sup>

The consumer welfare test presents a number of difficulties under Article 82 EC. The first is that the Court of Justice has held that Article 82 EC does not only encompass direct harm to consumers, but also includes indirect harm to an “*effective competition structure*” or the competitive process.<sup>29</sup> It could be argued, with some force, that these two concepts of harm to competition in fact amount to the same thing: there is no harm to the “structure of competition” that, ultimately, does not also lead to direct consumer harm.<sup>30</sup> Put differently, there can be no case for intervention under competition law where there is harm to the competitive process, but none to consumers.<sup>31</sup> But, at least as the law stands, Article 82 EC seems to encompass a somewhat broader notion of anticompetitive harm than direct harm to consumer welfare.

---

<sup>27</sup> “Welfare” in this context generally means consumer welfare, which courts and regulatory authorities typically use for evaluating competition issues. A number of economists argue that “welfare” should refer to social welfare (i.e., the sum of consumer and producer surpluses). See M. Motta, *Competition Policy: Theory and Practice*, 2004 and sources cited therein. Most of the following discussion does not, however, turn on which measure is, or should be, used in competition law.

<sup>28</sup> This distinction was first mentioned in various works by Professor E. Fox. See, e.g., E. Fox, “We protect competition, you protect competitors,” (2003) 26 *World Competition* 149.

<sup>29</sup> See, e.g., Case 6/72, *Europemballage and Continental Can*, [1973] E.C.R. 215, para. 26 (“As may further be seen from letters (c) and (d) of Article 86(2), the provision is not only aimed at practices which may cause damage to consumers directly, but also at those which are detrimental to them through their impact on an effective competition structure, such as is mentioned in Article 3(f) of the Treaty. Abuse may therefore occur if an undertaking in a dominant position strengthens such position in such a way that the degree of dominance reached substantially fetters competition, i.e. that only undertakings remain in the market whose behaviour depends on the dominant one.”).

<sup>30</sup> See D. Evans, H. Chang, and R. Schmalensee, “Has The Consumer Harm Standard Lost Its Teeth,” in *High- Stakes Antitrust: The Last Hurrah?* (2003) (Edited by R. Hahn), pp. 72 et seq.

<sup>31</sup> See J. Vickers, id. (“*In the limit, the idea that there could be harms to the competitive process, justifying competition policy intervention, that are not even capable of harming consumers is unattractive. Competition to serve the needs of the general public of consumers - not some abstract notion of competition for its own sake - is the point of competition policy.*”).

Another difficulty with the consumer welfare test, discussed in more detail below, is that statements in certain recent case-law would seem to rule out the need to conduct any detailed enquiry into the actual or even likely. Rather, the Court of First Instance has suggested that it is sufficient that a dominant undertaking's behaviour is liable to restrict competition or by its very nature did so.<sup>32</sup> Were these statements to come to represent the general state of the law under Article 82 EC, the utility and desirability of a consumer welfare test must be considered questionable.

D. The “limiting production” test under Article 82(b) EC

The final test suggested for clarifying exclusionary abuses relies on the wording of Article 82(b) EC: an abuse is conduct that “limits” either the dominant firm's or its competitors' production, in a manner that causes “prejudice to consumers.”<sup>33</sup> Article 82(b) states that “limiting production, markets or technical development to the prejudice of consumers” is illegal. Judgments of the Community Courts have confirmed that this prohibits a dominant enterprise from limiting the production, marketing or development of its competitors, as well as its own.<sup>34</sup> The Commission has also applied the same clause of Article 82 EC in the recent *Microsoft* case.<sup>35</sup> In other words, Article 82(b) prohibits foreclosure, and it is the principal clause in Article 82 which does so. Article 82(b) makes it clear that a dominant company may limit its rivals' possibilities if no prejudice to consumers results. Under this test, “limitation” means that the dominant company must not create an obstacle or handicap *that would not otherwise exist*: it does not mean that it has a duty to help to overcome or deal with an obstacle which it has not created, or which it has legitimately created.

---

<sup>32</sup> Case T-203/01, *Michelin v. Commission* (hereinafter “*Michelin II judgment*”) [2003], not yet reported, para. 239.

<sup>33</sup> The test was first proposed by J. Temple Lang, *supra* note 2.

<sup>34</sup> Joined cases 40-48/73, *Suiker Unie and others (Sugar Cartel)*, [1975] E.C.R. 1663, paras. 399, 482-483, and in particular paras. 523-527; Case 41/83, *Italy v. Commission (British Telecommunications)*, [1985] E.C.R. 873; Case 311/84, *Telemarketing CBEM* [1985] E.C.R. 3261, para. 26; Case 53/87, *CICR and Maxicar v. Renault* [1988] E.C.R. 6039; Case 238/87, *Volvo v. Veng* [1988] E.C.R. 6211; Joined cases C-241/91P, *RTE and ITP (“Magill”)* [1995] E.C.R. I 743 at para. 54; Case C-41/90, *Höfner and Elser* [1991] E.C.R. I 1979 at pp. 2017-2018 in particular para. 30; Case C-55/96, *Job Centre* [1977] E.C.R. I 7119 at pp. 7149-7150 paras. 31-36; Case C-258/98, *Carra*, [2000] E.C.R. I 4217; J. Temple Lang, Abuse of dominant positions in European Community law, present and future: some aspects, in Hawk (ed.), Fifth Annual Fordham Corporate Law Institute (1979) 25-83, 52, 60. This point is not mentioned in Faull & Nikpay, *The EC Law of Competition* (1999) 194, but is correctly stated in e.g., Bellamy & Child, *European Community Law of Competition* (5<sup>th</sup> ed., 2001) 754-755 and in Ritter, Braun and Rawlinson, *EC Competition Law – a practitioner's guide* (2<sup>nd</sup> ed., 2000) pp. 362-363; and in Waelbroeck & Frignani, *European Competition Law* (1999) p. 551 *et seq.* and in Mercier, Mach, Gilliéron & Affotten, *Grands principes du droit de la concurrence* (1999) 260-265, among others. In *Arkin v. Borchard Lines and others*, High Court, London, April 10, 2003, Colman J. said (at para. 293) “quite simply, an undertaking in a dominant position must not reduce or attempt to reduce the ability of other participants in the market or of the would-be entrants into the market to compete. This principle palpably underlies the reasoning of the European courts in all the authorities ...”

<sup>35</sup> *Microsoft*, *supra* note 7, Section 5.3.1.3.1 (“*Microsoft's refusal to supply limits technical development to the prejudice of consumers*”), paras. 693 *et seq.*

Proponents of the “limiting production” test suggest that the law would be clearer if Article 82(b) was always considered explicitly. An example of the application of the “limiting production” test is provided by the Commission’s decision in *National Carbonising*.<sup>36</sup> That was said to be a price squeeze case: NCC’s only source of coal for making industrial and domestic coke was the National Coal Board. The Commission finally concluded that there was no price squeeze on the market for industrial coke, but that NCC’s problem was that it had few long-term contracts for industrial coke. When demand for industrial coke fell, NCC became too dependent on its domestic coke sales, where the retail price was limited by the prices of other kinds of domestic energy. NCC’s difficulties had not been caused or increased by the Coal Board’s actions, and the Board’s long-term contracts (which of course reduced the demand for NCC’s product) were legitimate, even though NCC was not so well placed to make such contracts.

Other general principles are also said to follow from the “limiting production” test. For example, in general, a dominant company has no duty to help its competitors: such a duty arises only if it has done something which limits the possibilities which otherwise would be open to them. It is unlawful to prevent a competitor from offering its product or service on the market, or to make difficulties for it, but there is no duty to help it further. The fact that its competitors’ products or services are less attractive to buyers is irrelevant unless the dominant company’s conduct has done something which has made them positively less attractive or less readily available than they would otherwise be. If the competitors’ possibilities are limited, but not as a result of the conduct in question, there is no abuse.

A second principle is that, since harm to consumers is essential, offering a better price or a better product than competitors can never be unlawful. Article 82(b) embodies the idea of normal, legitimate, competition on the merits, used without much explanation in Community case-law, in contrast to conduct interfering with or restricting the possibilities open to competitors, whether by depriving them of access to customers, raw materials or other important inputs, official authorizations, or technology. This underlies the distinction between *e.g.*, a company which sells two products which must work together, which is not normally obliged to give its competitors notice when it changes the interface or interconnection between them, and a company which changes the interfaces of its products so often that competing producers of one of the products are always a step behind or can never be sure that they can make their products fully compatible with the dominant company’s. In the second case there may be a duty to disclose interface information.

#### **IV. Evaluating the Different Tests for Exclusionary Conduct**

The “limiting production to the prejudice of consumers” test has several advantages over the other tests suggested:

---

<sup>36</sup> Commission decision of 29 October 1975, *National Carbonising Co*, (1976) O.J. L-35/6; Case 109/75R, [1975] E.C.R. 1193.

- (i) It is based on the words of the EC Treaty. The other two principal tests are suggested by economic theory and have no legal basis, (although they may be useful as ways of verifying the “limiting production” test);
- (ii) It offers a comprehensive test of all exclusionary (anticompetitive) abuses;
- (iii) It offers a test for distinguishing between legitimate competition and unlawful conduct;
- (iv) It offers an answer to the question of economies of scale (discussed below);
- (v) It is consistent with, and provides a rational basis for, all of the EU judgments and decisions which are generally regarded as correct, clear, and satisfactory;
- (vi) The test can be applied by the dominant enterprise without knowing confidential details of its competitors’ costs and without waiting to see what effects the conduct has on the market;
- (vii) It offers an intelligible basis for the *Continental Can* judgment, which otherwise appears to be (and perhaps was) a striking example of judicial legislation;
- (viii) It does not prevent the use of the “profit sacrifice” test and the “equally efficient competitor” test in circumstances in which they seem valid and useful;
- (ix) It offers an intelligible basis for dealing with refusal to deal cases, where the first refusal to deal is in question. These are the most difficult cases for which to provide a clear justification, and which the “equally efficient competitor” test does not answer clearly. The “limiting production” test suggests that a refusal to contract is unlawful if it reduces existing competition or prevents the putting on the market of a new kind of product for which there is a clear and unsatisfied demand. (Other cases involve discrimination, or the duty to contract is a remedy for some other identified abuse,<sup>37</sup> whether exploitative or exclusionary);
- (x) It deals with price squeeze cases better than the “profit sacrifice” test, because a price squeeze may not involve any sacrifice of profit overall by a vertically integrated dominant company;
- (xi) It explains the distinction between a rebate conditional on exclusivity and the same rebate given without a condition: it is the condition, not the rebate, which is illegal, because it limits rivals’ production or marketing without any benefit to consumers;
- (xii) The “limiting production” test is compatible with the “equally efficient competitor” test, but expresses the test more usefully. If a competitor is equally

---

<sup>37</sup> See J. Temple Lang, “Compulsory licensing of intellectual property rights – a comprehensive solution”, (2004) 4 *Europarättslig Tidskrift* 558.

efficient in every respect, it can be unjustifiably disadvantaged or handicapped only by conduct which limits its production (*e.g.*, by cutting off supply of a raw material), or its marketing (by denying it access to buyers, *e.g.*, through exclusive agreements), or its technical development (*e.g.*, by depriving it of access to technology). Any other kind of harm would be due only to the supposedly dominant company charging lower prices, *i.e.*, accepting a lower profit margin;

- (xiii) It offers a useful and sound approach to cases in which the supposed exclusionary effect results from a combination of several kinds of conduct, such as *Irish Sugar* and *CEWAL*.

This test seems to describe well the key feature of exclusionary conduct, that it makes the rivals' product or service less attractive or less available, rather than making the dominant company's product better or more available. It must be undesirable to create handicaps or difficulties for competitors which do not result merely from offering better products than they do. Offering better or cheaper products must be legal, however great the difficulties it causes to rivals. But creating difficulties for competitors in other ways cannot be legal.

One criticism which has been made of the "limiting production" test is that it appears to be inconsistent with dicta in several judgments of the Community Courts, in particular *Irish Sugar* and *CEWAL*. Several comments are appropriate:

- (i) The test is consistent with the results in both cases: the production of rivals, and their freedom to market their products or services, was undoubtedly being deliberately limited in both cases;
- (ii) Both cases involved simultaneous use of several kinds of conduct to achieve the clear exclusionary aim. In these circumstances it would not necessarily be correct to consider separate kinds of conduct in isolation;
- (iii) The Community Courts, in both cases, were deciding whether individual Commission decisions were valid. Since the Commission had not proposed any comprehensive test, the Courts should not be criticised for not having adopted one. The judgments could hardly have been expected to be very much clearer than the decisions.

A second criticism of the "limiting production" test is based on the assumption that economies of scale may be illegal, or to put the argument more fully, that it may be "unfair" if a dominant firm takes advantage of economies of scale which enable it to charge lower prices than its smaller rivals. On this assumption, it is said that the "limiting production" test gives the wrong result, because a dominant firm passing on unit cost savings due to economies of scale which its rivals have not got would not be, in the usual meaning of the phrase, "limiting" its rivals' production, and certainly not limiting it "to the prejudice of consumers", which must be an important part of the test. But it is not, and certainly should not be, illegal to pass on cost savings due to economies of scale, and

rivals' production is not "limited" in this way differently from the effects of the dominant firm selling at lower prices for any other reason, which must be legal. The "limiting production" test is valuable precisely because it enables a distinction to be drawn between rebates conditional on buying only from the dominant company (where the condition, not the reduced price, limits the possibilities of rivals to sell), and generous rebates which rivals, for whatever reason, cannot match.

The "limiting production" test would mean that discounts are illegal only if they are conditional on exclusivity or near-exclusivity, or conditional on reaching quantities calculated by both buyers and sellers to be the buyer's total requirements. A seller may suspect that a quantity suggested by a buyer to get a better price represents the buyers' estimate of its requirements in the relevant period. But sellers must be free to offer discounts for quantity, since that is procompetitive, and a seller cannot know what the buyer's total requirements are unless the buyer discloses them. A buyer might be consistently choosing to buy from more than one source, to maximize the benefits of competition in the long term. This conclusion may seem radical, but it is not significantly more radical than the "equally efficient competitor" test, and the results which it produces are rational from both a legal and economic viewpoint. Nor is it significantly more radical than the profit sacrifice test, except that it produces clearer results (The profit sacrifice test, for example, seems to imply that rebates conditional on exclusivity are illegal only if the revenue sacrificed is greater than the advantage gained by denying rivals access to the buyer in question: how are the latter figures to be estimated?).

## **V. Other Issues Surrounding the Basic Definition of Abuse**

In addition to the basic definition of an exclusionary abuse, a number of specific issues regarding the general interpretation of Article 82 EC remain unclear. The most important of these are discussed below. These are: (1) is the list of abuses in Article 82 EC illustrative or exhaustive; (2) whether foreclosure cases involving discrimination against the dominant firm's rivals fall under Article 82(b) or Article 82(c); (3) whether harm to consumers is necessary under all of the clauses of Article 82 EC; (4) to what extent, if any, Article 82 EC requires an analysis of actual or likely effects on competition; and (5) the role of objective justification under Article 82 EC. These issues are treated in detail below.

### **A. Are there abuses not mentioned in Article 82 EC?**

The Community Courts have said that Article 82 EC should not be understood to list exhaustively the kinds of conduct which it prohibits.<sup>38</sup> The precise meaning and scope of this statement has not, however, been clearly articulated in any judgment. In particular, it is not clear whether the Community Courts intended to say that: (1) the principal *categories* of abusive conduct are listed exhaustively in Article 82 EC, but all the possible *examples* of abuses *within those categories* are not; or (2) the *categories* of abuse under

---

<sup>38</sup> See *Continental Can*, supra note 29.

Article 82 EC extend beyond the four clauses mentioned therein. A number of compelling arguments plead in favour of the former interpretation:<sup>39</sup>

- (i) First, the Court of Justice's statements regarding the non-exhaustive nature of the abuses listed in Article 82 EC were made in the context of a teleological interpretation of the EC Treaty intended to fill an important lacuna in the law – the absence at the time of rules governing mergers and acquisitions. That need no longer arises, since mergers with a Community dimension are now dealt with under the EU Merger Regulation. When the EU Merger Regulation was adopted, the Commission made clear that it did not intend to apply Articles 81 or 82 to concentrations that had a Community dimension. With respect to concentrations that did not have a Community dimension, the Commission expressly reserved the right to use its powers under Article 81 (but not Article 82), at least in regard to concentrations that exceeded *de minimis* turnover thresholds.<sup>40</sup> In other words, the Commission made clear that only the *lex specialis* will apply and that the “*effect utile*” arguments relied upon in *Continental Can* are no longer applicable;
- (ii) Second, the *Continental Can* judgment was given three years before the first judgment in which the Court held that Article 82(b) applied to conduct limiting the possibilities available to competitors of the dominant firm (*Suiker Unie*). It would be reasonable to argue that Article 82(b) applies to a merger, which ends all scope for independent marketing, production and technical development of the company acquired, just as it applies to *e.g.*, cutting off supply of an essential raw material or making exclusive contracts with customers. Thus, *Continental Can* may not, after all, be an example of an abuse which does not fall under any of the four clauses of Article 82;
- (iii) Third, it is very difficult to think of any kind of unilateral conduct which falls outside these categories, and which should be subject to competition law. Article 82(a) is ample to cover exploitative abuses and other unfair trading conditions. Exclusionary abuse cases fall within Article 82(b) since they can all be characterised as limiting either rivals' production or that of the dominant firm, to the prejudice of consumers. Article 82(c) contains a discrimination principle that is sufficiently broad to capture discrimination by a dominant firm against non-associated companies. Finally, as evidenced by *Microsoft*, Article 82(d) is more than capable of treating sophisticated tying and bundling cases. Even the miscellaneous abuses that could be broadly characterised as “raising rivals' costs” (*e.g.*, vexatious litigation, use and abuse of patent system) fit within the notion of “limiting production” under Article 82(b). Given the broad scope of the existing clauses of Article 82, the Court's statement that the examples in Article 82 are not exhaustive should probably be regarded as no more than a confirmation that there are kinds of conduct (*e.g.*, refusal to contract and bundling) which are not

<sup>39</sup> See Temple Lang, *supra* note 2.

<sup>40</sup> The Commission identified as €2 billion of worldwide turnover and €100 million of Community-wide turnover as the relevant thresholds. See Notes entered in the Minutes of the Council, December 21, 1989.

explicitly described and prohibited by Article 82, but clearly fall *within* the clauses listed therein;

- (iv) Finally, the notion that there may be some unexpressed underlying principles in Article EC that prohibit other kinds of abuses would be contrary to legal certainty. Legal certainty requires that a dominant company should be able to know what its legal duties are under Article 82.<sup>41</sup> It cannot be right that defendants should find themselves exposed to the risk that courts and competition authorities could apply words and principles not mentioned in Article 82 EC. It would be highly unsatisfactory to rely on an implied and not very clear underlying principle unless a case arose which clearly fell outside the four clauses of Article 82 EC.

#### B. The relationship between Article 82(b) and Article 82(c) EC

A number of Article 82 EC cases concern the cumulative or combined anticompetitive effects of several practices committed simultaneously by the dominant enterprise.<sup>42</sup> These cases have given rise to decisions and judgments which, even though they are considered correct, are not clear in their analysis or in their implications. In particular, although Article 82(c) is relevant in cases of “pure” discrimination (i.e., between companies not associated with the dominant enterprise), it has also been applied in several situations essentially involving foreclosure of competitors of the dominant enterprise under Article 82(b) (e.g., price reductions given on condition of exclusivity, a selective lower price which is predatory, and discrimination by a vertically integrated dominant enterprise in favour of its own downstream operations).

For example, in *Irish Sugar*, the Court of First Instance seemed to confuse discrimination that forecloses competitors of the dominant firm (i.e., an exclusionary abuse) with discrimination that distorted competition between customers of the dominant firm.<sup>43</sup> In condemning Irish Sugar’s rebates offered to customers at border areas exposed to competition as exclusionary, the Court of First Instance seemed to confuse the analysis by also suggesting that the rebates were objectionable because customers located in non-border areas would have paid higher prices – in effect, subsidising the low prices in the border area.

---

<sup>41</sup> See T. Tridimas, *The general principles of EC law* (Oxford, 1999) ch. 5, pp. 165-166; Temple Lang, Legal certainty and legitimate expectations as general principles of law, in Bernitz & Nergelius (eds.), *General principles of European Community law* (2000, Kluwer) 163-184; Case C-313/99 *Mulligan*, June 20 2002; Case C-63/93, *Duff v. Minister for Agriculture*, [1996] E.C.R. I 569 at 607, paras. 19-20.

<sup>42</sup> Case 27/76, *United Brands*, [1978] E.C.R. 207; Case 53/87 *CICRA v. Renault*, [1988] E.C.R. 6039, 6073; Case T-30/89 *Hilti*, [1991] E.C.R. II 1439, on appeal Case C-53/92P, [1994] E.C.R. I 667; T-83/91 *Tetra Pak* 1994 E.C.R. II 755 and 1996 E.C.R. 5951 (pricing abuses); T-65/89 *British Gypsum* [1993] E.C.R. II 389; T-228/97 *Irish Sugar* [1999] E.C.R. II 2969; C-395/96P, *Compagnie Maritime Belge* [2000] E.C.R. I 1365. Commission Merger Regulation decision *Microsoft/Liberty/Telewest*, JV 27, Thirtieth Report on Competition Policy (2000) pp. 186-187 (the Commission found that Microsoft regularly set up working groups to influence buyers’ choice of software). In predatory prices cases under the second *AKZO* rule (price between average variable costs and average total costs, plus evidence of intention to exclude a competitor), the evidence will necessarily be cumulative.

<sup>43</sup> See Case T-228/97 *Irish Sugar* [1999] E.C.R. II 2969.



The Court's approach in *Irish Sugar* creates unnecessary confusion between cases of "pure" discrimination (i.e., discrimination that produces effects at a vertical level against companies that do not compete with the dominant firm) and discrimination against competitors (i.e., discrimination that produces effects against firms that compete on a horizontal level with the dominant firm on the one hand).<sup>44</sup> The law would be clearer and more rational if this distinction was made more explicit in the decisional practice and case-law. This would mean that: (1) the prohibition under Article 82(c) would only deal with discrimination against non-associated companies;<sup>45</sup> and (2) to the extent that discriminatory conduct tends to exclude competitors, such conduct is not analysed under the discrimination clause of Article 82(c), but under the principles concerning foreclosure of competitors under Article 82(b). In the latter case, the issue is not discrimination *per se*, but merely that discrimination is a vehicle for exclusionary conduct. The determinative issue is whether the conduct is truly exclusionary, and not merely whether it has discriminatory effects. Discrimination may simply make the exclusionary conduct possible, reinforce its anticompetitive or exploitative effects, or allow the dominant firm to take advantage of that conduct. Of course, both levels of discrimination can result from the same conduct. Most obviously, a discriminatory rebate scheme could foreclose competitors of the dominant firm, as well as distort competition between customers of the dominant firm downstream. But this does not call into question the soundness, or need for, the basic distinction.

Although it can be criticised in terms of its analysis, the *British Airways/Virgin* case at least makes a correct basic distinction between the principles of foreclosure and discrimination.<sup>46</sup> British Airways granted bonus commissions to travel agents that increased their sales of British Airways tickets as compared to a previous reference period. The bonus commission was not calculated on the basis of absolute increases in sales applicable to all travel agents. Instead, it depended on the extent to which an agent had increased its individual sales over a period as compared to its sales in the same period

---

<sup>44</sup> The former is sometimes referred to as "primary-line discrimination" under antitrust economics and the latter as "secondary-line discrimination."

<sup>45</sup> In *Aéroports de Paris*, the defendant challenged the application of Article 82(c) to discrimination against non-associated companies on the basis that Article 82 could not be applied to markets in which the dominant firm is not present. The defendant was found dominant in a market for airport management where it charged discriminatory fees for handling services. The Court found that, although the discriminatory fees had effects on downstream markets where the dominant firm was not present (groundhandling services and air transport), the abusive conduct arose from the market on which it was both present and dominant (airport management). It held that, as a matter of law, Article 82 can be applied to markets in circumstances where the effects of an abuse materialise on markets other than those in which dominance arises. The Court added that the application of Article 82 in such circumstances is appropriate where, owing to the dominant position occupied by the supplier, the trading party is in a situation of "economic dependence" *vis-à-vis* the dominant supplier, without their necessarily having to be present on the same market. It is sufficient in this connection if the service offered by the supplier is necessary to the exercise by the trading party of its own activity. See Case T-128/98, *Aéroports de Paris v. Commission*, [2000] E.C.R. II-3929 (confirmed on appeal in Case C-82/01 P, *Aéroports de Paris v. Commission*, [2002] E.C.R. I-9297).

<sup>46</sup> Commission decision of 14 July 1999, *Virgin/British Airways*, (2000) O.J. L 30/1 (hereinafter "*BA/Virgin decision*"); Case T-219/99, *British Airways plc v Commission*, (hereinafter "*BA/Virgin judgment*"), [2003] not yet reported.

in the past. One possible effect of this scheme therefore was that agents selling the same number of tickets would receive different commissions depending on whether they had increased their sales relative to sales in the past.

In analysing the effects of the bonus commission scheme, the Commission and the Court of First Instance clearly distinguished between the exclusionary effects of the scheme vis-à-vis British Airways' competitors on the one hand and the discriminatory effects of the scheme on travel agents.<sup>47</sup> In regard to exclusionary effects of British Airways' conduct, the Commission applied its well-established principles on exclusionary loyalty rebates. Concerning the discriminatory effects of the bonus commissions on competition between travel agents, however, the Commission only relied on Article 82(c). Put differently, even if conduct with exclusionary effects vis-à-vis the dominant firm's competitors involves discrimination, the Article 82 analysis focuses on issues of foreclosure and not discrimination *per se*. In contrast, where conduct affects competition between downstream trading parties with whom the dominant firm does not compete, the analysis focuses on the extent to which differential treatment gives rise to a "competitive disadvantage" under Article 82(c).

The above distinction has been confirmed in several cases, including *Michelin I*<sup>48</sup> and *Soda-Ash*.<sup>49</sup> It is also confirmed by *Ladbroke*,<sup>50</sup> which drew a distinction between cases when the dominant enterprise is present in the downstream market and when it is not. If it is not present, it cannot be discriminating in favour of its own operations there. Recognising this distinction helps focus the analysis under Article 82(c), since a dominant firm is likely to have much less ability or incentive to distort competition between downstream customers with whom it does not compete than it would to exclude undertakings that it competes with directly.

In sum, the Commission's analysis should distinguish clearly between discrimination which creates disadvantages for customers which are in competition with each other and discrimination which forecloses competitors of the dominant enterprise from the markets, where both occur in the same case. The law would be clearer, more rational and more consistent with economic principles if Article 82(c) was applied only to cases of discrimination between companies not associated with the dominant enterprise. All primary line discrimination and foreclosure cases would then fall under Article 82(b). The two provisions would not then apply simultaneously.

---

<sup>47</sup> See *BA/Virgin decision*, paras. 97 et seq (exclusionary rebate schemes) and paras. 108 et seq. (discrimination); *BA/Virgin judgment*, paras. 233 et seq. (discrimination) and paras. 241 et seq.

<sup>48</sup> Case 322/81 *NV Nederlandsche Banden Industrie Michelin v. Commission* [1983] E.C.R. 3461, paras. 87 et seq.

<sup>49</sup> Commission decision of 19 December 1990, *Soda-Ash/Solvay*, (1991) O.J. L 152/1, para. 62

<sup>50</sup> Case T-504/93, *Ladbroke*, [1997] E.C.R. II-923.

C. Harm to consumers under the four clauses of Article 82 EC

A surprising feature of Article 82 EC is that the only clause that expressly mentions harm to consumers is Article 82(b) (“*prejudice to consumers*”). None of the other clauses contains a phrase like that found in Article 82(b), saying that the conduct is unlawful only if it is “*to the prejudice of consumers*”. In these circumstances, the question arises whether the other clauses of Article 82 contemplate a notion of abuse that does not necessarily include harm to consumers. On closer examination, however, this distinction is more apparent than real, or at least it should be regarded as such, for several reasons:

- (i) First, competition cannot be protected for competition’s sake: conduct only adversely affects competition where it operates in some sense to the detriment of consumer welfare. As made clear by Advocate General Jacobs in *Bronner*, “*the primary purpose of Article [82] is to prevent distortion of competition and in particular to safeguard the interests of consumers - rather than to protect the position of particular competitors.*”;<sup>51</sup>
- (ii) Second, the Court of Justice made clear in *Continental Can* that the purpose of Articles 81 and 82 should be consistent.<sup>52</sup> This leads to two comments. First, since Article 81(3) incorporates an analysis of consumer interests, so too should Article 82, and even in the absence of an express exemption clause (e.g., as part of “objective justification”). A second, more important comment is that it would make no sense to have consistency between Articles 81 and 82 and at the same time to have internal inconsistency within the four clauses of Article 82 EC;
- (iii) Third, the clauses of Article 82 that do not expressly mention consumer welfare do take this into account, both implicitly and in practice. Exploitative abuses Article 82(a) incorporate some element of loss of consumer welfare through excessive pricing. If it was accepted that all cases of foreclosure fell under Article 82(b), the vast majority of the most important abuses under Article 82 EC would be required to incorporate an express consumer welfare analysis. The Commission’s recent practice in tying cases under Article 82(d) has also clearly included detailed analysis of effects on consumers, as evidenced by *Microsoft*;
- (iv) Finally, there are also good arguments that consumer welfare is also, or should be, part of the analysis under Article 82(c) (which is treated in detail elsewhere in this paper). Many forms of discrimination can enhance consumer welfare, for example by allowing buyers who can only afford to pay less for a product to receive more favourable terms.<sup>53</sup> It would be anomalous, and contrary to the underlying

---

<sup>51</sup> Case C-7/97, *Oscar Bronner v. Mediaprint*, [1998] E.C.R. I-7791 at para. 58.

<sup>52</sup> See *Continental Can*, supra note 29.

<sup>53</sup> See H. Varian, “Price Discrimination And Social Welfare,” (1985) 75 *American Economic Review* 870.

objectives of Article 3(g) of the EC Treaty,<sup>54</sup> if Article 82(c) did not allow such contracts.<sup>55</sup> If, as is certainly the case, efficiency defences are available under the other provisions of Article 82 EC, it would be unreasonable if it was not a defence under Article 82(c) to show that there had been no prejudice to consumers, and that they would benefit from the different treatment. (It would be reasonable to presume harm to consumers conclusively, however, in cases of discrimination on the basis of nationality.<sup>56</sup>) If not, the criticism that Article 82 EC protects competitors and not competition would be true.

D. Analysis of actual or likely exclusionary effects under Article 82 EC

Whether proof of actual or likely exclusionary effects is necessary as a matter of law in pricing abuse cases is unclear. The decisional practice and case-law is inconsistent. On the one hand, several cases indicate that there must be a concrete assessment of the effects of a practice on the market before a finding of material adverse effect can be made.<sup>57</sup> This is consistent with the fact that there are no *per se* Article 82 EC violations. It

---

<sup>54</sup> Article 3 is relevant to the interpretation of Article 82. See *Continental Can*, supra note 29, para. 24; Cases 6 and 7/73, *Commercial Solvents* [1974] E.C.R. 223, para. 32; Case 27/76, *United Brands* [1978] E.C.R. 207; Case 85/76, *Hoffmann LaRoche* [1979] E.C.R. 461; Case T-51/89 *Tetra Pak* [1990] E.C.R. II-309.

<sup>55</sup> As the US Department of Justice explained in a long report on the Robinson Patman Act, a wide ban on discrimination is anticompetitive and damaging to consumers. See *Journal of Reprints for Antitrust Law and Economics* (2000 Reprint), U.S. Department of Justice Report on the Robinson-Patman Act, Vol. XXIX number 1, 259.

<sup>56</sup> Case C-18/93, *Corsica Ferries*, [1994] E.C.R. I 1783 and the performing rights societies cases; Case C-281/98 *Angonese*, [2000] E.C.R. I 4139.

<sup>57</sup> For example, in *BPB Industries*, the Court of First Instance held that promotional payments made by a dominant supplier to a customer in return for an exclusive purchasing commitment are “a standard practice forming part of commercial cooperation between a supplier and its distributors” that “cannot, as a matter of principle, be prohibited,” but rather must be assessed in the light of their effects on the market in the specific circumstances. See Case T-65/89, *BPB Industries and British Gypsum v. Commission*, [1993] E.C.R. II-389, paras. 65 and 66. More recently, in *Van den Bergh Foods Ltd*, the Court of First Instance examined the effects of exclusive contracts on the market in detail before concluding that they gave rise to material foreclosure under Article 82 EC. The Court held that contracts by which a dominant ice-cream firm insists that the refrigerators it provides to customers should be used exclusively for the dominant firm’s products were abusive. This conclusion was based on a detailed examination of several facts as evidence that the exclusivity clauses had a foreclosure effect. See Case T-65/98, *Van den Bergh Foods Ltd v Commission*, [2003] not yet reported. The Commission has also routinely examined actual market effects in other abuse cases. See Commission decision of 14 December 1985, *ECS/AKZO*, [1985] O.J. L374/1 at para. 86 (concluding after analysis of potential reaction from other competitors “that the elimination of ECS from the organic peroxides market would have had a substantial effect upon competition notwithstanding its still minor market share and the existence of other suppliers”); Commission decision of 20 March 2001, *Deutsche Post A.G.* [2001] O.J. L125/27 at paras. 36-37 (finding that below cost pricing where there is no prospect of price rise inhibited growth of more efficient rivals (para. 36) with identifiable welfare loss (para. 37). See also Case T-83/91, *Tetra Pak International SA v Commission* [1994] E.C.R. II-755, where the Court of First Instance noted that the Commission’s analysis that Tetra Pak’s prices were below cost was “corroborated by the eliminatory effect of the competition engendered by Tetra Pak’s pricing policy,” including “the increase of sales of Tetra Rex cartons in Italy and the corresponding reduction in the growth of sales of Elopak cartons, during a period of market expansion, followed by their decline as from 1981” (para. 151).

is also consistent with the notion that the hallmark of abusive conduct is that it has the effect of foreclosing competitors to the detriment of consumers (*i.e.*, of restricting competition), which means that it is necessary to examine the effects of the challenged practices.

On the other hand, in *Michelin II*, the Court of First Instance indicated that anti-competitive object or potential restrictive effects are sufficient to prove an abuse.<sup>58</sup> The Court rejected Michelin's argument that, as its market share and general price levels had fallen during the period of the practices in question, the Commission had failed to prove that the alleged abuses had in fact reinforced its dominant position or restricted competition. According to the Court, in order to fall under Article 82 EC, it is sufficient that a dominant undertaking's behaviour is liable to restrict competition or by its very nature did so.<sup>59</sup> Thus, where it is established that a dominant undertaking's behaviour has the object of restricting competition, such behaviour potentially has a restrictive effect: it is unnecessary to prove that there was an actual or concrete effect.<sup>60</sup> In support of this proposition, the Court cited the principles established in the *AKZO* case, where prices below average variable cost were presumed unlawful without the need to examine their market effect.<sup>61</sup> Similar comments have been made in margin squeeze cases under Article 82 (*Deutsche Telekom*<sup>62</sup>) and national law.<sup>63</sup> At the same time, a number of national decisions have rejected margin squeeze allegations based, *inter alia*, on the lack of actual

---

<sup>58</sup> See Case T-203/01, *Michelin v. Commission* (hereinafter "*Michelin II judgment*") [2003], not yet reported.

<sup>59</sup> *Id.*, para. 239.

<sup>60</sup> *Id.*, para. 241.

<sup>61</sup> Commission decision of 14 December 1985, *ECS/AKZO*, (1983) O.J. L 252/20; Case C-62/86 *AKZO v Commission*, [1991] E.C.R. I-3359. In *BA/Virgin*, the Court of First Instance adopted essentially the same reasoning as in *Michelin II*. The Court held that that it is sufficient for an abuse that the conduct "tends to restrict competition" or "*in other words... is capable of having, or likely to have, such an effect.*" (Case T-219/99 *British Airways plc v Commission*, (hereinafter "*BA/Virgin judgment*") [2003] not yet reported, para. 293) The Court added that "*where an undertaking in a dominant position actually puts into operation a practice generating the effect of ousting its competitors, the fact that the hoped-for result is not achieved is not sufficient to prevent a finding of abuse*" (*BA/Virgin judgment*, para. 295). As in *Michelin II*, the Court disregarded the decline in BA's share of sales and a corresponding increase in competitors' sales in favour of an assumption that competitors would have done better in the absence of BA's unlawful practices. The case is currently on appeal to the Court of Justice on this and other issues.

<sup>62</sup> *Deutsche Telekom*, supra 62, paras. 179-180 (once a margin squeeze was shown, it was not necessary to assess any effects on competition: such effects were presumed from the mere existence of a margin squeeze). However, the Commission nonetheless undertook a detailed analysis of likely exclusionary effects, noting Deutsche Telekom's 90% share of the affected market and competitors' falling share of analogue connections.

<sup>63</sup> See *France Télécom/SFR Cegetel/Bouygues Télécom*, para.242 (Conseil de la Concurrence stated that, under *Deutsche Telekom*, once margin squeeze is established, it is not necessary to evaluate its actual impact on competition). However, it still examined the actual scope of the margin squeeze's anticompetitive effects, particularly with respect to Cegetel. Decision available at <http://www.conseil-concurrence.fr/pdf/avis/04d48.pdf>.

or probable anti-competitive effects.<sup>64</sup>

The current state of the law on this issue is unsatisfactory. The following comments are offered by way of clarification:

- (i) First, ignoring the issue of actual or likely effect adverse effects in favour of presumptions of law is out of kilter with the Commission's current emphasis on an economics-based approach. Recent major Commission decisions on abuse of dominance have typically undertaken a detailed analysis of the effects of the conduct at issue. Most notably, in *Wanadoo*, the Commission undertook an extremely detailed recoupment and effects analysis,<sup>65</sup> despite the fact that Wanadoo's prices were found to be below average variable cost – which had been considered as presumptively unlawful under the *AKZO* case-law – and there was a range of evidence of an express exclusionary plan. The Commission relied on the fact that: (1) Wanadoo's market share rose by nearly 30% during the period of the infringement; (2) Wanadoo's main competitor at the time had seen its market share tumble; and (3) one competitor (Mangoosta) even went out of business. If such an analysis is undertaken for the practice under Article 82 EC that is generally considered to be closest to a *per se* abuse (pricing below average variable cost), the same *a fortiori* applies for other (less clear) abuses;<sup>66</sup>
- (ii) Second, it should be recalled that, in contrast to merger control decisions, abuse of dominance cases involve situations in which the defendant is *already* in a dominant position. In other words, abuse of dominance generally concerns known present facts and conduct that has already lasted for a period of time. In these circumstances, it should normally be possible to consider whether the market is consistent with a case of potential exclusion or exhibits characteristics more consistent with a competitive environment. In most cases, there should be relevant information regarding actual effects or, failing that, relevant information on which reasonable assumptions as to future likely effects can be made. Whichever information is more readily-available should dictate whether the analysis concerns actual or likely effects;
- (iii) Third, while the measurement and assessment of effects presents certain difficulties, some useful techniques are available. Quantitative economic techniques can be used to test for effects, for example where information is available for the period before and after the alleged conduct (e.g., natural experiments). Where such techniques cannot be applied, "second-best" solutions

---

<sup>64</sup> See e.g., Case CW/00615/05/03, *Suspected margin squeeze by Vodafone, O2, Orange and T-Mobile*, Ofcom decision of May 21, 2004; and *Investigation by the Director General of Telecommunications into alleged anticompetitive practices by British Telecommunications plc in relation to BTOpenworld's consumer broadband products*, Oftel decision of November 20, 2003.

<sup>65</sup> See Commission decision of 13 July 2003, *Wanadoo*, not yet published, paras. 332 et seq. (recoupment) and paras. 369 et seq. (effects on competition).

<sup>66</sup> See also *Microsoft*, supra note 35, paras. 693 et seq. (effect of Microsoft's refusal to deal on technical development and consumers analysed in detail) and paras. 879 et seq. (detailed analysis of likely adverse effects of Microsoft's conduct on content providers and software developers).

can still be used. For example, while certain difficulties of observational equivalence (i.e., the effects of exclusionary conduct and legitimate competition may look similar) and comparing counterfactual situations (i.e., the but-for world) may arise, evidence of new entry, lack of market exit, stable or growing market shares among rivals, and falling prices during the period of the alleged abusive conduct must point towards a lack of material adverse effect;<sup>67</sup>

- (iv) Fourth, statements by the Commission and Court of First Instance in *BA/Virgin* and *Michelin II* that *prima facie* evidence of *lack of adverse effect* can be ignored in favour of a presumption of law are unhelpful. There is no effective counter thesis to this assumption: it can *always* be assumed that practices had an adverse effect on competitors if evidence of lack of effect is disregarded in favour of such an assumption. This reasoning is also circular and inconclusive. It is circular because the conduct is said to be unlawful only because it ousts competitors, but if that is the reason, it cannot then be said that one does not need to look to see if it had that effect. It is inconclusive because legitimate competition can also result in competitors' exit (i.e., the observational equivalence problem). If a practice would be illegal because it caused foreclosure and so had anti-competitive effects, it cannot be shown to have those effects by merely stating that it is illegal. Even in a case where the practices in question had no effect on competition, an abuse could be found by relying on a presumption of law;
- (v) Fifth, the issue of effects almost certainly varies from practice to practice. A limited effects inquiry is probably justified where: (1) experience, logic, or empirical data suggest that the harm resulting from a practice is so clear and unambiguous that there is no point in wasting court or regulatory resources in investigating whether its adverse effects outweigh its anti-competitive effects; and (2) the risk of also condemning benign or efficient practices is very low. An abuse such as pricing below average variable cost (without objective justification) might fit this definition. Somewhere in the middle lie a number of practices that, in general, are pro-competitive. Examples include unconditional above-cost price cuts and conditional discounts that do not depend on express exclusive dealing or requirements contracts (e.g., standardised volume discounts). For such practices,

---

<sup>67</sup> One interesting contrast in this regard was the different conclusions reached by the US courts and EU authorities in respect of Virgin Airways' complaint against British Airways' incentive schemes. The Commission assumed that competitors were harmed by BA's loyalty rebates despite evidence that their market share had *increased* during the relevant period and BA's had decreased by 10% during the period of the infringement ("Despite the exclusionary commission schemes, competitors of BA have been able to gain market share from BA since the liberalisation of the United Kingdom air transport markets. This cannot indicate that these schemes have had no effect. It can only be assumed that competitors would have had more success in the absence of these abusive commission schemes." *BA/Virgin judgment*, supra note 46, paras. 105-106 (Emphasis added)). Similar facts were presented to the US courts in Virgin's lawsuit against BA and the Second Circuit concluded that no adverse competitive effect was made out. The Second Circuit held that business practices presumptively should not be viewed as anti-competitive when "*the practices have been on-going for several years and rivals have managed to profit, new entry has occurred, and their aggregate market shares are stable.*" See *Virgin Atlantic Airways v. British Airways*, 257 F.3d 256 (2d Cir. 2001), citing *III A P. E. Areeda and H. Hovenkamp, Antitrust Law* ¶ 807f (1996).

the effects inquiry should arguably be detailed, since there is much empirical evidence to suggest that they are generally efficient and, accordingly, a much higher risk of falsely condemning legitimate practices. Finally, at the extreme, there are practices that constitute an abuse in only exceptional circumstances (e.g., refusal to deal). These require particularly compelling facts justifying intervention;

- (vi) A final related, but no less important, point is that the issue of effects cannot be looked at in isolation from the substantive rules applied to a particular practice under Article 82 EC. Different situations should be contrasted. First, where an unduly strict rule applies, such as in the area of individualised retroactive target rebates calculated over a long reference period, a more detailed effects inquiry should be necessary. Second, where the substantive rules already incorporate a rule-of-reason type approach, such as in the area of tying, a less detailed effects inquiry may be justified. Finally, for abuses that involve serious interference with a dominant firm's freedom of action, such as refusal to deal, strict substantive conditions apply. For example, one of the conditions for mandatory dealing is that refusal "*risks eliminating all competition*" from the requesting party.<sup>68</sup> If this condition is met, it may be that a less detailed effects inquiry is appropriate. Thus, not only will the issue of effects vary from practice to practice, it may also vary depending on the particular substantive rules applied to a particular practice.

#### E. Objective justification

It is well-established under Article 82 EC that "objective justification" can immunise conduct from liability. This is inherent in the notion of an "abuse" and confirmed by case-law. In the area of pricing abuses, the defences of cost-savings, countervailing advantages, meeting competition, new products, and follow-on revenue have in principle been recognised.<sup>69</sup> Other defences have been recognised for non-pricing abuses.<sup>70</sup> Under national law, wider categories of objective justification have been mentioned, including fixed-cost recovery in discrimination cases.<sup>71</sup> In essence, all of these defences seek to put forward explanations of why the conduct in question is efficient or justified by some other legitimate business consideration other than the dominant firm's self-interest.

Despite general recognition of objective justification in the case-law, a number of problematic issues remain. In the first place, as a practical matter, there is almost no case-law in which objective justification has been accepted by the Commission or the Community Courts. This may reflect the fact that the basis for the defence put forward in

---

<sup>68</sup> See, e.g., Case 6/73, *Commercial Solvents*, [1974] E.C.R. 223, para. 25.

<sup>69</sup> See J. Temple Lang and R. O'Donoghue, *supra* note 3, at 99-111.

<sup>70</sup> See J. Temple Lang, *supra* note 2.

<sup>71</sup> See, e.g., Office of Fair Trading Guideline 414, para. 3.8: ("*[P]rice discrimination ... can be a means of [recovering common costs]; it can increase output and lead to customers who might otherwise be priced out of the market being served. In particular, in industries with high fixed or common costs and low marginal costs ... it may be more efficient to set higher prices to customers with a higher willingness to pay.*").



several cases was not strong enough, but it more likely suggests that there is something of a disconnect between the theory and practice on objective justification. This issue deserves serious consideration, since a defence that is recognised in theory, but not in practice, is the same as no defence. A second problem is that neither the Commission nor the Community Courts have explained the various stages in their analysis of objective justification. The defence is usually rejected with limited analysis and does not explain what framework is applied (see, e.g., *Michelin II*, *British Airways/Virgin*).

Efficiencies do not in all circumstances excuse conduct that is liable to hinder competition and prejudice consumers. EC case-law suggests that efficiencies can immunize conduct from liability provided that the efficiencies are actually pursued, objective, necessary or justified and proportionate. Building on this basic framework, the following four-stage analysis has been suggested by way of clarification:<sup>72</sup> (1) there should be an efficiency (or another legitimate objective other than exclusion of competitors); (2) the conduct should be “effective”, that is to say, capable of achieving the legitimate goal; (3) the conduct should be “necessary” in the sense that there is no alternative that is equally effective in achieving the legitimate goal but less with a restrictive or less exclusionary effect; (4) the conduct should be “proportionate”, in the sense that the legitimate objective pursued by the firm should not be outweighed by the exclusionary effect. The inquiry is similar to the balancing of pro-competitive and anti-competitive elements under Article 81(3) and, as such, would serve to maintain the consistency of approach between these two Articles that the Court of Justice has indicated underpins EC competition law enforcement.

## VI. Policy Recommendations

Distinguishing legitimate competition from exclusionary behaviour is undoubtedly difficult. Most of these difficulties can be avoided, however, by focusing on the following key principles:

- (i) First, the principles of legal certainty and the rule of law require that a dominant firm should be able to determine from the outset whether its conduct is likely to be legal or not. This pleads in favour of clear standards and against complex *ex post* balancing acts (except, perhaps, where a practice by nature has a combination of pro-competitive and anti-competitive features (e.g., tying, exclusive contracts);
- (ii) Second, Article 82(b) should apply to all exclusionary abuses. The test in Article 82(b) EC – whether conduct “*limits production*” and to the “*prejudice of consumers*” – offers the most useful test for distinguishing legitimate competition and exclusionary conduct. It has also been frequently applied by the Commission and Community Courts, though not always clearly;

---

<sup>72</sup> See M. Dolmans, “Efficiency Defenses Under Article 82 EC Seeking Profits Or Proportionality? The EC 2004 *Microsoft* case in context of *Trinko*,” 24<sup>th</sup> Annual Antitrust and Trade Regulation Seminar, NERA, Santa Fe, New Mexico July 8, 2004 (on file with authors).

- (iii) Third, the substantive rules for each type of exclusionary practice should be informed, where possible, by empirical evidence of whether the practice is, on balance, more likely to lead to harm rather than good. Where no reliable empirical evidence is available, economic theory can still provide useful information regarding likely consumer harm and the optimal conditions for identifying such harm. Economic theory and/or evidence is important to avoid legal rules that lead to under-inclusion and over-inclusion (i.e., an error-cost framework) and to evaluate which of these errors is more likely to be costly to consumer welfare;
- (iv) Fourth, where a practice in principle amounts to an exclusionary abuse, its actual or likely effects on competition should be assessed, assuming of course that useful relevant information is available. Quantitative economic techniques can play a role here;
- (v) Finally, Article 82 EC would not be well-served by an open-ended or unclear interpretation. Thus, it would not be helpful to suggest that there are new categories of abuse that fall outside the four clauses of Article 82 EC. Nor is the law well-served by unnecessary confusion between the various clauses in Article 82 EC, in particular Article 82(b) and Article 82(c).

# **Predatory Pricing**

Geert Goeteyn, Stephen Mavroghenis,  
Michele Piergiovanni, Eileen Reed and Derek Ridyard\*

## **I. Introduction**

This chapter provides the European Commission (hereinafter “Commission”) with recommendations for reform of the current EU legal framework disciplining predatory pricing abuse. Section II commences with an outline of the evolution over the years of the different economic theories of predation and concludes that, according to modern economics, in certain circumstances, predation may be a profit maximising strategy for a dominant company. Section III summarises the current discipline of predatory pricing under EC competition law with reference to the relevant Commission decisions and European Courts’ judgments. Section IV identifies the main problematic areas within the current legal framework regulating predatory pricing and proposes a number of amendments aimed at aligning the legal discipline of predation with modern economic theory. Finally, Section V formulates policy recommendations for the Commission to consider.

## **II. Economics of Predatory Pricing**

There are a variety of pricing and non-pricing business practices that are used by firms in response to marketplace interaction. Economic theory predicts that most of these practices are legitimate and reasonable reactions designed to increase market share, make incremental sales, introduce new products, engage in marketing promotions, and promote technological and productive efficiency. Over the last 20 years, however, an extensive corpus of economic literature has produced clear and logical models demonstrating that, under certain conditions, predatory price-cutting can be a rational profit-maximising strategy, and, thus, can lead to consumer harm.<sup>1</sup>

---

\* Geert Goeteyn is a Partner at Howrey, Simon, Arnold & White LLP, Brussels; Stephen Mavroghenis is a Senior Associate at Howrey, Simon, Arnold & White LLP, Brussels; Michele Piergiovanni is an Associate at Cleary Gottlieb; Eileen Reed is Director of CapAnalysis, Brussels and Derek Ridyard is a Partner and co-founder at RBB Economics.

1 P. Bolton, J.F. Brodley, M.H. Riordan, “Predatory pricing: Strategic theory and legal policy” (2000) 88 *Georgetown Law Journal*, 2239.

Broadly, predatory pricing refers to the practice of driving equally or more efficient rivals out of, or preventing entry into, the market by selling products or services at a price below cost. The predator's aim is to recoup its losses by charging higher prices after rivals have been dispatched or disciplined and set an example for potential future entrants, deterring them from entering the market.

The somewhat paradoxical notion that aggressive price-cutting can lead to long-run consumer harm has been a part of (U.S.) antitrust history since its beginning. Early models of predatory price-cutting were based on scenarios where price cutting by a larger dominant firm was thought to injure smaller rivals, and thus were *per se* unlawful. This approach ignored any assessment of the consumer benefits derived from the lower prices. Subsequent theoretical work by Chicago School researchers proposed that a firm's price-cutting response to a rival's or a new entrant's actions must be irrational as it results in short-run profit loss and, therefore, would be rarely practiced.<sup>2</sup> This view has had a significant impact on legal enforcement and competition policy to this day, despite the extensive economic debates and controversy associated with predatory pricing as a strategy. Such disagreement stimulated the search for a workable structure or framework for addressing these issues.

Inspired by advances in industrial organisation theory and the strategic, game-theoretic approach to antitrust and firm behaviour, an evolution of thinking has occurred over time to show how predatory pricing can be a rational strategy by focusing on the predator's goal of inducing its rival's exit, thereby harming consumers in the long-run. Essentially, it is the predator's goal of inducing market exit that distinguishes these pricing actions from normal welfare enhancing competitive pricing. Economists now support the need for a more complete analysis of competitive harm identifying the basic type of strategic, dynamic firm behaviour (such as Cournot, Bertrand, and Stackelberg) and a recognition of the inter-temporal interaction between firms in a given market allowing evaluation of the welfare effects of the price-cutting actions.

It is natural for profit-maximising firms to try to win customers from other firms. It is not predatory behaviour to compete aggressively. In general, any workable definition of price predation should reflect an economic assessment of a firm's business and pricing practices grounded on the assumption that the firm is acting in pursuit of long-run profit maximisation.<sup>3</sup> The traditional theory of predatory pricing is based on a predator in a defined relevant market cutting its prices for a sufficient period of time to induce its (possibly equally efficient) rivals to exit the market and to deter (equally efficient) entry and re-entry. This conduct implies both a predator and its rivals suffering losses. For this strategy to be rational the predator must believe that the losses can be recouped in the future through its ability to exercise market power without attracting re-entry or new entry.

---

<sup>2</sup> See generally the survey article by J. Ordover, and G. Saloner, "Predation, Monopolization and Antitrust", in Willig, R.D. and Schmalensee, R. eds. *Handbook of Industrial Organization*, (North-Holland: Amsterdam) 1989 pp.537-596.

<sup>3</sup> This simplification ignores other (non-profit) management goals and commercial objectives.

Although intuitively appealing, this more classical definition of predatory pricing has been heavily criticised for having significant shortcomings. Assuming that a predator is likely to be larger than its rival, any price cut (over its entire sales) would represent a greater profit loss than the rival's. General models of firm behaviour under non-collusive profit-maximising oligopoly settings demonstrate that, in most circumstances, the more profitable strategy would be for the predator to accommodate entry and share market sales (and profits) instead of engaging in a more costly price war. The further uncertainty of whether entry barriers would be high enough to permit later price increases and profit recoupment sufficient to cover current losses makes predatory pricing seem unlikely to be a profitable strategy. Furthermore, a rival would likely have access to well-functioning capital markets and enough information to inform it of the credibility of the predator's threats.

These criticisms principally rely on the notion that both the predator and its rivals presumably have perfect information about each other's costs, strategies and other resources. More recent academic research has suggested that by relaxing the perfect information assumption, and accepting that the established incumbent predator is likely to have superior information over its rivals, rivals would be uncertain as to whether the predator actually had lower costs and the ability to credibly cut prices inducing exit and deterring entry. This would give the predator a rational incentive to create a reputation as a credible price-cutter. The existence of high learning costs in the production and selling of particular goods or services, patents and/or other intellectual property barriers further equip the incumbent predator with the ability to embark upon a credible predatory pricing campaign.

Extensions of this model show that a rational strategy could still exist when both a predator and a rival have equally uncertain information about each other's costs. Using advances in game theoretic modelling and reasoning, it has been shown that even a so-called weak predator (an incumbent which does not have a strong probability or preference for aggressive price-cutting) will choose to act as a tough predator in one market in order to establish a credible reputation to prevent entry in other markets. Because of imperfect information, the potential entrants do not know the predator's true costs and the extent to which it may have a true cost advantage.

A more complete definition of predatory pricing requires evidence of a company deliberately engaging in loss-making conduct with the objective of eliminating its rivals and potential rivals and the possibility to recover these losses without attracting new entry. Three relatively recent models of rational exit-inducing predation strategies demonstrate this approach.

A. "Deep pocket"/"long purse" and financial market predation

A predator firm with greater financial resources can cut its prices and outlast its more limited rival. Early formulations of this model relied on somewhat implausible

assumptions about perfect information of the rival's costs and resources and an inability of the rival firm to secure financing beyond the incumbent's limits. To the extent that knowledge of costs and resources is common in markets, this strategy suggests that no rational rival would engage in a predatory episode. By relaxing the perfect information assumptions and accepting there is incomplete information about the incumbent's credibility in its pricing strategies, this model is plausible. Where the predator seeks to interfere with rival entrants' investor relationships, capital investors, which are outside the market, face uncertainty in evaluating predatory intent and credibility. The Commission's findings in *AKZO*<sup>4</sup> are consistent with the deep pocket theory where it was noted that the rival ECS could have believed that AKZO would have had the "superior financial resources" that could allow it to outlast it during the aggressive pricing episode.<sup>5</sup>

#### B. Reputation effect predation

An extension to the financial predation model recognises that by establishing a reputation for aggressiveness and toughness, predatory pricing can be a rational strategy. The incentives to deter future entrants would be enhanced particularly where predators operate in several markets either sequentially in time, over a series of geographic locations, or in multiple distinct product markets. By allowing the predator to be tough or irrational, entrants would have credible doubt about the possibility that the predator may choose to predate rather than accommodate.<sup>6</sup> This probability of seemingly irrational price-cutting can lead to the establishment of a credible (and growing) reputation for predation in other markets and future periods. Even the smallest probability that the would-be predator will act irrationally can deter, or at least delay future entry. Any threats of aggressive price-cutting will be more credible the greater the value or weight that rivals put on future outcomes and profitability. The *Tetra Pak II* case reflected aggressive pricing strategies across a range of geographic markets and may present conditions consistent with the underlying principles of reputation effect predation.<sup>7</sup>

#### C. Cost signalling

Breakthroughs in the modelling of rational predation were further extended by the so-called signalling models, which also require the entrant to have incomplete information about the predator's true costs and require the incumbent to seek to specifically induce exit or at least convince the entrant that its costs are low. The entrant could be persuaded

---

<sup>4</sup> Commission decision of 14 December 1985, *AKZO*, (1985) O.J. L374/1; Case C-62/86, *AKZO Chemie BV v. Commission*, [1991] E.C.R. I-3359.

<sup>5</sup> Id.

<sup>6</sup> This theory has its foundations in work published by D. Kreps and R. Wilson, "Reputation and Imperfect Information", (1992) *Journal of Economic Theory*, and P. Milgrom, and J. Roberts, "Predation, Reputation and Entry Deterrence" (1982) *Journal of Economic Theory*.

<sup>7</sup> Commission decision of 24 July 1991, *Tetra Pak II*, (1992) O.J. L 72/1; Case T-83/1991, *Tetra Pak International SA v Commission*, [1994] E.C.R. II-755; and Case C-333/1994 P, *Tetra Pak International SA v Commission* [1996] E.C.R. I-5951.

to reduce its output, increasing incumbent's profits, and perhaps improving its chances of acquisition.

The signalling model is analogous to the limit pricing model which describes a strategy where an incumbent firm produces at a sufficiently large output level and at lower prices to signal potential rivals that its costs are lower and entry to serve the remaining demand would be unprofitable.<sup>8</sup> In the signalling predation context, the rival has incomplete information about the incumbent's costs, the incumbent firm has the incentive to convince its rival that the incumbent's costs are low and that it can credibly cut prices. The incumbent is seeking to induce the rival to exit or just to reduce its production in reaction to the uncertain profitability. Even if the rival does not exit, its reduced production has the effect of increasing the incumbent's sales and of decreasing the asset value of the rival and perhaps making it a more attractive takeover target. For this model to be fully applicable, the signalling activity would also serve to notify potential entrants with a lack of experience and industry knowledge that the market entry will not be profitable. To the extent that the entrant had intended to offer an innovative product, the welfare loss would be identifiable.<sup>9</sup> There are elements in the Commission case against Wanadoo and its very aggressive pricing strategies, which are consistent with this model.<sup>10</sup>

In the light of the above, it can be concluded that, according to recent economic theory, predatory pricing can be a rational profit-maximising strategy or conduct for a company if it can be explained with recourse to economic models recognising the strategic barriers to entry under the assumption of imperfect information, which have been captured in the following general economic models: financial market predation; reputation effect predation; and cost-signalling.

### **III. Judicial Approach to Predatory Pricing**

There are only a limited number of Commission precedents and judgments of the European Courts specifically dealing with predatory pricing.

---

<sup>8</sup> This approach is discussed in D. Spector, "Definitions of Predatory Pricing" Massachusetts Institute of Technology, Department of Economics, Working Paper 01-10 January 2001.

<sup>9</sup> Although the above-described models of rational price predation rely on some form of imperfect or asymmetric information, modifications to these models demonstrate that rational predation can exist in situations where market conditions permit firms to be perfectly informed. In these specific situations, entry may still be fragile, particularly in the presence of network externalities, causing some entrants to miscalculate the timing of entry and miss the opportunity to enter before the incumbent is able to lock-in a captive market position allowing it to exploit customers and raise price.

<sup>10</sup> Commission decision of 16 July 2003, *Wanadoo Interactive*, Comp/38.233.

A. AKZO

Perhaps the most significant case including a claim of predatory pricing is the Commission's decision<sup>11</sup> and the subsequent court judgment in *AKZO*.<sup>12</sup> The Commission found that AKZO abused its dominant position in the UK flour additives market, inter alia, by selling its products above average variable cost ("AVC"),<sup>13</sup> but below average total cost ("ATC"),<sup>14</sup> with the intention to dissuade ECS, AKZO's main competitor in the flour additives market, from entering the more lucrative plastics sector. On appeal, the European Court of Justice (hereinafter "ECJ") upheld the Commission's findings.

Both the Commission and the ECJ adopted a cost-based test to assess the existence of predation. In particular, the ECJ held that: "[p]rices below average variable costs (that is to say, those which vary depending on the quantities produced) by means of which a dominant undertaking seeks to eliminate a competitor must be regarded as abusive. A dominant undertaking has no interest in applying such prices except that of eliminating competitors so as to enable it subsequently to raise its prices by taking advantage of its monopolistic position, since each sale generates a loss, namely the total amount of the fixed costs (that is to say, those which remain constant regardless of the quantities produced) and, at least, part of the variable costs relating to the unit produced.

Moreover, prices below average total costs, that is to say, fixed costs plus variable costs, but above average variable costs, must be regarded as abusive if they are determined as part of a plan for eliminating a competitor. Such prices can drive from the market undertakings which are perhaps as efficient as the dominant undertaking but which, because of their smaller financial resources, are incapable of withstanding the competition waged against them".<sup>15</sup>

The test adopted by the Commission and the ECJ in *AKZO* differs from the traditional Areeda-Turner test for predation.<sup>16</sup> Indeed, according to Areeda and Turner, prices below AVC are presumed unlawful but prices above this threshold are never predatory.<sup>17</sup> On the contrary, as noted, according to the ECJ, prices below ATC but above AVC can also be predatory if they form part of a plan for eliminating a competitor.

---

<sup>11</sup> See supra note 4.

<sup>12</sup> Case C-62/86 *AKZO Chemie BV v. Commission*, [1991] E.C.R. I-3359.

<sup>13</sup> Total costs comprise the sum of fixed and variable costs. Fixed costs do not vary with changes in output and typically include overhead and management expenses, interest on debt, and property taxes. Variable costs vary with changes in output. Average costs are the sum of total costs divided by quantity of output.

<sup>14</sup> Id.

<sup>15</sup> See supra note 12, paragraphs 71 and 72.

<sup>16</sup> P. Areeda and D. Turner, "Predatory pricing and related practices under Section 2 of the Sherman Act", (1975) 88 *Harvard Law Review* 697.

<sup>17</sup> As noted the Areeda-Turner provides that any price below short-run marginal costs is presumptively *unlawful* based on the principle that a profit-maximizing firm will set price equal to marginal cost and any price below that would result in profit sacrifice and hence predatory intent. Recognizing that marginal costs are difficult to measure in practice from typical accounting schedules, Areeda and Turner proposed using the more readily available AVC as an adequate proxy measurement for marginal cost.



With respect to the definition of “variable cost”, the Commission, in its decision, rejected AKZO’s definition of variable costs, which included only raw material and energy costs. Instead, it relied upon Areeda and Turner’s definition of variable costs, which included direct labour, supervision, repairs, maintenance and royalties.<sup>18</sup> The ECJ, on the other hand, considered that, in the present case, labour costs could not be considered as variable costs since they did not vary with quantity produced.<sup>19</sup>

Finally, it must also be noted that, in order to establish the underlying purpose of AKZO’s conduct, the Commission relied, inter alia, upon some of AKZO’s internal documents seized in the course of the on-site inspection, which, in its opinion, demonstrated AKZO’s clear intent to eliminate ECS.

#### B. Tetra Pak II

The Commission decision,<sup>20</sup> and subsequent court judgments, in *Tetra Pak II*,<sup>21</sup> confirmed the approach followed by the ECJ in *AKZO* with respect to the applicable test to determine the existence of predatory pricing conduct.

Tetra Pak’s prices on the Italian market for non-aseptic cartons were below AVC and, thus, according to the *AKZO* test, *per se* abusive. Moreover, the Commission also found that Tetra Pak’s pricing strategy was generally aimed at weakening competition on the relevant market and, in particular, at eliminating Elopak, Tetra Pak’s main competitor on the market for non-aseptic cartons in Italy. Given the above, the Commission concluded that Tetra Pak’s pricing strategy was abusive and, on appeal, the Court of First Instance (hereinafter “CFI”) upheld the Commission’s decision.

In its judgment, the CFI also took a position on the question of recoupment, i.e., of whether, for a finding of predation, it is necessary to demonstrate that the dominant firm is likely to recoup the losses incurred with its predatory pricing strategy by raising its prices after having forced its rivals out of the market. In this respect, the CFI concluded that, for a finding of predation, it is not necessary to demonstrate specifically that the dominant undertaking has a reasonable prospect of recouping the losses incurred through the implementation of its predatory strategy.

The issue of recoupment was also addressed by the ECJ on appeal against the CFI’s judgment. While confirming the overall validity of the CFI’s examination of Tetra Pak’s

---

<sup>18</sup> Areeda and Turner define AVC to include all production costs and such expenses as advertising, R&D, management, and certain administrative. Costs excluded from AVC would be limited to capital costs, investment in land, plant and equipment, property and other taxes not affected by output, and depreciation on plant and equipment. Note that this definition of AVC brings the Areeda-Turner AVC closer to a general description of average total costs.

<sup>19</sup> See *supra* note 12, paragraph 94.

<sup>20</sup> Commission decision of 24 July 1991, *Tetra Pak II*, (1992) O.J. L 72/1.

<sup>21</sup> Case T-83/1991 *Tetra Pak International SA v Commission* (1994) E.C.R II-755 and Case C- 333/1994 *P, Tetra Pak International SA v Commission*, (1996) E.C.R. I-5951.

predatory pricing practices, the ECJ also added that, since it must be possible to penalise predatory pricing whenever there is a risk that competitors are eliminated, and since, in the present case, there was such risk: “it would not be appropriate in the circumstances of the present case to require in addition proof that Tetra Pak had a realistic chance of recouping its losses”.<sup>22</sup>

C. Deutsche Post

In industries where fixed costs are high and variable costs very low, the traditional test developed by the Commission, and upheld by the European Courts, to determine whether a price is predatory could hardly ever apply. Indeed, it would be almost impossible to conclude that a price is below AVC, whereas proof of intent would be required to show the abusive nature of a price between AVC and ATC. As a consequence, with respect to such industries, the Commission tried to develop alternative rules to determine whether a price is predatory.

In its *Deutsche Post* decision,<sup>23</sup> the Commission concluded that pricing a service below the long-run incremental cost<sup>24</sup> of providing it amounts to predatory pricing. The case arose from a complaint lodged with the Commission by United Parcel Service (“UPS”), which was competing with Deutsche Post AG (“DPAG”), inter alia, in the German market for the provision of mail-order parcel services. UPS alleged that DPAG was using revenues from its profitable statutory monopoly on the delivery of post in Germany to finance a below-cost selling strategy in the market of mail-order parcel services, which was open to competition, with the aim of ousting competitors from the market.

The Commission’s analysis started by laying down the relevant cost concepts for the understanding of the case: “cross-subsidisation occurs where the earnings from a given service do not suffice to cover the incremental costs of providing that service and where there is another service or bundle of services the earnings from which exceed their stand-alone costs. The service for which revenue exceeds the stand-alone cost is the source of the crosssubsidy and the service in which revenue does not cover the incremental costs is its destination” and “when establishing whether the incremental costs incurred in providing mail-order parcel services are covered [by the earnings from such services], the additional costs of producing that service, incurred solely as a result of providing the service, must be distinguished from the common fixed costs, which are not incurred as a result of this service”.<sup>25</sup>

---

<sup>22</sup> Id. paragraph 44.

<sup>23</sup> Commission decision of 20 March 2001, *Deutsche Post AG*, (2001) O.J. L 125/27.

<sup>24</sup> Long-run incremental cost refers to a firm’s long-run costs, both fixed and variable, incurred in supplying an additional product, referred to as the “increment” over and above the cost of the existing activities of the firm. It can also be defined as those costs that a producer could save in the long run if an existing product were discontinued. This latter notion of long-run incremental costs is analogous to the concept of avoidable costs employed by the EC in the *Deutsche Post* case. (See D.E.M. Sappington, and G.J. Sidak., “Competition Law for State-owned Enterprises” (2003) 71 *Antitrust Law Journal*.)

<sup>25</sup> See *Deutsche Post*, supra note 23, paras. 6-7.

In order to determine the long-run incremental cost specific to the provision of mail-order parcel services, the Commission first analysed the share of DPAG's fixed costs attributable to this activity. In this respect, the Commission noted that some of the relevant fixed costs were common to DPAG's activities of mail-order and over-the-counter parcel services. The Commission then identified which of the common fixed costs would be eliminated if DPAG were to stop providing mail-order parcel services, i.e., the share of the common fixed costs specifically attributable to the incremental cost of providing mail-order parcel services. The Commission then identified a number of costs which, on the other hand, could be considered as specific to the provision of mail-order parcel services, i.e., that would cease to exist if the service was stopped. The sum of these costs and the fixed costs identified above constituted, according to the Commission, the incremental cost of providing mail-order parcel services.

Given the above, the Commission concluded that the average long-run incremental costs per item for DPAG's mail-order parcel services were not covered by the revenues earned from the provision of such services and, thus, DPAG abused its dominant position on the market for the provision of mail-order parcel services in Germany by charging predatory prices for such services. In particular, the Commission stated that: "in the period from 1990 to 1995 every sale by DPAG in the mail-order parcel services business represented a loss which comprises all the capacity-maintenance costs and at least part of the additional costs of providing the service. In such circumstances, every additional sale not only entailed the loss of at least part of these additional costs, but made no contribution towards covering the carrier's capacity-maintenance costs. In the medium-term, such a pricing policy is not in the carrier's own economic interest. This being so, DPAG had no economic interest in offering such a service in the medium-term. DPAG could increase its overall result by either raising prices to cover the additional costs of providing the service or – where there is no demand for this service at a higher price – to discontinue providing the service, because revenue gained from its provision is below the additional cost incurred in providing it. However, DPAG, by remaining in this market without any foreseeable improvement in revenue restricted the activities of competitors which are in a position to offer this service at a price that covers their costs".<sup>26</sup>

D. Wanadoo

The Commission decision in *Wanadoo* is the most recent case where the Commission found abusive conduct entailing predatory pricing.<sup>27</sup> The Commission found that retail prices charged by Wanadoo for the sale of its Internet access services (Wanadoo ADSL and eXtense) were below their AVC in certain periods, and approximately equivalent to variable costs, but significantly less than total costs, in other periods. The Commission also established that Wanadoo's practice was deliberate and coincided with a company plan to pre-empt the strategic market for high-speed Internet access.

---

<sup>26</sup> Id., para. 36.

<sup>27</sup> See *Wanadoo*, supra note 10.

In addition, the Commission found that, from January 2001 to September 2002, Wanadoo's market share rose from 46 percent to 72 percent, in a market that saw more than a five-fold increase in size over the same period. The Commission concluded that the level of losses required in order to compete with Wanadoo had a dissuasive effect on competitors. At the end of the period of Wanadoo's anti-competitive practices, no competitor held more than 10 percent of the market share and Wanadoo's main competitor had seen its market share plummet. Moreover, the Commission found that one ADSL service provider, Mangoosta, went out of business in August 2001.

Against the background of the above, the current EU legal framework concerning predatory pricing can be broadly summarised as follows: an undertaking must be found to be dominant; a price is considered *per se* predatory when it is below AVC; a price above AVC but below ATC is predatory only when accompanied by exclusionary intent; a price is predatory if it is below average long-run incremental costs; and the possibility of recouping losses need not be shown for predation to be found, nor is actual exit required.

#### **IV. Problems in the Existing Legal Framework and Possible Solutions**

The main problematic areas in the current discipline of predatory pricing under EU competition law are the following: (i) the use of the notion of AVC to assess whether a company is engaging in loss-making conduct on the market; (ii) the *per se* prohibition of below (average variable) cost prices; (iii) the illegality of above (average variable) cost (but below total cost) prices if accompanied by exclusionary intent; and (iv) the fact that the possibility of recoupment is not a pre-requisite for a finding of predation. Moreover, on a more general level, the current discipline of predatory pricing under EU competition law should systematically recognise modern economic theories reflected in the models of financial predation, reputation effect predation, and cost signalling predation.

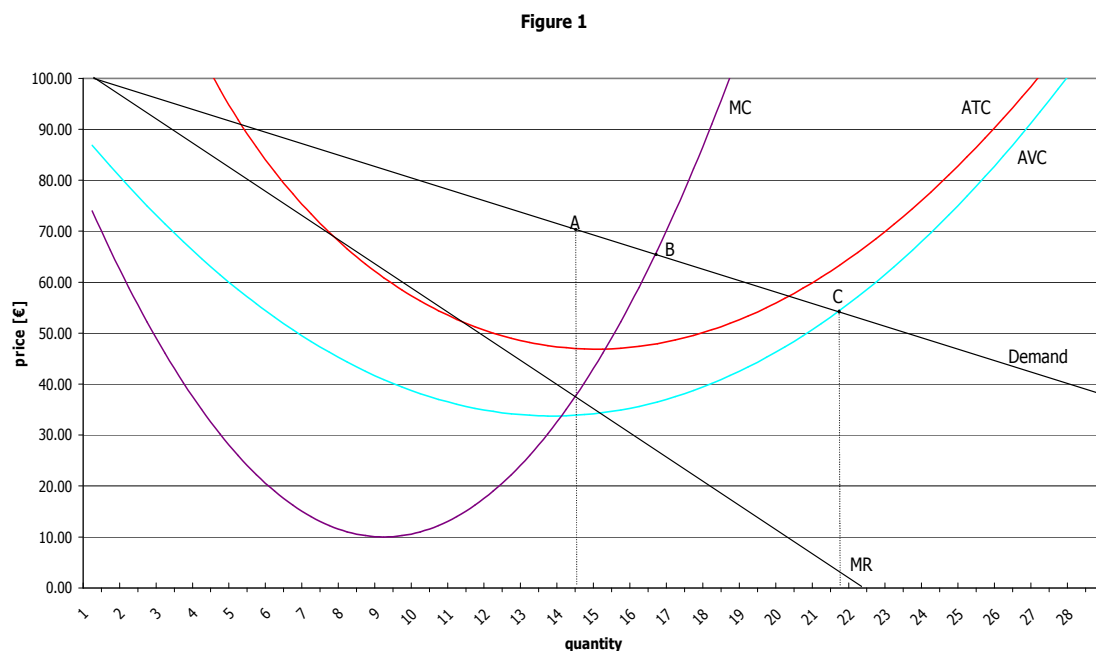
Below we summarise some of the main criticisms of the current law for each of the above-mentioned problematic areas and identify possible amendments to the current legal framework aimed at achieving a more economically sound regulation of predatory pricing conduct.

##### **A. AVC v. avoidable cost**

As noted, the ECJ in AKZO adopted a "revised" version of the Areeda-Turner test to assess whether a price is predatory. As also noted, however, both the Areeda-Turner test and the revised version of it endorsed by the European Courts rely on the notion of AVC. In particular, given the practical difficulty to measure a company's marginal cost, both Areeda and Turner and the European Courts accepted to substitute this concept with the easier-to-calculate AVC starting from the premise that a company's AVC constitutes a reasonable proxy of its marginal cost.

We note, however, that the Areeda-Turner test (and, thus, its revised version followed by the European Courts) have been widely criticised for their mechanical dependence on hard-to-measure cost concepts and flawed reliance on the substitutability of AVC for marginal cost, which may not be suitable in a wide range of firm settings.

Figure 1 below shows a simple framework of an incumbent predator firm facing a downward-sloping demand curve D. The profit-maximising point is found at A where  $MR=MC$  yielding a price of €70 at a quantity of 14.5.<sup>28</sup> Any price-quantity combination to the right of point A would cause the incumbent to sacrifice profits, but price points between A and C (i.e. between €55 and €70) are still in excess of AVC and will make some contribution towards the recovery of fixed costs while still allowing the incumbent to make sales that would otherwise be lost to a competitor. Price-quantity combinations between points B and C are below MC and therefore reflect technically inefficient pricing, but would be permitted under the revised Areeda-Turner standard. This would allow the incumbent to expand output to point C at a reduced price of €55, consequently permitting equally or more efficient entrants, but at technically inefficient prices and quantities.



<sup>28</sup> Note that, in virtually any situation where a dominant firm faces a challenge from an entrant, the act of entry will affect the demand curve facing the dominant firm, reducing demand for the dominant firm's brand and/or making demand more elastic. The short-run profit-maximizing response to such entry will always be for the dominant firm to reduce its price, and therefore a downward price response to entry cannot in itself provide any inferences as to the existence of predation. In Figure 1, we depict the demand curve facing the dominant firm after entry has occurred.

As mentioned above, economists have come to question whether short-run marginal cost (whether or not adequately “proxied” by AVC) is the proper pricing benchmark in a context of strategic behaviour over time and long-run welfare maximisation. Recall, for example, that in the reputation and signalling predation models described above, successful predation requires that the predatory price be set such that it signals or convinces the rival or potential rival that entering or remaining in the market will not be profitable. It could be argued that such a price does not necessarily systematically relate to the incumbent’s marginal cost.

Moreover, as also mentioned above, the illustration shown in Figure 1 shows that, under standard demand and cost conditions, the AVC test will tend to err on the side of permissiveness, ignoring price reductions that make the dominant firm worse off than if it adopted the profit-maximising response of equating marginal cost with marginal revenue.<sup>29</sup>

Given the above, we believe that at a more practical level and from an economic standpoint, the notion of “avoidable cost” provides a better standard than the notion of AVC against which to assess whether a conduct of a company on the market is loss-making and, thus, potentially predatory.<sup>30</sup>

The Commission’s decision in *Deutsche Post* provides a good illustration of why the avoidable cost concept provides a more suitable tool than AVC for the above purpose. In *Deutsche Post*, the Commission’s assessment of whether the dominant firm had priced its commercial mail-order parcel service below cost had to deal with two separate complications. First, the fact that DPAG’s conduct had remained in place for an extended period (more than five years), and secondly, the fact that DPAG’s commercial mail-order parcel business shared a number of assets and common costs with DPAG’s over-the-counter parcel delivery service covered by a statutory universal service obligation. Both factors caused the Commission to depart from the simple application of the AVC standard used by the ECJ in *AKZO*.

As regards duration, the Commission reacted to the longevity of DPAG’s conduct by including the relevant fixed costs that were attributable to the mail-order parcel business as part of the cost standard that DPAG was obliged to meet. On its face, this approach appears to strike a tougher cost standard than the AVC rule. However, this approach is justified in the case in hand by the fact that, over the time-period under consideration, DPAG had the opportunity to take steps to avoid the so-called “fixed” costs associated with its mail-order parcels business. For example, DPAG would have taken positive steps to replenish capital assets such as delivery vehicles over this time period, so its ability to

---

<sup>29</sup> In the Figure 1 illustration, the practical importance of this bias is to allow the dominant firm to cut price by €15 below the profit-maximizing price of €70, a reduction of over 20%.

<sup>30</sup> Avoidable costs are those costs that are allocated to the provision of a certain good or service and could be avoided if that good or service was no longer offered. They therefore include not only variable costs, but also certain costs of resources that in the short-term may be regarded as fixed, but in the longer term can be avoided as they can be redeployed elsewhere and are not sunk. Avoidable costs are analogous to the long-run incremental cost measure used in the *Deutsche Post* case discussed here.

argue that these costs were fixed was undermined, even if standard accounting rules might classify vehicles as a fixed cost element.

The Commission's approach of including these fixed costs, together with DPAG's variable costs, to form DPAG's "avoidable" costs, has been cited as a distinct departure by the Commission from the *AKZO* rule. However, the underlying economic reality of the case fits very well with the economic intuition behind the test applied by the Commission. Indeed, DPAG's decision to re-invest in, say, new vehicles to support its commercial mail-order parcel business when it knew that there was no prospect of earning an economic return on that capital investment is just as revealing of strategic intent as any other conscious decision to incur variable costs in the knowledge that price levels could not recover those outlays.<sup>31</sup> Moreover, this approach can be extended quite easily to many other situations in which the costs that are avoidable by a dominant firm vary according to the duration of the conduct under examination.

As regards the shared assets between the mail-order parcel services and the delivery of over-the-counter parcels, the Commission again adopted a standard that relied on the "avoidability" of costs. Since DPAG was under a universal service obligation to provide for the delivery of over-the-counter parcels irrespective of what happened in the competitive mail-order parcel activity, the Commission identified the costs that were common between these two activities to be (partly) unavoidable. Even if DPAG had taken a decision to withdraw from the mail-order parcels business, those costs would continue to be incurred in discharge of the company's other obligations.<sup>32</sup>

Overall, we believe that the notion of avoidable cost, by distinguishing explicitly between the costs that are within the control of the dominant firm and those that are not, focuses on the reality of the business decisions facing the firm in question and permits a better understanding of whether a company is engaging in loss-making conduct on the market and, thus, potentially, in predatory conduct. Moreover, the ambiguity as to the characterisation of certain costs as fixed or variable cost is significantly reduced if avoidable costs, rather than AVC, are used as the relevant measure of the costs of the dominant company.

---

<sup>31</sup> Had the relevant DPAG's conduct been of shorter duration, this analysis would no longer apply. Across a 3-month time horizon, for example, it is plausible that DPAG would have no option to sell or deploy such assets as its parcel delivery vans, so those costs should not be included in the relevant avoidable cost.

<sup>32</sup> In taking this approach to common costs, the Commission established a potentially important economic principle about the ability of dominant firms to benefit from economies of scope. To the extent that DPAG's competitive mail order parcel business was able to free-ride on the common cost platform provided by its existing parcel business under a universal service obligation, the Commission's approach to the price-cost test for predation, by distinguishing between avoidable and unavoidable costs, allowed the dominant firm to take advantage of economies of scope when competing with rivals, even if those rivals did not have access to similar cost synergies. This is entirely consistent with an enforcement approach that is aimed at promoting efficiency and consumer interests (as opposed to a level-playing field between dominant and competing firms).

Given the above, we believe that the concept of avoidable cost should replace that of AVC as the standard against which the loss-making nature of a company pricing strategy on the market needs to be assessed.

**B. Below-cost pricing**

As noted above, according to the Areeda-Turner test and the case-law of the European Courts, pricing below the relevant measure of cost (be it AVC or avoidable cost) is considered *per se* predatory.

We believe, on the other hand, that a number of benign explanations for below-cost pricing exist and a dominant company must be in a position to put forward all these explanations as defences when it is found to price its products below the relevant measure of cost. Consider the question posed by the ECJ in *AKZO*: why would a dominant firm choose to price in such a way with the inevitable consequences of making losses, and what plausible explanation could there be for such pricing other than the objective of eliminating rivals to secure longer-term gains in the form of monopoly pricing? As noted, closer examination reveals a rather wide range of possibilities in which below-cost pricing does indeed have benign explanations.

A first and most basic explanation is the possibility that the dominant firm simply made a commercial misjudgement. Given that entry creates uncertainty and poses new challenges to incumbent firms, an ex post assessment of pricing decisions should not assume perfect foresight on the part of the dominant firm. The test for predation should depend on an appraisal of the facts and expectations applicable at the time the pricing or output decisions in question were made.

A second explanation covers a wide range of situations where it is normal commercial behaviour for firms to make deliberate commercial choices that do not maximise short-term profits. Such behaviour is by its nature “strategic” in some sense, but strategic motives can encompass many situations other than predatory pricing. Some of the more commonly cited examples of benign strategic pricing behaviour include: (i) promotions on new products to encourage new consumers to test its attributes; (ii) situations where the supplier achieves greater knowledge over time as it gains experience of producing the product (in which case it is reasonable to factor in the expected cost savings rather than existing cost levels); and (iii) situations of loss-leading or two-sided markets where the making of one sale at below cost is commercially justified by the follow-on or related market sales that are anticipated as a result. In all such cases, the critical factor is that the same or similar considerations are likely to apply equally to dominant and competing suppliers, so there is none of the asymmetry between predator and prey that emerges in the classic predation story.

In this scenario, one practical way to test the reasonableness of non-predatory strategic pricing is to benchmark the behaviour of the dominant firm against the pricing practices of non-dominant firms in the same or similar industries. If they also adopt similar pricing



practices, the case for arguing that the dominant firm's sacrifice is inherently anti-competitive is revealed to be flawed, since it is evidence that smaller rivals are choosing to price in this way for reasons other than an expectation of predatory pricing and recoupment.

A third explanation is the so-called "meeting-competition" defence. Dominant firms should not be prohibited from participating in a "price-war" with competitors and meet (but not undercut) competitors' prices even if these prices are below the relevant measure of cost.

Given the above, it can be concluded that whilst evidence of below-cost pricing is a phenomenon that invites justifiable suspicion, and it is reasonable for dominant firms to be called to account for why they have adopted business practices that involve deliberate decisions to suffer losses, there are numerous plausible pro-competitive or neutral explanations for such behaviour, which a dominant company should be entitled to put forward.

#### C. Above-cost pricing and intent

As noted, contrary to the Areeda-Turner test, and according to the *AKZO* test followed by the European Courts, prices above AVC but below ATC can be predatory if accompanied by exclusionary intent on the part of the dominant company. Contrary to the above, we believe that, both from an economic and a policy perspective, prices above cost (be it AVC or avoidable cost) should normally be considered as perfectly legal. We also believe that, in any event, the element of "exclusionary intent" should not be part of the relevant test to assess whether a company's pricing conduct is predatory.

##### 1. Above-cost pricing

With respect to the first point above, the relevant question to ask is the following: can a finding that a dominant firm had not set its prices below its AVC or avoidable cost rule out any accusation of predation against the company?

Consider a dominant firm has an avoidable cost of €5 per unit, and charges a monopoly price of €10. Now suppose that an entrant, which would have unit costs of €7, considers competing in this market with a directly comparable product. At current (pre-entry) prices, market entry appears attractive, and entry would continue to be attractive even if post-entry prices fell to a level of say €7.50. But if the dominant firm were able to threaten credibly to reduce price to €6, still €1 above its avoidable costs but €1 below the entrant's costs, the attempt at entry would be deterred. As a result, the dominant firm is free to continue to charge consumers the price of €10 per unit, safe in the belief that entry will not occur. What conclusions can we draw from this scenario?

One possible conclusion is that the deterrence of entry by the dominant firm's threat of a price cut to a level above its costs is a valid competitive outcome, an instance of competition on the merits. The reason the entrant is deterred by the threat of a price cut is that its costs are higher than the avoidable costs of the incumbent. In other words, the incumbent is more efficient.

Proponents of above-cost predation theories contest this survival-of-the-fittest story by reference to the effect on consumers. They argue that inefficient competition may be better for consumers than no competition at all, citing as evidence that successful entry deterrence by the dominant firm leaves the consumer paying the monopoly price of €10 per unit, whereas if the dominant firm's response was limited to a minimum price of €7.50, entry would occur and consumers would benefit from the lower prices. Moreover, from an overall efficiency (as opposed to a consumer welfare) standard, because of the lower price, this outcome generates allocative efficiencies compared to the artificial restrictions of output that are inherent in the monopoly pricing outcome without entry.

In short, the proponents of above-cost predation theories advocate a form of managed competition, in which constraints on the incumbent's ability to respond to entry could yield net consumer and efficiency benefits.

This debate raises some quite fundamental questions about the nature of competition policy intervention in the free flow of competitive forces and in the trade-off between "type I and type II errors". The case for managed competition cannot be dismissed out of hand but there are some powerful economic arguments for resisting such interventions.

First, a compliance rule that requires dominant firms to accommodate rivals rather than compete with them poses a substantial risk of chilling legitimate competition, and this risk is magnified if dominant firms face potentially large exposure to fines for adopting price responses that do no more than respond to competition on the basis of the costs that are within the dominant firm's control.

Secondly, the case for managed competition is based on an unduly pessimistic view of the ability of entrants to overcome barriers to entry by innovation and dynamic responses to the challenges set for them by incumbents. Away from the rarefied assumptions of our simple numerical illustration, suppose the entrant was able to gain a foothold in the market by differentiating its product, such that it could establish a viable sales base even at a price premium to the dominant firm; or that it responded to the unit cost disadvantage by devising a new production process that, after a year's delay, enabled it to produce the product at a unit cost of €2; or that it invented around the threat of post-entry price reductions by securing a 5-year supply contract with a major customer at a price of €8.00. All these potential competitive developments could be denied to consumers if a regime of managed competition allowed the entrant to gain immediate government-regulated entry into the market.

Thirdly, there is no easy rule to determine the minimum permissible price response of the dominant firm. If the rule were that the dominant firm's "special responsibility" was not

to cut price below the costs of the entrant (or to accommodate entry in some other form), that would raise evident “gaming” possibilities in the regulatory system, whereby the entrant would have an incentive to exaggerate its costs to minimise the reduction in prices. If the incumbent’s product had a higher (actual or perceived) quality than the entrant’s, the analysis could become bogged down in a complex set of discussions about how best to trade-off the price/quality differentials so as to allow entry to occur.

Alternatively, if the rule is set at a measure such as the ATC of the dominant firm, that measure suffers from the problem that it is essentially arbitrary. The ATC per unit of output is endogenous to the output level (depending on how thinly the fixed cost element is spread across sales), and is therefore inherently problematic to calculate ex ante. It is also susceptible to change on the basis of purely financial changes (e.g., a re-financing shift from loan to equity finance, or re-valuation of fixed assets) that bear no relation to real factors in the market. Even if these problems were not considered fatal flaws, there is no good a priori reason to expect that an ATC measure will strike the optimum balance between the dominant firm’s freedom to compete and its “special responsibility” to accommodate entry.

Given the above, we believe that, even if it cannot be excluded that price above AVC (but below ATC) or avoidable cost can, in some exceptional instances, be considered predatory, as a general rule, predation claims based on above cost prices should be dismissed.

## 2. Intent

With respect to the requirement of “exclusionary intent”, we note that this element should not form part of any legal test of predation for two main reasons. First, all rational profit-maximising companies operate on the market with the intention of eliminating their competitors, inter alia, by means of price-competition. Thus, in practice it is almost impossible to draw a distinction between lawful pro-competitive intent and unlawful exclusionary intent.<sup>33</sup> Secondly, even in those exceptional cases where a predatory claim is brought against a company pricing its products above the relevant measure of cost, evidence of “exclusionary intent” on the part of the dominant company should not be the focus of the inquiry. On the contrary, as explained above, the analysis should focus on whether the dominant company’s pricing conduct is capable of excluding competitors in some anti-competitive way.<sup>34</sup> However, objective evidence demonstrating that the business justification for the price cut was motivated by a goal other than eliminating a competitor should be considered as forming part of a defence against a predatory claim.

---

<sup>33</sup> See R. O’Donoghue, “Over-Regulating Lower Prices: Time for a Rethink on Pricing Abuses under Article 82 EC”, *Working Paper*, 2003.

<sup>34</sup> Id.

**D. Recoupment**

As noted above, both the CFI and the ECJ in *Tetra Pak II* rejected the applicant's argument that the Commission should have shown a possibility of future recoupment by the dominant company of the losses incurred as a result of predatory pricing to succeed in a claim of predation against Tetra Pak. However, as also noted above, economic theory suggests that predation can be a profit-maximising strategy when a company: (i) engages in below-cost pricing for a sufficient period of time to induce equally-efficient, or even more efficient, rivals to exit the market; and (ii) believes that, in the future, it could recoup the losses incurred through its exercise of market power without attracting entry in the relevant market. Thus, a rational profit-maximising company which does not believe it has the capability of recouping the losses incurred as a result of a predatory pricing strategy to eliminate rivals would therefore never price its products below cost. As a consequence, from an economic standpoint, the possibility of recoupment is a constitutive element of a predatory pricing strategy.

Given the above, we believe that an economically sound regulation of predatory pricing should consider the possibility of future recoupment by the dominant company of the losses incurred as a result of its predatory pricing strategy as a pre-requisite of a finding of predation.<sup>35</sup>

**E. New economic models of predation**

Finally, as noted, recent economic research suggests that predatory pricing can be a rational profit-maximising strategy for a dominant company when it can be explained by recourse to economic models based on the assumption of imperfect information, which have been captured in the following three main economic models: financial predation, reputation effect predation, and cost signalling. This means that an economically sound legal framework disciplining predatory pricing should take these economic models (and the potential for the creation of financial or reputation effect entry barriers) into account and allow a debate between the parties involved on the applicability of any of these economic models to the case at stake.

**V. Policy Recommendations**

In the sections above, we have set out the economic and current legal framework for predatory pricing analysis. We also identified certain problems associated with the current legal framework and proposed possible solutions to these problems. This section

---

<sup>35</sup> The above is true despite the fact that it could be argued that the notion of dominance already incorporates the existence of high barriers to entry into a specific market and, thus, to a certain extent, the possibility for the dominant predator to recoup its losses after eliminating a competitor. This, however, cannot be considered sufficient to replace the necessity of an explicit finding that, in the light of the structure of the relevant market, the predator had the possibility to recoup its losses after the competitor exited the market.

provides a summary of our policy recommendations as to how the current EU regulatory framework of predatory pricing should be amended to better reflect modern economic thinking.

- (i) The notion of avoidable cost should replace that of AVC as the more appropriate yardstick to establish whether or not a certain pricing policy is predatory;
- (ii) Pricing below avoidable cost should not be considered *per se* illegal. Pricing below avoidable cost would be presumed to be predatory and, therefore, unlawful, unless the defendant can: (i) justify its conduct by putting forward an appropriate defence (commercial misjudgement, promotional sale of new products; loss-leading; two-sided market; meeting competition); and/or (ii) demonstrate that the market structure, demand characteristics and conditions of entry is not conducive to successful predatory pricing based on the relevant economic models of predation as a rational profit-maximising strategy;
- (iii) Pricing above avoidable cost, in principle, should not be regarded as predatory, unless in the most unusual case. The burden of proof should fall on the competition authority/private plaintiff to demonstrate that above avoidable cost pricing is abusive. Furthermore, the abusive nature should be established on the basis of sound economics and the intent of the dominant player should be irrelevant in this regard. In addition, where regulators have the confidence to intervene against above-cost predation, there is a strong public policy case for arguing that such intervention should be made in a way that signals the exceptional nature of the intervention so as to minimise the risks that it will create unintended chilling effects on competition. This might be achieved, for example, by confining such interventions to particularly strong dominant market positions where it is clear that the competitive process would have broken down irretrievably in the absence of intervention, and to avoid the use of fines in such cases (save for recidivism);
- (iv) The possibility for the dominant company to recoup the losses incurred as a result of its predatory pricing strategy by raising its prices in the future must be a prerequisite for a finding of predation. As an alternative, the impossibility to recoup can be used by a dominant company as a shield against allegations of predatory pricing.

The adoption of the above policy recommendations would also increase the use of economic evidence and models in predatory pricing cases both in cases of below-cost pricing at the initiative of the dominant company and of above-cost pricing at the initiative of the competition authority or private plaintiff.

## **Rebates as an Abuse of Dominance under Article 82 EC**

Jorge Padilla and Donald Slater<sup>\*</sup>

### **I. Introduction**

This paper considers the question of the conditions under which rebates granted by dominant undertakings might be considered as abusive under Article 82 EC. The need for clarification and indeed reconsideration of these conditions is urgent, in particular given the tension created, on the one hand, by the lack of legal certainty in this area and the resultant difficulty for practitioners to provide clear advice on what types of behaviour are acceptable and, on the other hand, by the progressive, general increase in the level of penalties being imposed on undertakings for violation of Article 82 EC.

Clarification and reconsideration of the conditions under which rebates might be considered abusive is also necessary given the need for coherency in the application of the competition rules generally. In this regard, the shift (in particular over the last decade) towards a more economic, contextual, effects-based approach to the application of Article 81, has not been mirrored for Article 82, thus putting at odds the philosophy of application of these complementary provisions.

In light of the above, the paper advocates an approach to the application of Article 82 in rebates cases, which places emphasis on the actual and likely potential effects of those rebates as opposed to an approach based on form and purpose.

The paper will not consider the potential tying, predatory or discriminatory effects of rebates as these issues form the specific subject matter of separate papers. Moreover, the paper is not intended to provide a comprehensive overview of existing case-law but rather concentrates on making proposals on the way in which the present approach could be improved.

---

<sup>\*</sup> The authors wish to thank the following people for their input into the discussions leading to this paper: Anne Vallery, Dimitri Loukas, Frederic Louis, Jean-Francois Bellis, Denis Waelbroeck, Jacques Derenne, Kurt Haegemann, Michael Rowe, Pierre Kirch. Any mistakes, omission etc are of course ours.

The paper will begin by considering the general shift towards a more economics based approach to competition law and the fact that this has not been mirrored under Article 82 (section II). Although the paper is focussed on rebates, these are comments that are evidently more generally applicable to the way in which Article 82 is applied. The paper will then go on to look at why an effects-based approach is specifically necessary in the area of rebates and consequently why *per se* prohibitions of certain types of rebates are inappropriate (section III). The paper will then consider other ways in which legal certainty in this area could be achieved through the use of secondary legislation and guidelines (section IV). Finally, the paper will consider some of the alternative ways in which the effects of rebates on competition might be measured (section V).

## **II. Conflicting Approaches under Articles 81/EMCR and Article 82**

### **A. Article 81/EMCR**

The shift towards a more economics based approach under Article 81 and in the field of EC merger control is widely recognised and will not be considered in great detail here.

Nevertheless, it is worth underlining that we are dealing with a true paradigm shift, illustrated both by changes in substantive law as well as institutional changes within the Commission.

The latter point is illustrated, for example, by the appointment of a chief economist within DG COMP and the increased implication of economic experts in the analysis of mergers.

Changes in substantive law abound and are evident not only in binding and non-binding instruments adopted by the institutions, but also in the practices of both the Commission and the Court of Justice (“Court” or “ECJ”). Thus, for example, the adoption in 1999 of the Vertical Restraints Block Exemption<sup>1</sup> and supporting guidelines<sup>2</sup> marked a clear shift away from the form based approach of its predecessors towards an analysis based on the economic effects of vertical agreements.

### **B. The contrast with the Article 82 approach**

In contrast with the above, the approach taken by the Commission and the Court under Article 82 has not known the same degree of shift towards an economic effects-based approach. Indeed, it could be said that there has been little or no shift, or even that there has been a shift *away* from such an approach.

---

<sup>1</sup> Regulation 2790/99, OJ [1999] L 336/21.

<sup>2</sup> OJ [2000] C 291/1.

These conflicting approaches to, on the one hand, the application of Article 82 and, on the other hand, the application of other competition rules, have created incoherency, confusion and resulting lack of legal certainty. In the long term they can only undermine confidence in and credibility of the system as a whole.

A striking example of this conflict can be found in the Court's contemporaneous judgments in the *Van den Bergh*<sup>3</sup> and *Michelin II*<sup>4</sup> cases.

The *Van den Bergh* case involved the analysis under Articles 81 and 82 of contracts requiring exclusivity in the use of ice-cream freezer space. Although HB, the undertaking subject to the Commission's decision, was dominant and with an 89% market share and the case involved contractual *exclusivity* of freezer space, both the Commission's decision and the Court's judgment in that case extensively considered the degree of foreclosure of competing ice-cream manufacturers on the relevant market before condemning the practices<sup>5</sup>. Foreclosure was not only considered in terms of the percentage of outlets that were considered tied to the dominant undertaking, but also took into account the broader market context.

By contrast, the Commission's decision in the *Michelin II* case and the Court's confirmatory decision (that will be discussed in greater detail below) involved effectively no consideration of the economic effects of the rebates in question. Thus, despite the fact that the market shares of Michelin were around half of those of HB in the *Van den Bergh* case, and despite the fact that Michelin had not imposed any exclusivity but rather what was deemed a "*loyalty inducing*" system of rebates, the Court confirmed in its judgment that "*in the contested decision, the Commission did not examine the specific effects of the abusive practices. Nor can it be required to do so.*"<sup>6</sup>. Moreover, the Court asserted that in the context of Article 82 that "*establishing the anticompetitive object and the anticompetitive effect are one and the same thing.*"<sup>7</sup>

The nature, extent and negative consequences of this failure to consider anticompetitive effects under Article 82, specifically with regard to rebate schemes, will be considered further below at point III. However, the urgency of the problem is underlined by the incoherency in approach taken to two allegedly complementary Treaty provisions, as exemplified by the contrasting *Michelin II* and *Van den Bergh* judgments.

Some of the more recent case-law has suggested that genuine effects on competition must be found before the conduct of a dominant undertaking is abusive. For instance, Advocate General Jacobs noted, in *Syfait v GSK*<sup>8</sup>, that refusal to supply was not a *per se* abuse even

<sup>3</sup> Case T-65/98, *Van den Bergh v. Commission*, [2003] E.C.R. I-4653.

<sup>4</sup> Case T-203/01, *Michelin v. Commission*, not yet published.

<sup>5</sup> See in particular points 75 to 119 of the Court's judgment. This analysis is made in the context of Article 81. Under Article 82, as was the case in *Michelin II*, the analysis is truncated. However, it is nevertheless clearly effects-based (see in particular point 160 of the judgment that considers the level of foreclosure, already considered under Article 81) which distinguishes it from *Michelin II*.

<sup>6</sup> At point 258.

<sup>7</sup> At point 241.

<sup>8</sup> Case C-53/03, not yet reported, at point 53.



if the dominant undertaking thereby intended to restrict competition. Also, the President of the Court of First Instance, noted in his Order relating to Microsoft's request for interim measures that, for conduct to be abusive, it must be inherently likely to have the effect of restricting competition, or must actually do so<sup>9</sup>. The Commission decided, in *Inntrepreneur*<sup>10</sup>, that the exclusivity obligations in Inntrepreneur's agreements with pubs did not infringe Article 81, as there was no foreclosing effect - Article 82 was not considered despite the fact that Inntrepreneur was likely to be dominant, suggesting that the Commission would have reached the same view as it did under Article 81.

### III. The Need for an Effects-Based Approach

A more effects-based approach to Article 82 is not only desirable to bring coherency to the application of the Treaty competition rules. Such an approach is also necessary since ignoring the competitive effects of rebates inevitably leads to the application of Treaty competition rules being counterproductive.

#### A. Competitive effects of rebates

As will be seen in further detail below (section B), under the current case-law of the Court and the administrative practice of the Commission, certain types of rebates are considered to be either *per se* illegal or are covered by (a) strong presumption(s) of illegality. Moreover, precedents often place unwarranted emphasis on the intentions of the dominant firm under investigation. The result of this approach is that the concrete effects of rebate schemes practised by dominant firms rarely play any significant role in the analysis of the legality of such schemes.

We consider that this approach is seriously flawed and that a shift towards a more effects-based analysis of rebate schemes is justified. We consider in more detail below the potentially positive effects of rebates and also the approach taken to the competitive analysis of such rebates in other jurisdictions.

#### 1. Positive effects of rebates

It is widely recognised that the economic effects of rebates are ambiguous and highly dependant, not only on the type of discounts in question, but also, crucially, the specific features of the market in which they are applied.

This statement applies to all types of rebates, including fidelity rebates, which are often considered as the most egregious example of rebate based abuses under Article 82 EC. Thus, for example, the OECD report on Loyalty and Fidelity Discounts and Rebates states in this regard that “*because fidelity discounts have potentially significant pro- and*

---

<sup>9</sup> Order of 22 December 2004, Case T-201/04 R, *Microsoft v Commission*, at point 400.

<sup>10</sup> Commission decision *Inntrepreneur* of 29 June 2000, OJ L 195 of 1 August 2000, pp.49-57.

*anti-competitive effects, and both are highly dependant on specific features of the discounts and the markets they are found in, a case by case approach to fidelity discounts seems warranted.”*

The most obvious positive effect to flow from the application of rebates schemes is the lowering of prices to customers as recognised, for example, in the OFT's draft guidelines in the UK which state that such price competition is generally to be encouraged<sup>11</sup>.

The OFT's Draft guidelines more generally state that “*a dominant company’s discount scheme may reflect competition to secure orders from valued customers or have beneficial effects*”. Examples of such beneficial effects have been described in more detail, particularly in the UK's submission to the OECD round table on loyalty discounts mentioned above, and include<sup>12</sup>:

- Meeting competition and lower pricing: Price reductions which enable companies with significant market power to meet the prices offered by their competitors appear to be justified from a commercial perspective. More generally, where one firm sets a loyalty discount to encourage a buyer to substitute a rival’s product for its own, that rival may respond with competing discounts. This process can lead to lower input costs for buyers which are eventually passed on to consumers in the form of lower prices.
- Recovering costs: Rebates are also likely to expand demand and thereby help supplier recover fixed costs more efficiently. More specifically, rebate schemes can allow a supplier to identify those retailers facing the most price sensitive (“elastic”) demand for the supplier’s product; if so, and the supplier faces fixed costs, the supplier will be able to lower costs for buyers that serve more “elastic” downstream demands, essentially applying a form of “Ramsey” pricing<sup>13</sup>. Rebates may also reflect efficiency savings resulting from supplying particular customers; for example, suppliers may offer loyalty-inducing discounts in an effort to learn more about their buyers (in particular, their cost structures), thus, reducing asymmetric information.
- Incentivising retailer effort: Rebates may provide an appropriate reward for the efforts of downstream undertakings to promote a dominant undertaking’s product. Suppliers often rely on retailers for access to private information on retail demand conditions and/or retailers can influence retail demand conditions by promotional or some other effort. If the supplier cannot incentivise retailer’s effort in promoting its goods by setting specific contractual terms, then it may wish to use a loyalty discount scheme to incentivise such effort. In this case, the rebate

---

<sup>11</sup> OFT Draft Guideline for the assessment of conduct (OFT414a) of April 2004.

<sup>12</sup> UK submissions to the OECD Competition Policy Roundtable of June 2002 on loyalty and fidelity discounts and rebates.

<sup>13</sup> See D. Ridyard, “Exclusionary Pricing and Price Discrimination Abuses under Article 82 – an economic analysis” (2002) *E.C.L.R.* 286.

structure may enhance either interbrand competition, intrabrand competition or both<sup>14</sup>.

- Promoting downstream competition: Loyalty rebates in particular may promote a competition “level playing field”, by allowing large and small firms to benefit from the same discounts. This could enhance competition downstream because the downstream sellers would have a similar level of marginal cost (assuming discounts are not lump sum rebates). As a result, the smaller buyers may exert a stronger competitive constraint on the larger buyers when they compete in the downstream market than would have been the case with volume discounts. Considering that this benefit is particular to loyalty rebates, UK regulators have taken the view that a *per se* prohibition of loyalty rebates might prevent a dominant firm that wished to provide discounts from providing them in a way that did not distort competition among downstream firms. At the same time, however, they have also indicated that an incremental rebate system should suffice to achieve this procompetitive effect.

An approach to rebates that is based on *per se* rules and presumptions worked out according to the form that rebates take writes out of the analysis the numerous positive effects that rebates can have. Such an approach (i) results in many dominant firms being condemned for behaviour that is pro-competitive/has only positive effects for customers and (ii) inhibits many others from adopting such strategies in the first place.

Moreover, reducing dominant undertakings’ scope for vigorously competing on price using entirely pro-competitive strategies, creates a great risk of a knock-on effect on the evolution of competitiveness of other undertakings. Thus, for example, in many markets competitors of dominant undertakings will take the lead from the latter on price. By shielding these price-takers from vigorous price competition by the dominant firm, (i) inefficient rivals that would otherwise leave the market will be protected and artificially “kept alive” and (ii) even the incentive of efficient rivals to compete on price risks being dampened. As already noted above, the evolution of competition downstream can also clearly be negatively affected.

To summarise, the failure to take into account the effects of rebates in the particular circumstances and on the particular markets in which they are applied increases in particular the risks of:

- generally chilling price competition by dominant firms and their competitors;
- protecting inefficient competitors to the detriment of consumers;
- inhibiting the development of competitiveness downstream;

---

<sup>14</sup> On this point, the OFT further indicates in its OECD submission that many of the usual arguments in defence of vertical restraints can be adapted to suit loyalty rebates. The vertical restraint literature suggests that vertical restraints should be assessed on a case-by-case basis and, to the extent that the analysis carries over to loyalty rebates, the same policy rule seems relevant.

- dominant firms being condemned for behaviour that is pro-competitive/has only positive effects for customers.

Failure to take an effects-based approach to the assessment of rebates therefore risks rendering the application of competition law counterproductive by exacerbating the ills it is intended to address.

## 2. Consideration of effects of rebates in other jurisdictions

The ambiguous effects of rebates and the need to take these into account in any competitive analysis is moreover reflected in the approach taken in practice to these issues in certain other jurisdictions.

For example, the US approach to exclusivity contracts and contracts liable to have similar effects broadly consists in (i) measuring the percentage of the market which is covered by the exclusivity and, if this is considered substantial, (ii) going on to consider whether the potential anticompetitive effects created by such substantial coverage is liable to exclude competitors in practice. It is to be underlined that the authority or private plaintiff alleging anticompetitive conduct bears the burden of proof in the first instance.

Thus, for example, in the case of *CDC v. IDEXX*<sup>15</sup>, the 2<sup>nd</sup> Circuit considered exclusivity contracts signed with distributors by an undertaking having 80% of the relevant market in certain blood analysis equipment. After finding that 50% of distributors were tied by the contracts the court went on to dismiss the claim against *IDEXX* because the arrangements were not capable of having the alleged anticompetitive effect in particular due to the fact the agreements were terminable on short notice and there were low barriers to entry.

*Concord Boat v. Brunswick* provides another, this time, rebate based example. In that case the 8<sup>th</sup> Circuit considered a progressive fidelity rebate scheme (1% discount for 60% of requirements, 2% for 70% and 3% for 80%) applied by an undertaking having a market share of 75% immediately prior to the period under examination. It concluded that the arrangements did not permit *Brunswick* to harm consumers by charging supra-competitive prices as it was easy for customers to switch suppliers, agreements were easy to terminate and there were no barriers to entry.

It is interesting to note that the US approach taken in these cases is highly reminiscent of that taken by the ECJ in *Delimitis*<sup>16</sup> to the issue of Article 81 and networks of beer producers' exclusive distribution agreements pubs. In that case the ECJ stated that to establish the existence of an anticompetitive exclusivity agreement it was necessary to establish the proportion of the market tied up by the exclusivity contracts and if that was

---

<sup>15</sup> *CDC Techs, Inc v. IDEXX Labx., Inc.*, 186 F.3d 74 (2<sup>nd</sup> Cir. 1999).

<sup>16</sup> Case C-234/89, *Delimitis v. Henninger Bräu*, [1992] E.C.R. I-935.

substantial, to go on to consider other factors, particularly barriers to entry<sup>17</sup>. This further underlines the inconsistency of approach taken to these issues under Articles 81 and 82 EC, as was illustrated above with the *Van den Bergh* and *Michelin II* cases.

As noted above, the UK is another jurisdiction in which the effects of rebates granted by dominant undertakings on competition are considered ambiguous, and this attitude is reflected in the approach taken in practice to cases involving such rebates. Thus, for example, in the *BSkyB* case<sup>18</sup>, the OFT considered a number of discounts offered by the dominant *BSkyB* and concluded that although the rebates at issue were hypothetically capable of having anticompetitive effects, such effects did not exist in practice.

The brief consideration given above of the pro-competitive effects of rebates and the consideration of such effects in competition analysis in other jurisdictions can be contrasted with the current situation in the EC, where effects are considered as a general rule to be irrelevant. The disregard of these effects has led to the creation in the EC of virtually *per se* rules against the granting of rebates by dominant firms and in other cases the use of strong presumptions that such rebates are abusive. The appropriateness of these *per se* rules and presumptions is considered below after looking briefly at the broad structure of analysis under Article 82.

## B. Objective justifications

Before going on to consider in more detail the *per se* rules and presumptions applied to the analysis of rebates under Article 82, the following brief observations should be made regarding the general structure of this analysis.

In broad terms, Article 82 is applied to the behaviour of firms following a two tier approach. Firstly, the existence of a dominant position and abuse are established by the competition authority and secondly, the dominant undertaking has the chance to overturn the finding of an abuse by demonstrating that there exists an objective justification for its behaviour.

In the present paper, the issue of objective justification is not considered in any detail. This is partly because on the basis of existing case-law, the scope of this defence appears to be extremely limited and indeed it has never been accepted in any judgment of the Court in relation to rebates.<sup>19</sup> Moreover, whilst it is generally accepted that rebates will be

---

<sup>17</sup> At points 19-27. The ECJ stated first that it was necessary to consider "*the number of thus tied in relation to the number not so tied, the duration of the commitments entered into, the quantities of beer to which those commitments relate, and on the proportion between those quantities and the quantities sold by free distributors*" before going on to stress that even if a substantial proportion of the market was tied it was necessary to consider other factors such as "*opportunities for access*" and in particular whether barriers to entry were such that potential competitors were de facto blocked from entering the market on an efficient scale.

<sup>18</sup> Decision CA98/20/2002, *BSkyB* of 29th July 2003.

<sup>19</sup> Thus, for example, in *Hoffmann-La Roche*, the Court of Justice rejected as an objective justification the fact that a rebate is granted at the request of a customer (at point 89) and in *Michelin I* (Case 322/81,

allowed provided they reflect gains in efficiency and economies of scale achieved by the dominant undertaking<sup>20</sup>, there are serious practical limits even to this application of the defence (as discussed further below).

We consider that the objective justification defence, although of limited application, should remain as part of the Article 82 analysis. Whilst some possible changes to the scope of the defence or the way in which it is applied could be considered, this paper is deliberately focused on the more urgent questions of making the preliminary analysis of authorities applying Article 82 more effects-based.

### C. Per se rules and presumptions

In light of the observation above concerning the ambiguous effects of rebates, it is a cause for concern that current EC precedents in this area create *per se* or virtually *per se* rules against the granting of certain forms of rebate (i.e. irrebuttable or virtually irrebuttable presumptions of illegality) without any serious consideration (or any consideration at all) of the effects of such rebates.

An example of such an approach can be found in *Michelin II*. In that case, the ECJ judged that standardised progressive discounts calculated as a percentage of the value of a customer's purchases and with a one year reference period would be considered as abusive when granted by a dominant undertaking, unless that undertaking could show that the rebates in question were based on a countervailing economic advantage given by the customer i.e. that it "*rewards economies of scale made by the [dominant undertaking] because of orders for large quantities*"<sup>21</sup>.

This approach creates a virtually *per se* rule against certain types of rebate, entirely based on the form of the latter. Indeed, before shifting the burden of proof to the dominant undertaking to show the existence of economies of scale, the ECJ did not consider any effects-based reasoning of the type discussed above relating to (i) the proportion of the market affected by the contracts or (ii) the extent to which other market circumstances such as barriers to entry confirmed the existence of anticompetitive effects.

The only "effects-based" reasoning considered by the ECJ was the "loyalty inducing" effect of the rebates under examination. Whilst such an approach to an extent takes into account the actual market context, it constitutes at most only the very preliminary steps of an effects-based analysis. Nevertheless, as noted above, this very preliminary analysis leads directly to a virtually irrebuttable presumption that the rebates at issue are anticompetitive and must be condemned. Thus, at point 65 of *Michelin II*, the ECJ confirms that:

---

[1983] E.C.R. 3461 at point 85), the Court of Justice rejected as an objective justification the fact that the rebate improved the organization of Michelin's production and distribution.

<sup>20</sup> *British Airways plc v. Commission*, Case T-219/99, not yet published, (paras 246 to 247); *Manufacture Française des Pneumatiques Michelin v. Commission*, Case T-203/01, not yet published (paras 98, and 108 to 109); *Portugal v. Commission*, [2001] E.C.R. I-2613 (para. 52).

<sup>21</sup> At point 98.

“any loyalty-inducing rebate system applied by an undertaking in a dominant position has foreclosure effects prohibited by Article 82”.

This is in fact not one presumption but a series of presumptions. Thus, once the potential loyalty inducing effect of the rebate has been established, it is simply presumed that this loyalty inducing effect engenders some form of exclusion of competitors, which is in turn presumed to be anticompetitive and to harm consumers.

The main problem here is that, given the ambiguous effects of rebates, these presumptions, that are devoid of any considerations of market context and actual (or likely potential) anticompetitive effects, are wholly unjustified.

That this chain of presumptions does not necessarily hold is explicitly recognised in the OFT draft guidelines for the assessment of conduct that state in relation to fidelity rebates that these:

“[...] may be abusive where they lead to foreclosure effects. It is the ‘loyalty inducing effect’ of a fidelity rebate that generally raises potential competition concerns. However, even where a discount scheme adopted by a dominant undertaking has a loyalty inducing effect, the scheme would not be found abusive if it did not (or was not likely to) harm competition”<sup>22</sup>(emphasis added).

This is of course not to say that such presumptions will never hold, but the fact that they are virtually irrebuttable means that they are simply not open to scrutiny and cannot be tested in individual cases.

As regards the opportunity the dominant firm has to rebut the presumptions above by showing the existence of economies of scale, the following observations should be made.

Firstly, even if such presumptions were to be considered acceptable in the context of rebates (a point that is returned to again below), having regard to the ambiguous competitive effects of rebates, these presumptions should be capable of being rebutted on the basis of an absence of anticompetitive effects. However, in *Michelin II*, such arguments by the dominant undertaking were to be considered irrelevant to the competitive analysis. It was therefore irrebuttably presumed that anticompetitive effects existed.

Secondly, although the presumption of the existence of an abuse in *Michelin II* was capable of being overturned by the dominant undertaking demonstrating the existence of economies of scale, the usefulness of this possibility is severely limited. Thus, it is highly unlikely that any firm, dominant or otherwise, could establish a quantity rebate scheme having a simple relationship with its cost function. As stated by Ridyard, “*there is almost no plausible cost function that would make [a quantity based] discount scheme cost*

---

<sup>22</sup> Para. 5.8 of the OFT Guideline for the assessment of conduct (OFT414a) of April 2004. Emphasis added.

*related in the sense that the differences in price were explained by differences in the cost of supply*”<sup>23</sup>. Moreover, were it even possible in theory to establish such a relationship, many complex questions would be left outstanding such as how costs are measured and allocated to different customers.

Thirdly, the presumptions of illegality discussed above are *prima facie* at odds with the principle that the party alleging an infringement bears the burden of proof<sup>24</sup> and more generally with the presumption of innocence as recognised by the ECJ to apply in competition cases<sup>25</sup>. Moreover, previous case-law in other areas would indicate that where the assessment of an undertaking's rights and obligations under EC law depends on complex economic assessments, presumptions that are unfavourable to such undertakings should be avoided. Thus, for example, in the *San Giorgio* case, the ECJ noted in relation to the Italian law presuming that a tax levelled in violation of EC law had been passed on to consumers that:

“in a market economy based on freedom of competition , the question whether , and if so to what extent, a fiscal charge imposed on an importer has actually been passed on in subsequent transactions involves a degree of uncertainty for which the person obliged to pay a charge contrary to Community law cannot be systematically held responsible (emphasis added)”.<sup>26</sup>

This is not to say that no presumptions or deductive reasoning should be allowed under EC competition law. However, in the absence of any demonstration by the regulatory authorities of negative competitive effects, the application of such presumptions in the context of rebates is in principle inappropriate. The reasoning behind this is best illustrated by a comparative example.

Article 81(1) EC prohibits *inter alia* agreements between undertakings to fix prices. Such agreements are generally considered to be restrictions by object, i.e. there is no requirement for the authorities to demonstrate any anticompetitive effect, all that is required is proof that the behavioural elements of the prohibition exist (e.g. by pointing to documents showing exchange of price information)<sup>27</sup>. The burden of proof then shifts onto the defendant undertakings which must then adduce proof of the pro-competitive effects of their behaviour under Article 81(3) EC.

---

<sup>23</sup> See D. Ridyard, “Exclusionary Pricing and Price Discrimination Abuses under Article 82 – an Economic Analysis” (2002) *E.C.L.R.* 286.

<sup>24</sup> Article 2, Regulation 1/2003.

<sup>25</sup> See e.g. Case C-199/92P *Hüls v. Commission* [1999] E.C.R. I-4287 at point 150 “*given the nature of the infringements in question and the nature and degree of severity of the ensuing penalties, the principle of the presumption of innocence applies to the procedures relating to infringements of the competition rules applicable to undertakings that may result in the imposition of fines or periodic penalty payments*”.

<sup>26</sup> Case 199/82, *San Giorgio*, [1983] E.C.R. 3595 at point 15.

<sup>27</sup> Some demonstration of at least potential effects is required in relation to the affectation of trade between Member States. However, given that this part of the Article 81(1) test essentially concerns jurisdictional, it can be disregarded for the purposes of the present analysis.



This situation is in a way analogous to a presumption that certain rebates are anticompetitive (with the authorities being obliged to prove the existence of the behavioural elements of the abuse – e.g. the fact that such or such a rebate was indeed granted – but not any concrete effects) but where the dominant undertaking can rebut the presumption by demonstrating certain pro-competitive effects a possibility which was, however, not considered to be available to the applicant in *Michelin II* as noted above).

However, these situations are also very different. In the Article 81 example above, agreements between undertakings are considered to be restrictions by object because there is well established economic theory backing up the idea that price fixing agreements are in the great majority of cases bad for consumer welfare. There are therefore good theoretical justifications for the creation of a presumption that such agreements are bad, without the regulator having to adduce proof in the first instance of existence of negative competitive effects.

This stands in stark contrast to our rebates example. As discussed above, the competitive effects of rebates are highly ambiguous. Even the effects of fidelity rebates, which are sometimes touted as among the most egregious of abuses, are ambiguous.

This is not to say that recourse to presumptions in the context of rebates should be totally excluded. However, before such presumptions are applied to any type of rebate, there must at least be concrete cases where (i) the effects on competition of such rebates have been analysed and have been found to be negative and (ii) it has been demonstrated that similar results would at least be likely where such rebates are applied in other contexts.

Such an approach would be likely to lead to fairly narrow presumptions, an entirely understandable outcome. Given the ambiguous effects of rebates on competition, a broad-brush approach to this type of presumption is apt unjustifiably to sweep up many cases where the rebates in question have no negative effects whatsoever or only positive effects.

#### D. Adopting an effects-based approach under EC law

In light of the above, it is advanced that a move towards an effects-based analysis of rebates under Article 82 is urgently required. We consider that the very definition of abuse, as it consistently appears in the case-law, favours such an effects-based approach. Thus, as the Court stated in *Hoffmann La Roche*:

“The concept of abuse is an objective concept relating to the behaviour of an undertaking in a dominant position which [...] has the **effect** of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition (emphasis added).”<sup>28</sup>

---

<sup>28</sup> At point 91, emphasis added.

Also, the language of Article 82 itself suggests that effects must be demonstrated before an abuse can be found: Article 82(b) requires “*prejudice of consumers*” and Article 82(c) requires that trading parties be placed “*at a competitive disadvantage*”.

The way in which the anticompetitive effects of rebates are measured is considered in detail below under section V. However, two general questions relating to the type of anticompetitive effects that should be considered under an effects-based approach are worth considering at this stage.

1. What anticompetitive effects?

Some of the pro-competitive effects of rebates were discussed above at section III.A but the question remains as to what anticompetitive effects an effects-based analysis under Article 82 should aim at identifying. There are essentially two types of anticompetitive effect potentially created by rebates: anticompetitive exclusion of competitors<sup>29</sup> and discrimination between customers<sup>30</sup>. As noted in the introduction, this paper does not consider the latter, but notes in passing that the idea that discrimination is *per se* anticompetitive is controversial and has little economic support.

The ways in which one can identify and measure the existence and extent of exclusion of competitors caused by rebates granted by dominant firms is discussed in detail under section V. However, some general comments can be made at this stage.

If an effects-based approach to rebates under Article 82 is to be favoured then it is simply not possible to equate anticompetitive exclusion with taking market share from competitors. If it were otherwise, any increase in market share of a dominant firm that could be attributed to rebates granted by it would be automatically considered as anticompetitive exclusion.

Nor can any analysis, be considered compatible with an effects-based approach, if it automatically finds anticompetitive exclusion, whenever a certain percentage of market demand is subject to contracts with a dominant firm that contain rebates clauses. Such an approach would again ignore market circumstances which could militate against a finding of anticompetitive effects. Thus, for example, even where the percentage of demand “tied” by such contracts were to be very high, factors such as absence of customer switching costs, alternative distribution methods or low barriers to entry could indicate that the dominant firm remains subject to considerable competitive pressure.

This point is demonstrated by the US case *Concord Boat v. Brunswick* cited above. As one commentator notes in relation to *exclusivity* contracts, “*the percentage of the market*

---

<sup>29</sup> See e.g. *Michelin II* at point 57-58.

<sup>30</sup> See e.g. Case T-219/99, *British Airways v. Commission*, not yet published at point 240; Case C-163/99, *Portugal v. Commission*, [2001] E.C.R. I-2613 at point 52.

*'foreclosed' by exclusive arrangements is rarely determinative and, often, not even very interesting*<sup>31</sup>.

## 2. Actual, potential or hypothetical effects?

What types of effects should be taken into consideration in the establishment of rebate related abuses under Article 82: actual effects, potential effects, likely potential effects, hypothetical effects?

We consider that there are good arguments that actual and likely potential effects should be taken into account but not hypothetical effects. There are a number of reasons for favouring this approach.

Firstly, Article 82 should not be limited to prohibiting anticompetitive abuses that have actually occurred but should also be capable of being applied preventatively. Therefore, analysis of the anticompetitive effects of rebates should not be limited to actual effects only.

Secondly, an approach taking into account any effects, no matter how hypothetical or unlikely would be equally unacceptable. Taking into account purely hypothetical effects or any potential effects regardless of their likelihood would in practice amount to the introduction of presumptions of illegality through the back door, an approach which has been rejected as inappropriate for the reasons given above. However, taking into account likely potential anticompetitive effects of rebates would square with the idea that the burden of proof should fall on the authority or person alleging an abuse, who should be capable of showing that on the balance of probabilities anticompetitive effects are likely. Such an approach would moreover respect the need for a preventive application of Article 82.

Thirdly, such an approach would be in line with the standard of proof required in other areas of EC competition law. Thus, for example, the Commission's horizontal guidelines indicate that an agreement will be considered as having the effect of restricting competition if such an agreement is *"likely to effect competition in the market to such an extent that negative market effects as to prices, output, innovation, or the variety or quality of goods or services can be expected"*<sup>32</sup>. Moreover, under the EMCR, for a concentration to be blocked it must be shown that it will in all "likelihood" create or strengthen a dominant position<sup>33</sup>.

---

<sup>31</sup> J. M. Jacobson, "Exclusive dealing, foreclosure and consumer harm", (2002) 70 *Antitrust Law Journal*, 311 at p.349.

<sup>32</sup> See Commission guidelines on the applicability of Article 81 to horizontal cooperation agreements OJ [2001] C 3/2 at point 2.

<sup>33</sup> See e.g. Case T-5/02, *Tetra Laval v. Commission*, [2002] E.C.R. II-4831 at point 153.

#### **IV. The Need for Legal Certainty**

In the introductory comments it was underlined that there is a need for greater certainty in this area of the law. There is, however, inevitably a tension between, on the one hand, this need for greater legal certainty and, on the other hand, the need to employ a case-by-case, effects-based analysis. This section considers two ways in which greater legal certainty might be achieved without appreciably affecting the need for an effects-based approach, namely the adoption of guidelines creating safe harbours and the use of secondary legislation to create presumptions of illegality for certain types of rebate.

##### **A. Safe harbours**

The definition in Commission guidelines of certain types of rebate that are generally not capable of having appreciable anticompetitive effects would provide dominant firms with greater legal certainty, whilst not compromising the objectives of Article 82 or the general rule that the anticompetitive effects of rebates should be analysed on a case by case basis.

Safe harbours could be applied, for example, to rebates with a short reference period and that are constructed in such a way that they can only apply to a limited percentage of demand. Thus, rebates with a three month reference period that require customers to acquire 50% (or less) of their demand during that time from the dominant undertaking are highly unlikely to have any anticompetitive exclusionary effects.

Such rebates by definition can only cover an absolute maximum of 50% of demand – in the extreme case of monopoly – and will in many cases cover a far smaller portion of the market, leaving the large majority of demand fully open to non-dominant/potential competitors. It should also be underlined that the percentage of demand covered by the rebates is not covered by exclusivity but merely by an incentive to exclusivity, leaving customers open to source from elsewhere should they find a better deal. Moreover, order cycles will in many cases be longer than three months and even where they are shorter, giving rise to repeat purchases within the same reference period, the percentage of demand covered by the rebates will only be so covered for a very limited period, being opened to competition at regular intervals. The potential for such rebates to create anticompetitive effects is marginal and is likely to exist only in very specific circumstances.

Conversely, such rebates potentially have a number of highly positive effects. For example, by definition they result in reduced prices to customers and may also contribute to stability of supply and demand and incentivise retailer efforts.

Creating a safe harbour for this type of rebate is moreover compatible with existing case-law. Rebates conditional upon customers taking 50% (or less) of their requirements from a dominant undertaking during a defined period do not fall within the definition of

fidelity rebates<sup>34</sup> and precedents indicate that reference periods of three month or less are generally acceptable<sup>35</sup>.

A second example of a possible “safe harbour” would be for standardised volume rebates. Prior to the *Michelin II* case, it indeed had seemed that standardised volume rebates were generally considered as competition on the merits and not an abuse of dominance under Article 82<sup>36</sup>. Two different types of rebate can be distinguished here.

Firstly, progressive standardised volume rebates applied to the last “tranche” of a customer's demand should not raise concerns of anticompetitive exclusion. Such discounts are simply competitive price reductions on marginal volumes that do not create any increased switching costs for customers and carry no risk of negative pricing at the margin. There is moreover appears to be no reason why a limited reference period should be attached to the application of such a safe harbour. Again, the creation of such a safe harbour is consistent with existing case-law<sup>37</sup>.

Secondly, we can distinguish progressive standardised volume rebates with each increase in the rebate being rolled back to the first unit. The roll back aspect of such rebates which distinguishes them from the last “tranche” rebates considered in the preceding paragraph has been identified in some cases as a source of concern<sup>38</sup>. However, it is advanced that the potential anticompetitive nature of the roll back feature was overstated in these cases. Indeed, as noted in that case by the appellants in the *Michelin II* case<sup>39</sup>, the difference between last tranche and roll back volume rebates is essentially one of presentation. The Court in that case did not accept this argument, in essence pointing to the negative pricing element created by the roll back aspect at the start of each tranche. Should this feature of roll back volume rebates be considered problematic, it would nevertheless be possible to qualify any safe harbour created for roll back volume rebates by, for example, making it a condition that they are structured in such a way as not to involve negative pricing at any point on the scale and/or to limit the reference period to which such rebates apply to e.g. three months. If a rebate does result in some negative pricing, a safe harbour could nevertheless be created by reference to the percentage of total market demand foreclosed by the rebate. If a roll back volume rebate results in negative pricing for some of the products sold (as will almost always be the case), the anti-competitive effect of the rebate

---

<sup>34</sup> That cover rebates conditional on over 50% of requirements being sourced from the dominant firm.

<sup>35</sup> See e.g. the Commission's Article 19(3) Notices in *British Gypsum*, OJ 1992 C321/9-12 and the Press Release on the Interbrew settlement IP(04)574 of 30 April 2004 where a one year reference period was accepted. Also, after adopting its *Virgin/British Airways* decision, the Commission, with the aim of assisting British Airways and other dominant airlines, adopted a series of guidelines to help carriers ensure that their travel agent commission rebate schemes did not infringe Article 82. As regards the reference period, the guidelines set forth a rule permitting aggregations for a period not exceeding six months. See Press Release IP(99)504 of 14 July 1999. In *Michelin II* at points 85-89 the CFI suggests that a three month reference period is generally acceptable, while one year is likely to be excessive.

<sup>36</sup> See *Hoffmann La Roche* at point 90.

<sup>37</sup> See e.g. Case 322/81, *Michelin v. Commission*, [1983] E.C.R. 3461, point 70; Case C-163/99, *Portugal v. Commission*, [2001] E.C.R. I-2613 at point 50.

<sup>38</sup> See *Michelin II* at point 113; *British Airways* at point 272.

<sup>39</sup> At point 86.

is arguably limited if the products sold at or below cost (and hence not contestable by competitors) account only for a limited percentage of the total number of products sold in the market.

The safe harbours discussed above are merely examples and others could no doubt be considered for different types of rebate.

Whilst giving comfort to the overwhelming majority of industries in which these rebates would create absolutely no concern, should the Commission find that very specific circumstances apply in a particular industry and such rebates do raise concerns it could withdraw the benefit of the safe harbour for that particular industry. However, such withdrawal should be *ex nunc* and not *ex tunc* and no fines should be imposed for behaviour the period prior to withdrawal. Such an approach recognises that a slight possibility that in a particular industry certain types of rebate may cause problems, should not prevent the vast majority of industries where no such problem exists benefiting from the added legal certainty that safe harbours would provide. Such an approach is moreover adopted in several other EC competition law instruments<sup>40</sup>.

#### B. Presumptions of illegality

Another way in which greater legal certainty could be created in this area would be through the identification of certain types of rebate that are presumed to be abusive. As noted above, the use of broad presumptions of illegality in the context of rebates is generally inappropriate. However, if experience indicates that particular types of rebate present problems when applied in particular industries, then it should be possible to create appropriate presumptions of illegality using secondary legislation. Such presumptions should be rebuttable on the presentation of evidence of lack of anticompetitive effect.

### V. **Economic Analysis of the Effects of Rebates**

In what follows we define loyalty rebates as rebate schemes characterised by long reference periods (more than three months, possibly a year) and retroactive discounts for reaching targets that are based on total sales<sup>41</sup>. This definition of loyalty rebates includes: explicit fidelity rebates, where the customer's target relates to the share of its needs that it takes from the supplier; growth rebates, where the customer's target relates to the quantity it takes from the supplier relative to the quantity it took last year; and 'loyalty-inducing' quantity rebate schemes where the rebates are given on total sales for reaching specific targets over a specific reference period.

---

<sup>40</sup> See e.g. Articles 2 and 6 of the Vertical Restraints Block Exemption.

<sup>41</sup> Other, alternative analytical frameworks for the assessment of the competitive effects of rebates have been proposed elsewhere. See e.g. the UK submissions to the OECD Roundtable on loyalty discounts (supra note 12).

A. Possible anti-competitive effects

The use of loyalty rebates by firms with market power may have anti-competitive implications: competitors are “denied” access to customers operating under loyalty rebate schemes and, therefore, may fail to reach the minimum efficient scale and be forced to leave the market. That is, the use of loyalty rebates by dominant firms may lead to the anti-competitive exclusion of competitors that are, in principle, as efficient as the dominant firm.

Crucial to this story of anti-competitive harm is the existence of an assured base of sales for the dominant firm with each customer. These are sales that the customer would be reluctant to shift to a rival, without substantial price incentives to do so. Absent an assured base of sales with a particular customer, the pricing structure offered by a dominant firm to that customer would be irrelevant. The reason is that a rival could simply contest the whole of the dominant firm’s business with the customer. The existence of an assured base of sales may be the result of real switching costs at the customer (learning costs, transaction costs, etc.) or end-consumer level (must stock brands), or of long-term contractual commitments.

Suppose that a customer will always cover 90% of its needs from the dominant firm, such that the dominant firm has an assured base of 90% with that customer which cannot be contested by its rival. In this situation, a loyalty rebate can have the effect of impeding the ability of the rival to contest the remaining 10% of the customer’s needs. It does this by lowering the average incremental price faced by the customer for this additional 10% of its needs. Consider a very simple loyalty rebate under which a customer receives a 5% discount across its entire turnover with the dominant firm if it purchases only from this firm. Although the average discount is just 5%, the average incremental discount for those 10% of the customer’s needs that are potentially contestable is substantially higher: 50%.

This example illustrates how loyalty rebates can give rise to powerful incentives, even where they are apparently fairly small and innocuous. The example explains when a loyalty rebate scheme may lock a retailer into an exclusive dealing relationship with a manufacturer. But it does not tell us much about the potential exclusion of competitors. To consider the possibility of exclusion one needs to change perspective and move from individual contracts to market outcomes. The use of loyalty rebate schemes by a dominant company will lead to the exclusion of as-efficient competitors only when a significant fraction of market volume is locked in for a sustained period of time as a result of those schemes. How large that fraction of market volume should be, and for how long should the market be foreclosed, to justify concern? The answer varies from case to case. It depends on the minimum efficient scale in the industry under analysis and the size of the contestable market.

Loyalty rebates are likely to cause serious anti-competitive effects where (1) the position of the dominant firm is sufficiently strong that rivals are unlikely to win substantial share from it over the short term, but might – absent the loyalty rebate scheme – nibble away at

the edges, gradually eroding its market position; (2) loyalty rebates cover a significant fraction of market demand, and (3) they have long-reference periods. Just because a loyalty rebate makes it hard for a rival to win additional sales from one customer may have minimal implications for competition if the rival is able to win sales from the dominant firm elsewhere in the market, and indeed compete for these sales by offering its own loyalty rebates.

B. Possible pro-competitive effects

Loyalty rebate schemes need not have anti-competitive effects, either actual or even potential. Instead they may result in increased competition and consumer welfare.

First, where efficient rivals can profitably match the dominant firm's offer to customers, then such discounting is not anti-competitive, but rather as pro-competitive and part of the normal competitive process.

Second, loyalty rebate schemes between manufacturers and retailers can have beneficial effects for end-consumers by improving the incentives given to retailers. This may solve various moral hazard problems in a vertical relationship: conflicts of interest between manufacturers and retailers as regards promotions, advertising, investment in more professional sale force, etc. For example, if retailers face a low marginal input cost for a product they will have good incentives to promote that product, or to expand sales of that product by competing on price. The Court and the Commission already recognise, to some extent, that a dominant company may legitimately reward its retailers for services provided by them<sup>42</sup>.

Third, loyalty rebates may also contribute to resolve hold-up problems. For example, a manufacturer may be reluctant to invest in training the sales force of its retailers because part of the knowledge transferred to them may be used to promote the sales of competitors rather than its own. This under-investment problem may be resolved if retailers could commit to concentrate their purchases from the manufacturer who trains their staff. Such commitment is however difficult and may not be credible: ex post, when the staff has been trained, retailers will have an incentive to purchase from the lowest-priced manufacturer. One option open to the manufacturer is to offer a market share discount, or other loyalty-inducing discount, so as to ensure that the retailer has a high-powered incentive to concentrate its purchases on its products. This solves the hold-up problem and increases efficiency.

Fourth, loyalty rebates may facilitate efficient recovery of fixed costs. When production involves significant fixed costs, prices will be set above marginal costs. The price-cost margin must be sufficiently high to recover fixed costs; otherwise production will not be sustainable in the long run. The problem is that higher prices mean lower volume, which

---

<sup>42</sup> For instance, the CFI suggests, in *Michelin II*, at points 136-150, that a service bonus will not infringe Article 82, if it is awarded in an objective and non-discriminatory manner.



implies that in order to recover fixed costs prices may have to be significantly high. This has adverse implications on consumer welfare. One possible way to eschew this dilemma is to charge a relatively high price for those units where the elasticity of demand is low (the assured base of sales) while at the same time charge a small price for those units for which demand elasticity is high. In this way, the manufacturer can simultaneously profit from a higher margin on the infra-marginal units without losing volume at the margin. The manufacturer does well by doing good: prices are lower and volume higher than they would be had it not employed the pricing flexibility of a rebate scheme.

C. From *per se* illegality to rule of reason and modified *per se* legality rule

It should be clear from the discussion above that there is no support in economics for a formalistic approach to the analysis of loyalty rebates. Economic theory does not support a *per se* illegality standard for rebate schemes, even when they involve retroactive discounts and long reference periods. A *per se* illegality standard will lead to many false positives, condemning rebate schemes that are socially efficient. Furthermore, it will force dominant firms to search for means to achieve those efficiencies that, though less desirable from a private or social viewpoint, are not subject to the rigours of Article 82: for example, vertical integration.

Economic theory does not support a *per se* legality standard either: loyalty rebates may have pro and anti-competitive effects. In this case, as in many others, economic theory supports a rule of reason approach where the pro-competitive and anti-competitive effects of the use of loyalty rebates are balanced. It also supports an effects-based analysis: loyalty rebates should be assessed on the basis of their effects (actual or potential), not their form.

Economic theory also suggests the key steps in a complete and rigorous analysis of whether a particular loyalty scheme is capable of inhibiting competition. For each customer, one would need to (a) determine what portion of the customer's needs is assured for the dominant firm; (b) calculate the average incremental price faced by the customer for its residual 'contestable' purchases, under the dominant firm's loyalty rebate scheme; and (c) conduct a price- cost comparison to determine whether an equally efficient competitor would be able to compete profitably against this average incremental price. Then, one would need to extend this analysis across all customers, in order to determine the aggregate effect of the rebate. Finally, one would need to balance the potentially exclusionary effects of the rebates with the efficiencies it generates.

While this analytical framework may be theoretically correct, it is far from straightforward to carry out. First, there are a number of measurement issues that are quite unclear: how to draw the line between assured and contestable sales; how to deal with uncertainty when calculating the average incremental price; what measure of cost should be used in this analysis; what proportion of the market needs to be foreclosed to a rival through loyalty rebate schemes for there to be an abuse? Second, even if all issues were resolved satisfactorily one would still have to deal with the most difficult problem

of all: the balancing of the pro- and anti-competitive effects of the loyalty rebates. A task for which economists and non-economists are not well equipped as practice demonstrates once and again.

If *per se* rules do not work and rule of reason is not feasible, what then? The logical adoption is to adopt a modified *per se* legality rule, where loyalty rebates are presumed pro-competitive and efficient, unless there is overwhelming evidence that the loyalty rebate scheme is capable of excluding efficient competitors to the ultimate detriment of consumer welfare.

## **VI. Policy Recommendations**

The following conclusions can be summarised from the above:

- (i) to avoid counterproductive application of competition policy there must be an effects-based approach to any assessment of behaviour under Article 82 EC;
- (ii) *per se* rules and presumptions of illegality should be avoided;
- (iii) an effects-based approach should take into consideration both actual and likely potential effects;
- (iv) for the sake of legal certainty, safe harbours should be adopted that could include the following:
  - rebates requiring customers to source 50% (or less) of their requirements from the dominant firm with a reference period of 3 months or less;
  - progressive quantitative rebates with the increased rebate being applied only to the final tranche;
  - progressive quantitative rebates with the increased rebate being rolled back to all purchases;
- (v) for the sake of legal certainty, if experience indicates that particular types of rebate present problems when applied in particular industries, then it should be possible to create appropriate presumptions of illegality using secondary legislation.

## **Price Discrimination under Article 82(c) EC: Clearing up the Ambiguities**

Damien Gerard<sup>\*</sup>

### **I. Introduction**

At last, an issue on which lawyers and economists seem to agree: price discrimination is an ambiguous concept. Its welfare effects on consumers are generally uncertain; the contours of its legality are unclear. From a legal perspective, price discrimination seems to be prohibited, at EU level, by Article 82(c) of the EC Treaty ("EC"), which reads as follows:

"Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in: [...] (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage; [...]"<sup>1</sup>

Non-discrimination is a cornerstone principle of the EC Treaty: it lies at the heart of the market integration provisions of the Treaty and extends to all types of discrimination based on nationality (Article 12 EC). In general, the principle of non-discrimination or equal treatment requires persons in the same situation to be treated in the same way and, conversely, persons in different situations to be treated differently. Although it proceeds from the same reasoning, price discrimination is, however, a peculiar concept. As Waelbroeck wrote, "business firms cannot realistically be required to treat all their customers in the same manner [because they need to] adapt to different marketing

---

<sup>\*</sup> Member of the Brussels and New York Bars; fellow of the Global Competition Law Center Young Professional Programme. This article has benefited from the invaluable input of Penelope Papandropoulos, Giulio Federico and Cristina Caffara on the economics of price discrimination and from various contributions and comments by Kurt Haegeman, Gloria Crichlow, Betina Volpi, Ritter Lennart, Damien Geradin and Robert O'Donoghue.

<sup>1</sup> Article 82 EC (a), (b) and (d) read as follows: (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions; (b) limiting production, markets or technical development to the prejudice of consumers; [...] (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

environments, respond to competitive pressures and, generally, remain competitive”.<sup>2</sup> Article 82(c) EC also differs from all other anti-discrimination principles of the EC Treaty in that it is applicable horizontally, *i.e.* among private entities. Section II, below, analyzes in greater depth the legal and conceptual framework of price discrimination.

Price discrimination is also a peculiar concept from an economic point of view. Although it may, in theory, be optimal in terms of aggregate allocative efficiency,<sup>3</sup> its actual welfare effects for consumers are ambiguous, especially for those whose demand is particularly inelastic. Price discrimination generally allows firms to increase their profits above what may be obtained from uniform pricing, to exploit economies of scale in full and to efficiently recover fixed costs. It may, likewise, allow access to goods to additional categories of buyers, encourage increased output and bring to consumers the benefit of reduced long run average costs. As explained in Section I, below, it is crucial, from a welfare and an antitrust policy perspective, to appreciate the relationship between price discrimination and output.

The notion of price discrimination embraces a broad range of trading conducts, the word “price” including anything that might be translated into a price advantage. In general terms, price discrimination is often defined as a situation in which a firm charges different prices to different buyers for the same product and where the difference in prices does not correspond to the difference in the cost of supplying the product. Empirically, it is easy to see that price discrimination is a pervasive phenomenon and that consumers encounter it almost every day. From an antitrust perspective, discrimination is also all around. It is difficult to think of abusive conduct, whether exploitative or exclusionary, prohibited under Article 82 EC that would not be discriminatory or entail some sort of discriminatory feature. Excessive or predatory prices are hardly applied across the board and tying practices, refusals to deal or issues of access to essential facilities raise most of the time a question of discrimination. Yet, if discrimination is a factor, possibly an important one,<sup>4</sup> present in most types of abuses, is it or should it be treated as a distinct type of abuse? Does a category of discriminatory abuses exist that differs from the well-known exploitative and exclusionary types of abusive conduct? This paper argues the negative: price discrimination should be held abusive only to the extent that it entails a distortion of competition, that is exploitative or exclusionary effects similar to those caught under Article 82(a) or (b) EC.

---

<sup>2</sup> M. Waelbroeck, “Price discrimination and rebate policies under EU competition law”, (1995) *Fordham Corp.L.Inst.* 148.

<sup>3</sup> A situation of so-called “perfect price discrimination”, where the producer sets prices according to its customers’ exact willingness to pay, would be optimal from an allocative efficiency point of view, because the producer would be encouraged to maximize output, *i.e.* to produce until marginal revenue equals marginal cost.

<sup>4</sup> While pointing at the fact that discrimination is often linked to other anticompetitive conducts, Temple Lang suggests that discrimination may actually “make the other conduct possible, [...] reinforce the anticompetitive or exploitative effect of the other conduct or [...] take advantage of that conduct”. He adds that “in each case the harm to consumer welfare is likely to be significantly greater than if the anticompetitive conduct was not accompanied by discrimination” (see J. Temple Lang, “Anticompetitive non-pricing abuses under European and national antitrust law”, (2004) *Fordham Corp.L.Inst.* 270).

Most price discrimination cases dealt with so far by the Commission or the EU courts have involved so-called “discrimination on grounds of nationality”, *i.e.* discrimination resulting not so much in anticompetitive than in protectionist effects. Prohibiting price discrimination on alleged grounds of nationality on the part of private economic actors as an abuse under Article 82(c) EC is ill-conceived. The case-law of the European Court of Justice (hereinafter “ECJ”) demonstrates that only State-owned or -related entities have been found guilty of protectionist price discrimination. These cases would be better treated under free movement provisions of the EC Treaty or Article 86 EC; they are a matter of Member States’ responsibility, not of abusive conduct by independent undertakings. Likewise, case-law shows that price discrimination supposedly “aimed at partitioning the common market” has been narrowly related to contractual or other devices aimed at preventing arbitrage, *i.e.* the resale by low-price purchasers to purchasers to whom a higher price is charged. That type of anticompetitive practice has been traditionally dealt with under Article 81 EC and the rules applicable to vertical agreements. As a result, the mere fact that a dominant company applies dissimilar conditions to equivalent transactions with trading parties located in different Member States should not be considered abusive under Article 82(c) EC, in the absence of an established distortion of competition.

The Commission is currently engaged in a comprehensive review of its policy under Article 82 EC with the view to clarifying its approach towards unilateral conducts. This paper aims at feeding the current debate on Article 82 EC enforcement and, to that end, delivers a very clear message: with firmly established principles under Article 82 (a) and (b) EC, a solid rule against vertical agreements preventing arbitrage under Article 81 EC and practicable rules preventing protectionist state measures to free trade within the common market, there is no need for a rule, hardly manageable and susceptible to inhibit legitimate pricing behavior, prohibiting the mere “application of dissimilar conditions”, as a distinct type of abuse. Conversely, the Commission should make clear that price discrimination may constitute an abuse under Article 82(c) EC only to the extent that it results in a distortion of competition among the dominant firm’s trading parties. This conclusion is supported by the analysis performed in Section III, below.

## **II. The Economics of Price Discrimination**

Under economic theory, a seller price discriminates by charging price markups over marginal cost that vary across the customers of identical or closely related products. To be effective, price discrimination usually requires three conditions: (i) some form of market power, (ii) some form of knowledge of consumer’s willingness to pay and the ability to segment the market accordingly and (iii) the possibility to discourage or prevent arbitrage, *i.e.* “resale” (through contractual devices or vertical integration).<sup>5</sup>

Price discrimination has ambiguous welfare implications. It can be beneficial if it allows monopolists to expand output beyond the level set at a uniform price, by allowing more consumers to access the goods or services in question. It can, likewise, encourage price

---

<sup>5</sup> M. Motta, *Competition Policy - Theory and Practice*, Cambridge, 2004, p.492, citing Varian (1989).

competition; if a dominant supplier cannot discriminate, a buyer would, in theory, not gain competitive edge through price negotiation and the supplier will have greater incentive to resist price reductions.<sup>6</sup> However, price discrimination also implies an appropriation of the consumer surplus, or part of it, by the producer and quantity increases are typically necessary for an aggregate welfare gain to occur in the short- or medium-term. As Motta underlines, “economic theory shows that price discrimination unambiguously reduces welfare only when it does not raise total output, whereas the sign of welfare change is ambiguous in all other cases”.<sup>7</sup> Economists traditionally distinguish three types of price discrimination -first degree, second degree and third degree- according to a classification attributed to Pigou.<sup>8</sup> The ability to implement these types of price discrimination depends on firms’ capacity to identify customer characteristics and the pricing tools at their disposal. These types of price discrimination have been primarily devised and analyzed in a monopoly context.

#### A. First degree price discrimination

First-degree price discrimination means that a monopolist sells different units of output for different prices and these prices differ across customers according to their precise willingness to pay. The seller therefore charges each customer exactly the maximum that he or she would be willing to pay. This is known as “perfect price discrimination”.<sup>9</sup> This situation is optimal from an allocative efficiency point of view, because the producer will be encouraged to maximize output, *i.e.* to produce until marginal revenue equals marginal cost. Thus the result of first-degree price discrimination is the same as under perfect competition; it is efficient, though not “equitable” from a consumer point of view. Indeed, it implies that the producer actually ends up getting all the consumer utility from consumption (*i.e.*, the area under the customer’s demand schedule) and may thereby substantially increase profits.

Perfect price discrimination is an idealized concept and there are few real-life examples of it, in particular because it is costly in terms of information and because of the need to prevent arbitrage, *i.e.* the resale by low-price purchasers to purchasers to whom a higher price is charged. Varian suggests that a close example would be “something like a small-town doctor who charges his patients different prices, based on their ability to pay”.<sup>10</sup> Others mention road-side fruit sellers or markets where prices are set by individual negotiations. On the other hand, the perfect price discrimination model illustrates one of the main possible effects of price discrimination, namely an increased aggregate efficiency, which may however result in lower consumer welfare relative to linear or uniform pricing.

---

<sup>6</sup> “The Reform of Article 82: Recommendations on Key Policy Objectives”, Speech by Dr. A. Fletcher, Chief Economist of Fair Trading, Competition Law Forum, Brussels, March 15, 2005 (available at [www.offt.gov.uk/Speeches+and+articles/2005/index.htm](http://www.offt.gov.uk/Speeches+and+articles/2005/index.htm)).

<sup>7</sup> See M. Motta, *supra* note 5, at p.496.

<sup>8</sup> A.C. Pigou, *The Economics of Welfare*, 1920 (pt.2, ch.17), cited by L. Philips, *The Economics of Price Discrimination*, Cambridge Univ. Press, 1983, p. 11.

<sup>9</sup> M. Motta, *supra* note 5., p.492.

<sup>10</sup> H.R. Varian, *Intermediate Microeconomics, A modern approach*, Norton&Co., 1987, p.431.

B. Second degree price discrimination

Under second degree price discrimination, a firm offers different baskets of output for different prices but leaves the buyer to self-select one particular deal that is offered. Second-degree price discrimination typically entails different prices set according to the quantity purchased. The characteristic that distinguishes second-degree price discrimination is that prices do not depend on the identity of the customer,<sup>11</sup> *i.e.* do not vary “across people”.<sup>12</sup> It may result from the fact that if a seller has some information about the heterogeneity of buyers’ preferences, it may be, however, unable to (or it is too costly to) observe the characteristics of each buyer in particular.<sup>13</sup> This form of price discrimination, a typical case of nonlinear pricing, is for instance commonly used by public utilities in selling electricity according to quantities bought and by other industries which offers bulk discounts for large purchases,<sup>14</sup> as well as in some end-consumers’ sales in supermarkets (*e.g.*, family packs). Other examples of second degree price discrimination include airfares or, generally, bundle or tie-in sales, whereby a producer charges more to customers with a low value for one good but a high value for the other.

In terms of welfare, self-selection may lead to welfare losses for “low types” (small, less informed, etc.) customers, but tends to be efficiency-enhancing by expanding output for high-consumption customers in particular. Second-degree discrimination is relatively unproblematic from an antitrust point of view, as it tends to be cost-reflective. Some forms of quantity rebates (*e.g.* retroactive rebates) have, however, recently attracted antitrust scrutiny in spite of being instances of second-degree price discrimination.

C. Third degree price discrimination

Under third degree price discrimination, different groups of customers are charged different prices according to observed elasticity differences among them, which often equate to demographic characteristics. In this scenario, a profit-maximizing firm would have the incentive to follow an “inverse elasticity rule” vis-à-vis each of these groups, *i.e.* charge a higher price to those whose elasticity is low and a lower price to those who have a more elastic demand.<sup>15</sup> This is the most common form of price discrimination and requires that, by definition, market segments have different elasticity of demand and that producers are able to identify and separate these segments. Third-degree price discrimination also provides a framework of analysis for time or geographic discrimination. Classic examples of third-degree discrimination include cheaper tickets at theaters for younger customers, differential bus ticket prices for students or elderly

---

<sup>11</sup> L.M.B. Cabral, *Introduction to Industrial Organization*, MIT Press, 2000, p.170.

<sup>12</sup> H.R. Varian, *supra* note 10, Norton&Co., 1987, p.430.

<sup>13</sup> L.M.B. Cabral, *supra* note 11, MIT Press, 2000, p.169.

<sup>14</sup> H.R. Varian, *supra* note 10.

<sup>15</sup> This is known as “Ramsey pricing”; see, originally, F. Ramsey, “A Contribution to the Theory of Taxation”, (1927) *Econ. Journ.* 47.

people, different subscription prices being charged to libraries and individuals. In all these instances, it is implied that demand by adults, middle aged people or libraries would be more inelastic.

The ambiguous consumer welfare effect of third-degree price discrimination is self-evident: if it may increase output and allow an entire new category of customers to have access to the good in question, it will inevitably also cause customers allocated to higher price segments to support welfare losses compared to a situation of uniform pricing. In a “real-life” study of price discrimination in a Broadway theatre, Leslie finds, however, that uniform pricing, relative to the existing price discrimination policy, implies lower overall attendances for the play without significantly altering the consumer surplus, and concludes that “the lack of concern by antitrust enforcement agencies [in the US] for price discrimination in final goods may be well founded”.<sup>16</sup>

#### D. The ambiguous welfare effect of price discrimination

The three models presented above capture the essence of the ambiguity of price discrimination and of the trade-offs it leads to, as Cabral puts it, between (i) efficiency (which favors price discrimination) and consumer welfare (which tends to favor uniform pricing) and (ii) “fairness” (which favors uniform pricing) and the objective of making the good accessible to as many consumers as possible (which favors price discrimination). He adds that “if distribution between firms and consumers, as well as across consumers, is an important issue, then a case can be made for disallowing price discrimination”.<sup>17</sup> It also should not be forgotten that price discrimination may have important social benefits (*e.g.*, cheaper bus tickets for elderly people) and positive long-term effects if it enables firms in the decreasing part of the average cost curve to exploit economies of scale in full and reduce their average costs over time.

All debates surrounding the welfare effects of price discrimination end up focusing on the same issue:<sup>18</sup> does discrimination result in an increase of output, which may counteract, from a welfare point of view, the higher prices imposed to certain customer groups? In turn, are there some features or guiding principles suggesting that price discrimination by certain firms is more likely to result in a rise in production? These questions should guide the effort to define “harm to competition” under Article 82(c) EC.

---

<sup>16</sup> P. Leslie, “Price discrimination in Broadway Theatre”, (2004) *RAND Journal of Economics* 520.

<sup>17</sup> L.M.B. Cabral, *supra* note 11 at p.181.

<sup>18</sup> So far, much of the economic intuition and work on price discrimination is centered around the monopoly case, where there is no competition to the firm that is discriminating. The economic literature on “competitive price discrimination” is relatively recent and, unsurprisingly, states that the welfare effects of price discrimination are ambiguous: it may encourage greater competition for marginal/contestable consumers but may also prevent some of these efficiency gains from benefiting infra-marginal consumers and may support exclusionary pricing strategies (*e.g.*, selective price cuts). See J. Vickers, Abuse of Market Power, Speech to the 31st conference of the European Association for Research in Industrial Economics, Berlin (Sept.3, 2004).



Posner has explained that price discrimination is most likely to expand output when the seller has declining average total costs and when it “may even find it impossible to cover those costs without discriminating”.<sup>19</sup> This is typical for goods with strong intellectual property (“IP”) content; as the marginal cost of intellectual property tends to be lower than its average total cost, price discrimination is an attractive strategy for increasing output while covering total costs. Ridyard has described how expanding output through price discrimination is, in real life, a feature peculiar to most businesses encountering the problem of fixed cost recovery, that is, firms that incur large fixed costs and then seek to recover those costs through the sale of goods whose production relies on the fixed cost investments.<sup>20</sup> These firms, when also facing different market segments to which they sell their products, will tend to charge different prices to these different segments, although the cost of supplying them is not necessarily different, in order to obtain some surplus of revenue over costs. In turn, those firms have incentives to expand production and price down towards marginal costs to secure sales and -even limited- margins that they would not otherwise achieve but that could usefully contribute to their long term profitability. Ridyard’s finds that “there is virtually no industry that makes worthwhile investment [and that could come under Article 82 scrutiny, *i.e.* dominant companies] and that does not exhibit some characteristics of fixed cost recovery”.<sup>21</sup> Prohibiting price discrimination, which allows for fixed price recovery, could therefore greatly hinder legitimate and efficient pricing behavior. Mindful of that risk, the U.K. Office of Fair Trading’s conduct guidelines emphasize that to appreciate the welfare effects of price discrimination, it is relevant “to consider whether the pricing structure in question allows the efficient recovery of fixed costs and expands demand substantially or opens up new market segments.”<sup>22</sup>

It results from the above that economic theory identifies significant welfare benefits associated with price discrimination, as well as the possibility for welfare losses. It is, moreover, difficult to predict the kinds of industries in which welfare will be enhanced or reduced by price discrimination, save that welfare enhancing effects may be more likely in industries involving fixed costs recovery. Economics therefore suggests that price discrimination (i) should not be *per se* unlawful and (ii) is either beneficial or too ambiguous as to merit *ex ante* prohibition where it increases output and/or access to the goods or services, or facilitates fixed costs recovery in high fixed costs industries. Where price discrimination is shown to reduce output and to lack cost recovery justification, legal certainty and the risk of deterring firms from engaging in pro-competitive conduct require that clear rules be defined to determine under which circumstances it is likely to be illegal. Because the restriction of output is at the core of the welfare effects analysis of price discrimination, as it is to the general notion of abuse under Article 82 EC, it is suggested that, from a legal perspective, price discrimination should be assessed, like any type of potential abuse, on the basis of its exclusionary and/or exploitative effects. Accordingly, price discrimination should be held abusive only if it distorts competition,

---

<sup>19</sup> R. A. Posner, *Antitrust law*, Chicago Press, 2001 (2<sup>nd</sup> ed.), p.83.

<sup>20</sup> D. Ridyard, “Exclusionary Pricing and Price Discrimination Abuses under Article 82 – An Economic Analysis”, (2002) 25 *E.C.L.R.* 287.

<sup>21</sup> D. Ridyard, *id.*

<sup>22</sup> OFT Technical Guidelines; Assessment of Individual Agreements and Conduct, 3.1-3.16.

*i.e.*, entails anticompetitive effects, and not if it merely results from the application of different prices to similar transactions causing some “disadvantage” to customers competing against one another. Although the Commission did again recently, in the *Clearstream* case,<sup>23</sup> take a different stance, it should now clarify, in light of economic theory, that price discrimination is abusive only to the extent that it actually distorts competition.

### III. Price Discrimination as a Legal Concept

Cabral points to the fact that the analysis of price discrimination is further complicated by the fact that, both in the US and in the EU, public policy toward it has been driven by considerations that differ by far from the economic principles outlined hereinabove.<sup>24</sup> The present section, after reviewing some basics of the law against discrimination, thoroughly examines the legal framework for the enforcement of Article 82(c) EC, as well as other statutory provisions dealing with price discrimination in other jurisdictions. It also discusses the main ambiguities surrounding the enforcement to date of Article 82(c) EC.

#### A. The principle of non-discrimination

Non-discrimination is a fundamental right within the Community legal order, enshrined in Article 20, 21 and 23 of the EU Charter of Fundamental Rights (and in chapter II of the draft Constitution for Europe) under the heading “equality”. In the words of the ECJ, “the prohibition of discrimination [...] is merely a specific enunciation of the general principle of equality which is one of the fundamental principles of Community law [and] requires that similar situations shall not be treated differently unless discrimination is objectively justified”.<sup>25</sup> Discrimination is largely prohibited in EC internal market law, under the rules on free movement of goods, persons, services and capital, unless the observed difference in treatment is “objectively justified” or “not arbitrary”, *i.e.* necessary, legitimate and proportional. With respect to the international movement of goods and persons, commentators suggest that the principle of non-discrimination has emerged from the practice of states and international organizations as a general principle of international law.<sup>26</sup>

---

<sup>23</sup> Commission decision of 2 June 2004, *Clearstream*, not yet published but available at [www.europa.eu.int/comm/competition/antitrust/cases](http://www.europa.eu.int/comm/competition/antitrust/cases). In *Clearstream*, the Commission found the application of different per transaction tariffs for primary clearing and settlement services to Central Securities Depositories (CSD’s), on the one hand, and Euroclear (an International Central Securities Depository), on the other hand, to be abusive. The Commission reached that conclusion after it concluded that the observed price difference lacked objective cost justification; it did not establish, however, that competition between Euroclear and CSD’s had been distorted as a result of the different prices they were charged for Clearstream’s services. In other words, it derived harm to competition from the mere observance of price differences.

<sup>24</sup> L.M.B. Cabral, *supra* note 11 at p.182.

<sup>25</sup> Joined Cases 117/76 and 16/77, *Ruckdeschel*, [1977] E.C.R. 1753, para. 7.

<sup>26</sup> See e.g., J.-P. Colin and M. Sinkondo, *Principe de non-discrimination et protection de la concurrence en droit international et en droit communautaire*, (1993) *Rev. Marché Com.* 37.

Broadly speaking, the principle of non-discrimination or “equal treatment” requires persons in the same situation to be treated in the same way and persons in different situations to be treated differently. That principle is not an abstract rule of law, but an objective concept narrowly tied to the factual circumstances of each case. Hence, most of the ECJ’s judgments dealing with the concept of discrimination have revolved around the requirement that like should be treated in a like manner and unlike in an unlike manner, as well as around the possibility that the unequal treatment be justified, *i.e.* not arbitrary. Schwarze<sup>27</sup> [...] reports that the first attempt to define, in EC law, the concept of “like treatment of like matters” goes back to 1956 and a decision of the ECJ dealing with a discriminatory levy imposed on imported coal where it expressly referred to then Article 60(1) ECSC “which indicates that practices involving [...] the application of dissimilar conditions to comparable transactions are discriminatory”.<sup>28</sup>

The wording of Article 82(c) EC has presumably been influenced by that of Article 60(1) of the defunct ECSC Treaty, which reads as follows: “Pricing practices contrary to Articles 2, 3 and 4 shall be prohibited, in particular: [...] discriminatory practices involving, within the common market, the application by a seller of dissimilar conditions to comparable transactions, especially on grounds of the nationality of the buyer”. In practice, that provision aimed at prohibiting, on the one hand, unfair discriminatory pricing practices of a purely temporary or local nature aimed at the acquisition of a monopoly position within the common market (*i.e.*, exclusionary) and, on the other hand, discriminatory practices involving the application by the seller of dissimilar conditions to comparable transactions, especially on grounds of the nationality of the buyer. Article 60 ECSC aimed first and foremost to guarantee customers equal access to the fundamental inputs of coal and steel.<sup>29</sup> To that effect, sellers were required to publish their price lists (Article 60(2) (a) ECSC) and were free to align their quotations to meet competitors prices, so that customers could secure the most advantageous delivery terms. Article 60 ECSC was implemented by Decision 30/53 of the High Authority<sup>30</sup> which stated that (i) “transactions are comparable if they are concluded with competing purchasers, involve the same or similar products and their other relevant commercial features do not essentially differ” and (ii) “conditions are dissimilar if the price differs *appreciably* from the price published” (emphasis added). Under that regime, the seller was bearing the burden of proving that transactions were not comparable, that prices were not essentially different (*i.e.*, proportional) and that differences were justified.<sup>31</sup> It is evident from the focus on national discrimination in Article 60 ECSC that its enactment was motivated by public policy considerations to ensure that essential economic inputs were available on “non-discriminatory terms”. The EC Treaty introduced another dimension to the

---

<sup>27</sup> J. Schwarze, *European Administrative Law*, Sweet & Maxwell, London, 1992, p.564.

<sup>28</sup> Joined Cases 7 and 8/54, *Groupement des Industries Sidérurgiques Luxembourgeoises v. High Authority*, [1954-1956] E.C.R. 53 at 94.

<sup>29</sup> Note that the major concern underlying the adoption of the US Robinson-Patman Act was to avoid that large buyers -mainly chains- may use their size and power to extract from sellers prices lower than their small competitors can obtain, thereby causing smaller firms to lose sales and the unable to compete effectively. See E. M. Fox and L.A. Sullivan, *Antitrust*, West Publ., 1989, p.714.

<sup>30</sup> (1954) O.J. L 217, as amended by Decision 72/440/ECSC, [1972] O.J. L 297/39.

<sup>31</sup> First Report on Competition Policy, points 101-105 and Second Report, point 12.

European project -the creation of a general single market- and Articles 81 and 82 were introduced to secure that effective competition within that single market would not be distorted. The emphasis on competitive disadvantage in Article 82(c) EC also suggests that it was not intended as an absolute non-discrimination rules in private commercial dealings.

Waelbroeck has pointed to the “apparent contradiction between what appears to be a fundamental principle of Community law [equal treatment] and the requirements of business life”.<sup>32</sup> Important differences exist between the principle of equal treatment elevated by the ECJ to the status of “superior rule of law *protecting individuals*”<sup>33</sup> (emphasis added) and instances of price discrimination by and among private undertakings. It is acknowledged, indeed, that the principle of equal treatment, even in economic matters, is primarily aimed at State (or the Community Institutions’) conduct towards “individuals”, *i.e.* vertical relations, and excludes decisions and behaviors by companies, *i.e.* horizontal relations.<sup>34</sup> Hence, firms are generally not subject to such a “superior rule of law” and, absent specific prohibition, should be free to discriminate in their own commercial behavior, on the basis of the fundamental freedom to contract.<sup>35</sup> Article 82(c) EC should therefore be understood not so much as one instance of the application of a fundamental principle of non-discrimination than as belonging to the antitrust framework of analysis applicable to unilateral conducts. In other words, it should be interpreted according to the rules, principles and policies of competition law, which do not aim to ensure equal treatment of all market actors but, on the contrary, to foster the competitive process. Hence, instances of price discrimination should be consistently assessed under Article 82(c) EC on the basis of their exclusionary and/or exploitative effects.

#### B. Price discrimination as an abuse of market power

Article 82(c) EC is said to deal with one instance of abusive unilateral conduct by dominant companies. For discriminatory pricing to be eventually considered unlawful, it is thus first necessary to demonstrate that the discriminating firm holds substantial market power. Conversely, a company that does not hold a dominant position is free to set its prices unilaterally at the level it wishes. Although it may seem evident, that feature distinguishes Article 82(c) EC from what is too often considered as its US equivalent, the Robinson-Patman Act. It also makes Article 82(c) EC distinct from some Member States’ law, such as Article 20(4) of the German Act against Restraints of Competition and Article 442-6(I)(1) of the French Commercial Code.

---

<sup>32</sup> M. Waelbroeck, *supra* note 2, p. 148.

<sup>33</sup> See e.g. Case 50/86, *Grands Moulins de Paris*, [1987] E.C.R. 4857, at 10.

<sup>34</sup> J.P. Colin and M. Sinkondo, *supra* note 26, p. 55.

<sup>35</sup> Although an evolution towards horizontal effect of the non-discrimination principle has emerged, it results essentially from a functional approach of the original vertical effect, *i.e.* the extensive interpretation of the notion of “State” conduct. See e.g., Case 251/83, *Haug-Adrion*, [1984] E.C.R. 4277.

From an economic point of view, it has been explained above that, in theory, some form of market power is always necessary to entitle firms to price discriminate. Bork emphasizes, however, that “*price discrimination poses a consumer welfare problem only when it is relatively stable, and that will occur only when the seller has monopoly power*”, i.e. substantial market power.<sup>36</sup> Motta explains by the negative that firms with little market power have also very limited ability to have an impact on market prices through discriminatory practices.<sup>37</sup> The requirement that substantial market power be demonstrated to hold economic discrimination abusive seems therefore rooted in sound economics. Still, was price discrimination originally condemned for reasons related to possible output restrictions? Probably not. At least in some countries or, at the EC level, under the former ECSC Treaty, as outlined above, political economy and fairness certainly motivated the enactment of such laws. Hence, it is of great interest to survey the underlying motivation of those regulations that do not require full-fledged dominance to label price discrimination as potentially abusive. The section below offers a quick overview of the laws against discriminatory prices in three jurisdictions that, in different ways, do not directly correlate price discrimination with market power.

#### 1. Germany

According to Section 20 (1) of the German Act against Restraints of Competition,<sup>38</sup> dominant undertakings and associations of undertakings “shall neither directly hinder in an unfair manner other undertakings engaged in business activities open to similar undertakings, nor directly or indirectly treat them differently from similar undertakings, nor [...] grant them preferential terms without any objective justification”.<sup>39</sup>

Interestingly, the prohibition of “unfair hindrance” through discriminatory terms applies, under German law, not only to dominant companies but also to undertakings or associations of undertakings holding a so-called “superior” market position (Section 20(4)), to the extent that small or medium-sized enterprises depend on them, as suppliers or purchasers, in such a way that sufficient or reasonable alternatives of resorting to other undertakings do not exist. SME-suppliers are presumed to depend on a “superior” purchaser if the latter regularly obtains from it, in addition to normal consideration, special benefits which are not granted to similar purchasers. Likewise, it is presumed that SME-purchasers, on the other hand, may be greatly hurt by discriminatory conditions from suppliers on which they are dependent. This provision, which, like Article 442-6(I)(1°) of the French Commercial Code, resorts to the concept of “abuse of economic dependency”, relies on the notion of “obligatory trading partner” which may be, but not always is, tantamount to a dominant position under EC competition law.

---

<sup>36</sup> R. Bork, *The Antitrust Paradox*, New York, the Free Press, 1993 (2<sup>nd</sup> ed.), p.395.

<sup>37</sup> M. Motta, *supra* note 5, Cambridge, 2004, p.492.

<sup>38</sup> Available at <http://bundesrecht.juris.de/bundesrecht/gwb/index.html>

<sup>39</sup> “Marktbeherrschende Unternehmen, Vereinigungen von Unternehmen im Sinne der §§ 2 bis 8, 28 Abs. 1 sowie § 29 und Unternehmen, die Preise nach den §§ 15, 28 Abs. 2, § 29 Abs. 2 und § 30 Abs. 1 binden, dürfen ein anderes Unternehmen in einem Geschäftsverkehr, der gleichartigen Unternehmen üblicherweise zugänglich ist, weder unmittelbar noch mittelbar unbillig behindern oder gegenüber gleichartigen Unternehmen ohne sachlich gerechtfertigten Grund unmittelbar oder mittelbar unterschiedlich behandeln.”

Instances of unlawful price discrimination by dominant undertakings are reported to have consisted in below-cost sales, refusal to supply or refusal of access to a network, *i.e.* classic instances of abuse, the abusive character of which was reinforced by their discriminatory application. Discriminatory practices by “superior” firms have been found abusive mainly in relation to the supply of branded goods. The German Federal Court has apparently stated in various cases, however, that a dominant company is under no duty to charge uniform prices.<sup>40</sup>

## 2. France

Pursuant to Article 442-6 (I) (1) of the French Commercial Code (“Article 442-6”), any person engaged in commerce, excluding consumers, may be held civilly liable if it “practices or obtains from an economic partner discriminatory prices, payment terms, sales conditions or purchase modalities, not justified by effective considerations and creating thereby, for that economic partner, a competitive advantage or disadvantage”. This provision is peculiar not only because of the absence of any express market power requirement for price discrimination to be held illegal, but also because both the grantor of the discriminatory favor and the grantee can be held liable for damages on that basis. The assessment of the existence of a discriminatory practice requires a finding of a difference of treatment imposed to economic actors placed in identical situations. Such difference of treatment can be justified, however, if they amount to an “effective consideration” for, *e.g.*, the purchase of large quantities, the agreement to a long-term contract or the acceptance by the purchaser of bearing the risks associated with the transaction (the last two examples being hardly quantifiable, however). Despite its strict terms, Article 442-6 does not therefore hold price discrimination *per se* illegal. Still, the French Supreme Court has ruled that the requirement to benefit from a competitive advantage or suffer from such a disadvantage was deemed to result from the discriminatory treatment itself and was thus not an autonomous condition. Lower courts seem to agree, nonetheless, that offering preferred terms in view of matching a competitor’s offer may be justifiable.

Article 442-6, which is rarely enforced by the French competition authorities but is frequently invoked in private commercial litigation, is supplemented by Article L.420-1 of the French Commercial Code, which deals with discriminatory abuses of market power in a way similar to Article 82(c) EC. Still, this section is odd because it also sanctions so-called “abuses of economic dependency”, similar to Section 20(4) of the German Act

---

<sup>40</sup> See the cases cited by M. Lorenz, M. Lübbig and A. Russell, “Price Discrimination, a Tender Story”, (2005) *E.C.L.R.* 355, 360: Case KZR 1/95, March 19, 1996, GRUR 1996, 808; Case KZR 13/02 and KZR 14/02, February 10, 2004, available at [www.bundesgerichtshof.de](http://www.bundesgerichtshof.de).

against Restraints of Trade.<sup>41</sup> The latter is held abusive, however, only insofar as it is “susceptible to affect the functioning or the structure of competition.”<sup>42</sup>

### 3. The United States

The United States’ price discrimination law<sup>43</sup> was enacted in 1936, in the middle of the Great Depression, to strengthen the Clayton Act’s prohibitions against discriminatory pricing.<sup>44</sup> Section 2(a) of the Act makes it unlawful “for any person engaged in commerce in the course of such commerce, [...] to discriminate in price between different purchasers of commodities of like grade and quality where either or any of the purchasers involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States [...] and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants, or knowingly receives the benefit of such discrimination, or with customers of either of them.”<sup>45</sup>

The Robinson-Patman Act has been interpreted as prohibiting price differences applied by “any person engaged in commerce”, *i.e.* regardless of whether it holds market power, to reasonably contemporaneous transactions in physically identical tangible goods.<sup>46</sup> Moreover, the Supreme Court, in *FTC v. Morton Salt Co.*,<sup>47</sup> created what is referred to as the “inference of injury test”, pursuant to which injury to competition is established *prima facie* by proof of a substantial price discrimination between competing purchasers over an extended period of time.

US price discrimination law admits two statutory and one judicial defense to inference of abusive discriminatory pricing. Section 2(a) of the Robinson-Patman Act states that “nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or qualities in which such commodities are to such purchasers sold or

---

<sup>41</sup> The French and German respective specificity of prohibiting abuses deriving from the state of “economic dependency” of one economic actor from another has been largely seen as the underlying reason responsible of the “exception” clause of Article 3(2) of Regulation 1/2003, whereby “Member States shall not [...] be precluded from adopting and applying on their territory stricter national laws which prohibit or sanction unilateral conduct engaged in by undertakings.”

<sup>42</sup> Article L420-2-2 of the French Commerce code reads as follows: “Est en outre prohibée, dès lors qu'elle est susceptible d'affecter le fonctionnement ou la structure de la concurrence, l'exploitation abusive par une entreprise ou un groupe d'entreprises de l'état de dépendance économique dans lequel se trouve à son égard une entreprise cliente ou fournisseur. Ces abus peuvent notamment consister en refus de vente, en ventes liées ou pratiques discriminatoires visées à l'article L. 442-6.”

<sup>43</sup> Price discrimination is peculiar to US federal law, since no individual state has a meaningful price discrimination law.

<sup>44</sup> With his usual verve, Bork considers the adoption of the Robinson-Patman Act to “*constitute what is surely antitrust's least glorious hour*” (R. Bork, *supra* note 35, p.382).

<sup>45</sup> Provisions similar to the Robinson-Patman Act were adopted by other Anglo-Saxon countries, such as Australia which, however, abolished it in 1995.

<sup>46</sup> Conversely, services are beyond the reach of the Act.

<sup>47</sup> *FTC v. Morton Salt Co.*, 334 U.S. 37, 50-51 (1948).

delivered.” In addition, Section 2(b) of the Act provides that a seller can rebut a prima facie case by showing that its lower “price was made in good faith to meet an equally low price of a competitor.”<sup>48</sup> In addition to these statutory defenses, courts have held that there is no unlawful price discrimination if the lower price is “functionally available” to the disfavored purchaser<sup>49</sup> or if the purchasers that receive different prices operate at different functional levels in the production or distribution chain.

The Robinson-Patman Act is becoming largely un-enforced by the US antitrust authorities. The U.S. Department of Justice has adopted a policy that it will defer all price discrimination enforcement to the Federal Trade Commission, for which Robinson-Patman Act enforcement is a very low priority. In the past fifteen years, the FTC has initiated only one price discrimination enforcement proceeding, which was highly controversial.<sup>50</sup> In private litigation, US courts increasingly dismiss price discrimination claims at an early summary judgment stage.<sup>51</sup> Still, the US price discrimination law exists, and companies, particularly those that sell consumer goods, follow the law’s requirements to be certain that potential claims will be easily dismissed.

Political considerations clearly underlie the provisions outlined hereinabove, which all are designed to protect small market players from unfair terms imposed by presumably larger, although not necessarily dominant, undertakings upon which they are either dependent or with which they are simply trading. The legislative history of the Robinson-Patman Act is particularly telling in that respect. In enacting the Act in the middle of the Great Depression, the US Congress was driven by a desire to protect small stores from unfair competition by the nascent large chain stores that it believed were destroying small retailers by demanding and getting preferential prices from their suppliers. Generally, the concerns addressed by these provisions stem from the belief that small companies would be better off under “equal” market conditions. Yet, in real market conditions, the case may be that small companies may in fact be the first beneficiaries of price discrimination if, when unable to pay the full purchase price, discriminatory conditions permit them to access a product or service that, in turn, enables them to develop and offer new services or products and enter new markets. Finally, from a purely legal point of view, it is not self-evident that transactions with small market

---

<sup>48</sup> As the Supreme Court has observed, the “meeting competition” defense requires that the seller offer the lower price in good faith for the purpose of meeting the competitor’s price, that is, the lower price must actually have been a good faith response to that competing low price” (*Falls City Industries*, 460 U.S. at 439).

<sup>49</sup> This defense essentially requires that a competitor of the favored purchaser could have obtained the lower price had it elected to meet certain objective and attainable criteria. In order for the functional availability defense to apply there must have been notice to all competing customers that the lower price was available (*Hanson v. Pittsburgh Plate Glass Industries Inc.*, 482 F.2d 220 (5th Cir. 1973), cert denied, 414 U.S. 1136 (1974)).

<sup>50</sup> Two of the three Commissioners dissented from the necessity to bring an enforcement proceeding and from the analysis of the anticompetitive effects of the pricing involved. See *McCormick & Company Inc.*, File No. 961 0050 (Mar. 8, 2000) at <http://www.ftc.gov/opa/2000/03/mccormick.htm>.

<sup>51</sup> With respect to damages, private plaintiff in a Robinson-Patman Act case must prove that the unlawful discrimination resulted in a diversion of sales to the favored purchaser with a resulting loss of profits to the disfavored buyers, usually a difficult burden to sustain.



players or new entrants, on the one hand, and established competitors, on the other hand, should necessarily be considered equivalent transactions.

A more sophisticated variant of the “equality” argument is that price discrimination hurts competition by giving favored customers an edge in the market that has nothing to do with any superior efficiency on the part of those customers. It is hard to imagine, however, that flat prices or conditions would necessarily result in a more efficient outcome. Moreover, efficiency is first and foremost driven by competition, including competition for the best sales terms.

Before engaging in a closer analysis of the terms of Article 82(c) EC, one should reflect on another aspect of the relation between price discrimination and market power, namely whether market power or dominance may be inferred from the ability to apply different prices and conditions to similar transactions. In other words, can persistent price discrimination, in the economic sense, serve as evidence of market power on the assumption that it is, in theory, inconsistent with perfectly competitive markets? Motta responds in the negative, arguing that it is unlikely that real-world firms lack any market power and that it should be expected that all firms have an incentive to discriminate.<sup>52</sup> In addition, Ridyard points at the fact that the recovery of fixed costs is a common problem for firms in several industries, regardless of whether they enjoy a dominant market position.<sup>53</sup> The OFT Technical Guidelines also recognize that “price discrimination occurs frequently and in a wide range of industries, including industries where competition is effective”.<sup>54</sup> Accordingly, it is safe to assume that, as a matter of enforcement, the mere existence of price discrimination cannot be used as evidence of dominance.<sup>55</sup>

### C. The conditions of price discrimination under Article 82(c) EC

Article 82(c) EC deals with abuses resulting from “*applying dissimilar conditions to equivalent transaction with other trading parties, thereby placing them at a competitive disadvantage*”. It is established that it is also concerned with the “*equal treatment of non-equivalent transactions*”.<sup>56</sup> The term “discrimination” is not expressly used in the wording of Article 82 EC: it only indirectly results from the successful demonstration of four statutory conditions. Although the four conditions are independently analyzed hereinafter, the sequencing of the analysis is inherently blurred by the interference of objective justifications with the determination of the equivalence of the transactions to which dissimilar conditions are applied. Moreover, as Advocate-General Jacobs underlined in *Syfait*, the possibility to provide justifications for practices that have been held abusive is misconceived. If objective reasons can be advanced to justify a specific

<sup>52</sup> M. Motta, *supra* note 5, p.462.

<sup>53</sup> D. Ridyard, *supra* note 18, p.290.

<sup>54</sup> OFT Technical Guidelines [Assessment of Individual Agreements and Conduct], paras. 3.1-3.16.

<sup>55</sup> In the same conclusion is reached by M. Lorenz, M. Lübbig and A. Russell *supra* note 40 at p.356.

<sup>56</sup> See Commission Decision of July 23, 2004 in Case COMP/A.36.568/D3, *Scandlines Sverige AB v Port of Helsingborg*, para.276. See also Commission Decision of 29 March 1994, *Deutsche Bahn*, (1994) O.J. L104/34.

unilateral conduct, it is then “more accurate to say that [the] conduct on the part of a dominant undertaking do not fall within the category of abuse at all”.<sup>57</sup>

1. Dissimilar conditions

The wording of Article 82(c) EC is particularly broad in defining the ways in which discrimination can occur. It may apparently occur through an unlimited number of trading conducts, which can all be translated into a price advantage. Hence, the word “price” discrimination is an appropriate proxy for any type of “dissimilar conditions”. The “dissimilarity”, or simply the “difference”, in the trading conditions applied is appreciated from the point of view of the party to which such conditions are applied. Conversely, circumstances particular to the party that imposes the conditions seem irrelevant in a determination of whether the conditions are actually different.<sup>58</sup>

2. Equivalent transactions

As in any instance where discriminatory treatment is an issue, the core of the test lies in the determination of the equivalence of the situations. The assessment of that equivalence relates both to the nature of the goods or services supplied and to their marketing conditions.<sup>59</sup> Hence, it involves an evaluation of the nature, composition or quality of the products or services concerned, *i.e.* whether they are of “like grade and quality”, as well as of the costs involved in providing them.<sup>60</sup> Yet there may be a myriad of other circumstances that differentiate one transaction from another in the eyes of a “seller”, not all of them regarded as equally relevant for the purpose of assessing their equivalence under Article 82(c).<sup>61</sup> In particular, circumstances that are specific or inherent to the “buyer” tend to be disregarded.

The most obvious and generally accepted reason to conclude that two transactions are not equivalent is the demonstration that they entail different costs for the seller, *e.g.* in terms

---

<sup>57</sup> Opinion of A.G. Jacobs in Case C-53/03, *Syfait et al./Glaxosmithkline*, not yet published.

<sup>58</sup> The fact that a seller realizes different rates of return on sales of the same product to different purchasers does not seem relevant to the determination of the similar or dissimilar character of the trading conditions applied. It may, however, become relevant to demonstrate that the transactions with the different purchasers are not equivalent or that the apparently different treatment imposed on trading parties is objectively justified.

<sup>59</sup> For a case where the Commission found that the transactions compared were *not* equivalent, see Commission Decision of July 23, 2004 in Case COMP/A.36.568/D3, *Scandlines Sverige AB v Port of Helsingborg*, paras. 249 and foll.

<sup>60</sup> Temple Lang and O’Donoghue rightly point that “any industry in which all products or services are adapted to the needs of customers, transactions are never sufficiently ‘similar’ for Article 82(c) to apply” (see J. Temple Lang and R. O’Donoghue, “Defining legitimate competition: how to clarify pricing abuses under Article 82EC”, (2002) *Fordham Inter.L.J.*, pp.83-162).

<sup>61</sup> In the *Clearstream* case referred to above, Clearstream argued that “for the question of discrimination of trading partners, the relevant basis for comparison is not simply the ratio between price and service, but that all circumstances which shape the business relationship, including the different functions, are relevant” (310). The Commission considered that argument but ultimately rejected it by finding that CSD’s and Euroclear were in fact performing essentially the same function on the relevant market, *i.e.* secondary clearing and settlement services with respect to securities issued in accordance with German law.

of delivery. Less evident are the reasons related to the circumstances of the transaction itself, such as its timing. Certainly, the timing of a transaction may influence the related costs, but this is not always the case and one may wonder whether the adoption of a selling scheme making large price differences heavily dependent on the time factor may, as such, render transactions non-equivalent.<sup>62</sup> To differentiate transactions on the basis of circumstances that are specific or inherent to the “buyer” is even more controversial. If reserving benefits to regular customers may seem unproblematic, for instance, granting specific conditions, and discounts in particular, with the view of securing customers’ loyalty is certainly regarded with suspicion.<sup>63</sup> As explained in section II, customers may also value differently the goods or services they are acquiring and, in turn, have a different demand elasticity. As explained earlier, applying different conditions to customers with different demand elasticities is one of the most common ways for producers to expand output, which in turn may enhance welfare and lead to increased competition.<sup>64</sup> Applying different prices in transactions with customers whose financial capacity is different could likewise lead to higher production levels and increased competition. On the contrary, the nationality or the geographic location of a customer hardly ever will be considered as a legitimate criterion to differentiate transactions. Still, geographic market differentiation will most often translate to cost differences and increases in production. In *United Brands*, the ECJ expressly recognized that differences in “transport costs, taxation, customs duties, the wages of labor force, the conditions of marketing, the differences in the parity of currencies, [or even] the density of competition” could justify price differences.<sup>65</sup> With respect to the last element cited by the ECJ, the different “density of competition” among customers, *i.e.* downstream, appears to be a rational criterion in applying different trading conditions. More curiously, in *Deutsche Bahn*, the Court of First Instance of the European Communities (hereinafter “CFI”) assumed, while rejecting the argument on its facts, that the more or less intense nature of competition at the seller’s level could eventually justify the application of discriminatory prices.<sup>66</sup>

### 3. With other trading parties

The terms “trading parties” refers generally to customers, whatever their nature, provided that they are, at least potentially, in competition with each other. As a result, there is little doubt that Article 82(c) EC is primarily concerned with so-called “secondary line” injury – that is, the competitive harm to businesses in competition with the favored customer. In that regard, Waelbroeck argues vehemently that “where customers are not in competition

---

<sup>62</sup> The airline industry provides the most obvious example of such time sensitive pricing behavior that, to some extent, may enhance output, although it is hardly transparent. In *Tetra Pak*, the Commission has demonstrated a clear sensibility to the timing factor ( Commission decision of 24 July 1991, (1992) O.J. L72/1, 62-68.). In a different but related way, regular sales and promotional sales are generally not regarded as equivalent.

<sup>63</sup> See Case 382/81, *Michelin I*, [1983] E.C.R. 3461.

<sup>64</sup> Waelbroeck reports that in the *Kevlar* case, the Commission upheld DuPont’s “value in use” pricing system, whereby it distinguished between various categories of customers on the basis of the possibilities they had of switching to alternative products (See M. Waelbroeck, *supra* note 2, p.156).

<sup>65</sup> Case 27/76, *United Brands v. Commission*, [1978] E.C.R. 207, para. 228.

<sup>66</sup> Case T-229/94, *Deutsche Bahn v. Commission*, [1997] E.C.R. II-1689, para. 91.

with each other, the fact that they are treated differently should be considered as irrelevant from the point of view of competition law”.<sup>67</sup> Still, different conditions applied to transactions with firms that do not compete with each other may lead to what is referred to as “primary line” injury – that is, injury to competitors of the seller.<sup>68</sup> That type of abuse, most likely in the form of exclusionary below costs sales, is, however, a matter to be dealt with under Article 82(b) EC. The distinction between primary line and secondary line abuse is discussed more extensively in section IV below.

The requirement that trading parties be in competition with each other makes the finding of a discriminatory abuse inherently dependent on the definition of the “secondary” market. In *Ladbroke*,<sup>69</sup> for instance, because the CFI considered the market of “televised pictures and news of French horse-races” to be ancillary to the betting market, which was national, it refused to hold that a refusal to license Ladbroke in Belgium was discriminatory because no license had been granted within that market in the first place.<sup>70</sup> Yet, as Korah observed, had the market been defined as the supply throughout Europe of live film and commentary on French horse-races to those providing betting services, it would not have been possible to decide that the refusal to supply Ladbroke was not discriminatory just because none had been licensed in Belgium.<sup>71</sup>

#### 4. Competitive disadvantage

Article 82(c) EC further requires that the dominant firm’s trading parties be placed at a competitive disadvantage as a result of the dissimilar conditions applied among them. Thus, price discrimination requires more than merely charging different prices to different customers for identical goods or services. The application by a seller of dissimilar conditions must harm competition and, more precisely, competition among its trading parties.<sup>72</sup> It is apparently difficult to determine what “harm to competition”

---

<sup>67</sup> M. Waelbroeck, *supra* note 2, p.160. In *Clearstream* (*supra* note 21), the Commission noted that Euroclear and CSD’s did “form comparable customer groups” providing similar secondary clearing and settlement services for cross-border transactions in securities issued under German law (para. 311). It also noted in a footnote that the difference between International Clearing and Settlement Depositary, such as Euroclear, and other CSD’s (national) “is blurring as ICSDs merge with local CSDs...and local CSDs offer cross-border settlement” (fn 13).

<sup>68</sup> As Furse points out, “this might be the case, for example, were the product an intermediate one, and the customers incorporated the product into end products which were not in the same market” (see M. Furse, “Monopoly Price Discrimination, Article 82, and the Competition Act”, (2001) 24 *E.C.L.R.* 151). Discrimination among final consumers, which do not compete with each other, may also give rise to an issue of exploitation.

<sup>69</sup> Case T-504/93, *Ladbroke v. Commission*, [1997] E.C.R. II-923, para. 124.

<sup>70</sup> Although the fact that it involved intellectual property rights makes it peculiar, Ladbroke can, at least in theory, be considered as a type of “secondary line abuse” case because the ten associations that organized horse-races collectively in France licensed “downstream” their performing rights in the films of the race to PMU, which in turn licensed its subsidiary PMI to grant licenses outside France to competitors of Ladbroke.

<sup>71</sup> See V. Korah, “The Ladbroke Saga”, (1998) 21 *E.C.L.R.* 169, 170.

<sup>72</sup> In *Clearstream*, referred to above, the Commission stated that “the existence of discrimination presupposes that the conditions applied be dissimilar, that transactions (...) be equivalent, and that through its behaviour the dominant undertaking places trading parties at a competitive disadvantage” (para. 302). Yet, while it seemed to acknowledge the need to demonstrate that “through its behavior

actually means under Article 82(c) EC, because the Commission and the EU courts have most of the time neglected to address that condition in their analysis of discriminatory practices,<sup>73</sup> focusing their reasoning, rather, on the existence of similar or dissimilar transactions.

In *Deutsche Bahn*, the CFI, in a statement that is typical of the vagueness that has constantly surrounded the assessment of price discrimination cases, held that “*an undertaking may not apply artificial price differences such as to place its customers at a disadvantage and to distort competition*”, and thus seemingly deducted a distortion of competition from the mere application of price differences, deemed “artificial”.<sup>74</sup> Such a stance is very similar, indeed, to the “inference of injury test” adopted by the US Supreme Court, in *FTC v. Morton Salt Co.*<sup>75</sup> However, the classic definition of the concept of “abuse” under Article 82 EC, which is borrowed from the ECJ’s holding in *Hoffman-LaRoche*,<sup>76</sup> states that an abuse is “*an objective concept related to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market*”, notably by “*hindering the maintenance of the degree of competition still existing in the market or the growth of that competition*” (emphasis added).<sup>77</sup> From that definition, it has been consistently derived that the concept of abuse covers two kinds of conducts likely to hurt consumers’ interest: those that could prejudice consumers directly by exploiting them and those that may harm them indirectly through their impact on the market structure.<sup>78</sup> Hence, it would be contrary to the definition of an abuse to prohibit the mere application of different prices in equivalent transactions in the absence of impact on the structure of the downstream market. This issue is further discussed in section IV.B, below.

The EU courts have, nonetheless, devoted considerable effort to assessing so-called “objective justifications” for the observed dissimilar trading conditions. Since there seems to be no such thing as an efficiency defense under Article 82 EC, those efforts are relevant to the extent that the justifications proposed are such as making it unlikely that competition and the structure of the market will be affected by the discriminatory

---

[i.e. charging dissimilar prices] the dominant undertaking places trading parties at a competitive disadvantage”, the Commission did not demonstrate the existence of any such “competitive disadvantage”. It merely derived it from the absence of cost justification for the observed price difference.

<sup>73</sup> J. Faull and A. Nikpay (eds.), *The EC law of competition*, Oxford Univ. Press, 1999, p.176.

<sup>74</sup> Case T-229/94, *Deutsche Bahn v. Commission*, [1997] E.C.R. II-1689, para. 78.

<sup>75</sup> See above, section III.B.3.

<sup>76</sup> Case 85/76, *Hoffman-La Roche v. Commission*, [1979] E.C.R. 461, para. 91; repeated, e.g., Case T-65/89, *BPB Industries and British Gypsum v. Commission*, [1993] E.C.R. II-389, para. 118; Case 128/98, *Aéroports de Paris v. Commission*, [2000] E.C.R. II-3929, para. 171.

<sup>77</sup> *In extenso*, the definition of “abuse” reads as follows: “*the concept of abuse is an objective concept relating to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods different from those which condition normal competition in products or services on the basis of the transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition*”.

<sup>78</sup> Case 85/76, *Hoffman-La Roche v. Commission*, [1979] E.C.R. 461, para. 125.

practice, in the first place. Among the objective factors explored by the Commission and the EU courts -besides the pure cost differences that may make transactions un-equivalent-, the reward of a customer for a service rendered, such as cash payment, that benefited the supplier has generally been accepted to justify different trading terms. Such service is usually considered part of the consideration given for the goods or services acquired. Less clear is whether and under what circumstances a dominant undertaking can price discriminate in order to meet competition from another competing supplier.<sup>79</sup> It is argued, however, that “meeting competition” is less relevant to the assessment of discriminatory practices under Article 82(c) EC than to the analysis of predatory practices under Article 82(b) EC, so long as it is acknowledged that Article 82(c) EC deals with secondary line abuses and that harm to competition does not merely result from the application of dissimilar conditions among trading parties.<sup>80</sup>

In the *Clearstream* case, the Commission undertook a lengthy analysis of the possible cost justification for the observed difference in the per transaction tariffs charged by Clearstream for primary clearing and settlement services rendered to Euroclear, on the one hand, and other Clearing and Settlement Depositories (“CSDs”), on the other hand. In the course of the proceedings, Clearstream was apparently reluctant to respond to the Commission’s requests concerning its actual per transaction costs, and stated in a letter that “*it is not critical to the allegation of improper discrimination...whether every penny of price differentials can be attributed accurately to differences in cost. For in competitive markets...prices are set by supply and demand, and not by the principle of covering costs*” (para. 313). Clearstream’s point is a valid one: if the market -in this case Euroclear- can bear higher prices which are not necessarily cost-related, why should Clearstream be accountable for making higher profits, to the extent that it is not demonstrated that competition between Euroclear and other CSDs is distorted, *i.e.* that the higher price charged to Euroclear is either excessive or exclusionary? The Commission recognizes that “*in competitive markets, costs and prices must not always keep the same proportional relationship as prices are determined by supply and demand*”.

Yet, it is solely from the lack of cost justification of the observed price differential that the Commission deducted the existence of an abuse on the part of Clearstream. As explained hereinabove, it is inconsistent with the definition of an abuse to forbid the application of different prices to equivalent transactions -how substantial that difference might be- in the absence of an impact on the structure of the affected market. The Commission’s position in *Clearstream* is particularly surprising because it seemed, at first sight, to have recognized the autonomy of the “competitive disadvantage” criteria of Article 82(c) EC by starting its analysis with the following sentence: “*the existence of*

---

<sup>79</sup> S.O. Spinks, “Exclusive dealing, discrimination and discounts under EC competition law”, (2000) *Ant.L.J.* 642, 663.

<sup>80</sup> On the contrary, because the “inference of injury test” adopted by the US Supreme Court implies that mere price differences are deemed to lessen competition, the good faith meeting of competition is a strong and particularly relevant defense to a *prima facie* allegation of harm of competition. For a discussion of the “meeting competition defense”, see D. Slater and D. Waelbroeck, Meeting competition: Why it is not an Abuse under Article 82, (2004) *Coll. Europe Research Paper in Law*, 3/2004.

*discrimination therefore presupposes that the conditions applied be dissimilar, that transactions [...] be equivalent, and that through its behaviour the dominant undertaking places trading parties at a competitive disadvantage”* (para. 302, emphasis added).

Finally, as explained in Section II, price discrimination is likely, in economic terms, to entail welfare losses in cases when it does not expand output. Thus, from an economic perspective, conduct would infringe Article 82(c) EC primarily if it restricts output.<sup>81</sup> The “limitation of production” is often presented as the overarching test to determine whether a practice is abusive or not under Article 82 EC. It describes, indeed, the key feature that makes conduct “exclusionary” and not merely “difficult to match” for rivals. The convergence between the economic theory of price discrimination and the concept of abuse reinforces the conclusion that price discrimination should be held illegal only if it distorts competition and not if it merely results from the application of different prices to similar transactions causing some disadvantage to customers competing against one another.

#### D. The ambiguities of prohibiting price discrimination

Paradoxically, it has been demonstrated that, in several ways, imposing a ban on price discrimination may by itself lead to anticompetitive effects. For instance, Posner has pointed to the fact that non-discrimination rules have served as devices to sustain collusion between firms and to foster cartelization.<sup>82</sup> It has also been observed that a too-strict interpretation of non-discrimination rules may provide a rather comfortable umbrella to dominant firms for charging monopoly prices “across the board” and may reduce the incentives to compete by the dominant firm’s competitors. It has already been explained that a ban on price discrimination would also hurt price competition because if a dominant supplier cannot discriminate, buyers would be precluded to gain from price negotiation and the supplier will have greater incentive to resist price reductions.<sup>83</sup> Likewise, as input price discrimination may make market entry easier, *e.g.* if new entrants are able to benefit from preferential conditions, a price discrimination ban imposed on an upstream monopolist may reduce entry into the downstream market, and, as a result, hurt consumers and reduce overall welfare.<sup>84</sup>

A more general argument often formulated to dismiss non-discrimination rules is that competition is not about fairness or equality or, in other words, about protecting the weak or the inefficient from the process of competition. Prohibiting the application of different prices to similar transactions with trading parties in the absence of a demonstrated harm to the competitive process entails, indeed, a risk that pro-competitive effects be unduly constrained. Yet, whether fairness and competition are incompatible depends on the

---

<sup>81</sup> Notwithstanding the fact that harm to competition may result from the direct exploitation of consumers.

<sup>82</sup> R. Posner, *supra* note 19, p.86.

<sup>83</sup> “The Reform of Article 82: Recommendations on Key Policy Objectives”, Speech by Dr. A. Fletcher, Chief Economist of Fair Trading, Competition Law Forum, Brussels, March 15, 2005 (available at [www.ofc.gov.uk/Speeches+and+articles/2005/index.htm](http://www.ofc.gov.uk/Speeches+and+articles/2005/index.htm)).

<sup>84</sup> J. Haucap and Ch. Wey, Input Price Discrimination (Bans), Entry and Welfare, mimeo, 2004.

definition given to the notion of “fairness”. Fox and Sullivan, for instance, argue that fairness in the antitrust context has three different components, which are not incompatible with consumer interests: exclusion, exploitation and (discriminatory) refusal of access to the competition process, all three through the use of market power.<sup>85</sup> From an EC law perspective, as shall be discussed in more detail below, such a definition sounds perfectly in line with the concept of harm to competition under Article 82(c) EC. Yet the Commission has, in the past, confusingly interpreted Article 82(c) EC in a way hardly compatible with the protection of competition or fairness, as understood in the antitrust context. In *Aéroports de Paris*, for instance, the Commission held that “a system of undistorted competition, as laid down in the Treaty, can be guaranteed only if equality of opportunity is secured between the various economic operators.”<sup>86</sup>

Finally, it is difficult to conceive of appropriate remedies to a strict “non price discrimination” rule. Such remedies would probably require that the same price be offered to all trading parties, which would be extremely inconvenient for companies engaged in price negotiations with various customers and would seriously discourage price competition.<sup>87</sup> Moreover, the respect of such a rule would be difficult to monitor and would probably entail huge enforcement costs.

#### IV. Is Price Discrimination a Distinct Type of Abuse?

In analyzing the anticompetitive effects of price discrimination, it is classically referred to as “primary line price discrimination”, on the one hand, which may foreclose the direct competitors of the dominant company, and “secondary line price discrimination”, which may harm customers of the dominant company who are competing with each other. It has been explained hereinabove that Article 82(c) EC is inherently concerned with distortion of competition among the dominant company’s trading parties, *i.e.* with secondary line abuse, which is limited, by nature, to a limited number of situations. Yet so far, Article 82(c) EC has been mainly enforced against discriminatory practices that entailed either protectionist or market partitioning effects.<sup>88</sup> Although it can be convenient from an enforcement point of view to use Article 82(c) EC to tackle those practices, which touch upon fundamental values of the EC Treaty, that provision is not, legally and rationally speaking, the suitable legal basis to address these issues, notably because, as the ECJ stated in *United Brands*, “the responsibility for establishing the single [...] market does not lie with [private parties]”.<sup>89</sup>

---

<sup>85</sup> E. Fox and L. Sullivan, *supra* note 27, p.145.

<sup>86</sup> Commission decision of 11 June 1998, *Alpha Flight Services/Aéroports de Paris*, (1998) O.J. L230/10.

<sup>87</sup> Temple Lang and O’Donoghue add that in case of strict prohibition of price discrimination, “there would have to be a rule which said whether a dominant company which lowered its price had to give the reduction retroactively in contracts it had already entered into, or only in subsequent contracts. There would have to be a rule which said how long the enterprise would have to continue to charge the same price before it could raise it again” (see J. Temple Lang and R. O’Donoghue, *supra* note 56.).

<sup>88</sup> In fact, besides *Soda Ash* and *British Airways*, all cases referring to Article 82(c) EC seem to deal with protectionist or market partitioning effects.

<sup>89</sup> Case 27/76, *United Brands v. Commission*, [1978] E.C.R. 207, para. 227.



The analysis developed in the present section is based on the fundamental premise, already mentioned, that price discrimination is abusive only insofar as it distorts competition, as the wording of Article 82(c) EC suggests. As an abuse of dominant position, price discrimination should therefore be assessed on the basis of its exploitative and/or exclusionary effects. If it is acknowledged that exclusionary or exploitative effects must be demonstrated, there should be no *per se* rule against discriminatory pricing and alleged “abuses”, in whatever forms they occur. The later point should assuredly be clarified once and for all by the Commission, to clear up ongoing ambiguities resulting from its previous practice and some EU courts’ decisions.<sup>90</sup>

#### A. Primary line discrimination

Primary line discrimination aims to affect competition among competitors of the dominant discriminating company. In that regard, the competitive assessment is similar to a predation analysis. Price discrimination in the form of selective price cutting can be used, indeed, as an instrument for predatory pricing or other exclusionary practices that eliminate competition and allow the price-discriminating firm to subsequently raise price above competitive levels. This is arguably not different from any other exclusionary practices caught under Article 82(b) EC, the discriminatory character of which is inherent since they aim, in most cases, to target specific competitors. As a result, even if their discriminatory character may have been a prevailing cause for the injury to the market structure, such tactics should preferably be dealt with under Article 82(b) EC to ensure that consistent standards of analysis are applied. Treating so-called discriminatory predation under different standards entails a risk of arbitrariness and might lead to the unjustified prohibition, e.g., of discriminatory “above costs” pricing.<sup>91</sup>

Interestingly, the US Supreme Court, in *Brooke Group*, while addressing the relationship between predation standards under Section 2 of the Sherman Act and Section 2(a) of the Robinson-Patman Act, stated that to prevail on predatory pricing claims under both Acts, the same standard applied because “*the essence of the claim under either statute is the same: a business rival has priced its products in an unfair manner with an object to eliminate or retard competition and thereby gain and exercise control over prices in the relevant market*”.<sup>92</sup> Today, most appellate courts in the US have indicated that the standards for judging primary line Robinson-Patman offenses and Section 2 predatory pricing offenses require essentially the same analysis.<sup>93</sup> This is all the more remarkable

---

<sup>90</sup> See, e.g., Joined Cases T-24/93, T-25/93, T-26/93 and T-28/93, *Compagnie Maritime Belge v. Commission*, [1996] E.C.R. II-1201, 149, where the CFI seems to have denied that a showing of anticompetitive effects was necessary to establish that an abusive conduct occurred.

<sup>91</sup> This is not to say that some form of above cost pricing could never be held abusive, although that may be discussed. It is well-known that in *Compagnie Maritime Belge*, the Commission and the CFI have considered that above cost pricing can be abusive where there is clear evidence of super-power on the side of the dominant supplier and of an apparent intent to eliminate a competitor (Joined Cases T-24/93, T-25/93, T-26/93 and T-28/93, *Compagnie Maritime Belge v. Commission*, [1996] E.C.R. II-1201).

<sup>92</sup> See *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 US 209 (1993).

<sup>93</sup> E. Fox and L. Sullivan, *supra* note 29, p.211.

given that under the *Morton Salt* “inference of injury test”, harm to competition would normally derive from the mere observance of substantial price differences. Since, under EC law, price discrimination seems to require a distortion of competition to be held abusive, there is assuredly no reason to maintain double predation standards based on an artificial distinction between discriminatory and non-discriminatory practices.

B. Secondary line discrimination

In light of the foregoing, it is in relation to secondary line effects, that is effects on competition among the dominant discriminating firm’s trading parties, that Article 82(c) EC may constitute a distinct type of abuse by incorporating the content of Article 82(a) and (b) EC and applying it to anticompetitive and exploitative effects in a related market, *i.e.*, in most cases, a downstream market. The concept of secondary line injury is, however, by its very nature, limited in scope. Two types of practices, in particular, may entail actual or potential harm to competition among the dominant company’s trading parties.

The first type of possible secondary line abuse lies with the discriminatory charging of excessive prices. If the anticompetitive analysis is no different than under Article 82(a) EC, it is, to some extent, as problematic. In *General Motors*, the ECJ expressly recognized that the imposition of a charge that was “*excessive in relation to the economic value of the service provided*” could constitute an abuse of a dominant position.<sup>94</sup> There is no easy way to determine when a price is sufficiently high to be excessive. In theory, prices could be regarded as excessive if they allow the dominant firm to sustain profits that are well in excess of what it could expect under competitive market conditions. In practice, due regard will be given to the production costs of the product or services<sup>95</sup> and to the pattern of prices over time and across geographical markets (or sub-markets).<sup>96</sup> That type of analysis may encounter, however, important cost allocation problems.<sup>97</sup> Given those practical difficulties, the scale of the price differential and thus the extent of the discrimination between customers could constitute a factor in establishing the excessive character of a price.<sup>98</sup> It is unclear, however, to what extent competition authorities should devote efforts investigating claims of excessive prices in the absence of exclusionary effects, *i.e.* when high prices charged by a dominant company do not deprive its customers of the possibility to participate in the downstream interplay of supply and demand.

---

<sup>94</sup> Case 26/75, *General Motor Continental N.V. v. Commission*, [1975] E.C.R. 1379.

<sup>95</sup> Case 27/76, *United Brands*, [1978] E.C.R. 207, para. 251.

<sup>96</sup> Case 395/87, *Tournier*, [1988] E.C.R. 2521, para. 38; Case 30/87, *Bodson*, [1988] E.C.R. 2507, para. 31.

<sup>97</sup> It is beyond the reach of this paper to explore the different tests possible to establish the excessive character of a price. A factor that may have been underestimated by commentators and scholars, so far, is the ability of the customers to resale with a profit and thus to participate in the competitive interplay at the downstream level.

<sup>98</sup> In Case 226/84, *British Leyland v. Commission*, [1986] E.C.R. 3263, the ECJ took account of the fact that “the fees charged for left-hand-drive vehicles was six times greater than that for right-hand drive vehicles” to infer a finding of excessive price (para. 28).

The second type of possible secondary line abuse, of an exclusionary nature, lies with the application of discriminatory conditions in the access to essential inputs. The problem is particularly acute where the dominant firm that is the owner of an essential “facility” at the upstream level also acts in the downstream market in competition with the customers of its upstream business and applies discriminating conditions to undermine its downstream competitors. For example, Economides has explained how a vertically integrated monopolist in an input market has a strong incentive to increase the costs of the rivals of its downstream subsidiary, thereby foreclosing its downstream rivals.<sup>99</sup> In the absence of integration, however, it is unclear what the incentive would be for the owner of an upstream essential facility to charge price differentials such that they may lead to exclusionary effects.

Since *Commercial Solvents*, the prohibition of discrimination in relation to access to essential facilities<sup>100</sup> owned by vertically integrated companies is a long-standing rule that suffers little disagreement.<sup>101</sup> It has also become a standard rule under many liberalization regulations that the vertically integrated incumbent may not price discriminate between the parties to different access agreements. In the same vein, the Commission decision in *Microsoft* ordered the disclosure of interoperability information on “reasonable” and “non-discriminatory” terms.<sup>102</sup> In *British Sugar*, the discriminatory abuse sanctioned by the Commission was rooted in the fact that British Sugar operated in both the wholesale and retail sugar markets and was charging itself a lower price at wholesale than it was charging Napier Brown, allowing it to undercut Napier Brown in the retail market.<sup>103</sup> In *Irish Sugar*, the CFI also confirmed the Commission’s finding of abuse in a similar situation after observing that the dominant company “charged sugar packers who competed with it on the retail market discriminatory prices for industrial sugar”.<sup>104</sup> Such discrimination by a dominant firm in favor of its own downstream operations is therefore subject to strict scrutiny, and rightly so. Still, there is no reason to impose a *per se* rule in that respect: the discrimination should be concretely established and economic justifications properly investigated.

Besides the two situations outlined above, there is little reason to outlaw secondary line price discrimination. In particular, the mere fact that a dominant company charges

---

<sup>99</sup> N. Economides, “The Incentive for non-price discrimination by an input monopolist”, (1998) *Int.J.Ind.Org.*271.

<sup>100</sup> A facility may be deemed essential if in the absence of access, the access seeker would not be able to participate in the downstream market due to a lack of feasible alternatives.

<sup>101</sup> In that case, *Commercial Solvents* was providing an essential input to a downstream customer, Zoja, until it decided to enter itself into the downstream market. As the ECJ stated: “an undertaking which has a dominant position in the market in raw materials and which, with the object of reserving such raw material for manufacturing its own derivatives, refuses to supply a customer, which is itself a manufacturer of these derivatives, and therefore risks eliminating all competition on the part of its customer, is abusing its dominant position”. Case 7/73, *Commercial Solvents and Others v. Commission*, [1974] E.C.R. 223, para. 95.

<sup>102</sup> See Article 5(a) of Commission Decision of 24 March, 2004, *Microsoft*, available at <http://europa.eu.int/comm/competition/antitrust/cases/decisions/37792/en.pdf>.

<sup>103</sup> Commission decision of 18 July 1988, *Napier Brown/British Sugar*, [1988] O.J. L284/41.

<sup>104</sup> Case T-228/97, *Irish Sugar v. Commission*, [1999] E.C.R. II-2969, 157.

different prices to downstream customers, even if it impacts, in one way or another, on the earnings of these latter customers, is likely to respond to objective reasons or result from the interplay of supply and demand. In other words, absent exploitation or exclusion, dominant companies should be able to charge “what the market can bear”. In *United Brands*, the ECJ expressly stated that a dominant company was entitled “to take ‘what the market can bear’ provided that it complies with the rules for the regulation and coordination of the market laid down by the Treaty.”<sup>105</sup> It is difficult to reconcile this view with the position adopted by the CFI in *British Airways* (“BA”) when it held that the performance schemes set up by BA to reward travel agents “by remunerating at different levels services that were nevertheless identical and supplied during the same reference period, those performance reward schemes distorted the level of remuneration which the parties concerned received in the form of commissions paid by BA.”<sup>106</sup> This statement is arguably misconceived: a distortion of the level of remuneration can hardly equate to a distortion of competition and thus justify a finding of abuse under Article 82(c) EC.

### C. Discrimination on grounds of nationality

Many of the findings of abusive discriminatory practices under Article 82(c) EC have involved protectionist fee schemes by State or State-related entities in the field of transport. Those cases have featured, *e.g.*, the *Aeroportos e Navegação Aérea Empresa Publica*, the State company responsible for the management of Portuguese airports and air navigation whose landing fees favored national airlines,<sup>107</sup> the *Corpo dei Piloti del Porto di Genova*, providing mandatory piloting services in the port of Genoa under regulated terms favoring vessels flying the Italian flag,<sup>108</sup> *Deutsche Bahn*, the German national railway which favored carriage by rail passing through the northern German ports<sup>109</sup> or *Aéroports de Paris*, the State company managing Paris airports, which offered preferential treatment to Air France’s catering subsidiary “Orly Air Traiteur”.<sup>110</sup> None of these cases, however, clearly displayed elements of distortion of competition, as understood under Article 82 EC.

This sensitivity towards protectionist measures by State entities is rooted in the main goal of the EC Treaty, *i.e.* market integration, and its corollary, the prohibition of any discrimination on grounds of nationality. Pursuant to Article 3(1) (g) EC, competition policy is one of the components of the “machinery” of market integration. Yet, all market integration provisions of the Treaty, including Article 86 EC, impose obligations on Member States and are directed at State measures. Conversely, if private entities are not the direct addressees of those provisions, they are directly subject to the EC Treaty rules on competition. In parallel, the Commission has the power to adopt administrative

<sup>105</sup> Case 27/76, *United Brands v. Commission*, [1978] E.C.R. 207, para. 227.

<sup>106</sup> Case T-219/99, *British Airways v. Commission* not yet reported at para. 236; for a similar reasoning, see Commission decision of 19 December 1990, *Soda-ash – Solvay*, (1991) O.J. L 152/21.

<sup>107</sup> Case C-163/99, *Portugal v. Commission*, [2001] E.C.R. I-2613.

<sup>108</sup> Case C-18/93, *Corsica Ferries*, [1994] E.C.R. I-1783.

<sup>109</sup> Case T-229/94, *Deutsche Bahn v. Commission*, [1997] E.C.R. II-1689.

<sup>110</sup> Commission decision of 11 June 1998, *Alpha Flight Services/Aéroports de Paris*, [1998] O.J. L230/10; See Case 128/98, *Aéroports de Paris v. Commission*, [2000] E.C.R. II-3929.

decisions against private undertakings in the field of competition, whereas it is bound to bring infringement actions before the EU courts to force Member States to dismantle protectionist schemes. Ambiguities remain as to the appropriate legal basis to tackle protectionist abuses, in particular because free movement and competition rules have sometimes been enforced together against discriminatory practices by State-related entities.<sup>111</sup> Moreover, discriminatory pricing practices “on grounds of nationality” were also expressly condemned by Article 60 ECSC. Private companies do not have natural incentives to act in a protectionist way; protectionist abuses derive inherently from the ties of certain economic actors with the State.<sup>112</sup> Hence, such abuses are in many ways similar to the “measures having equivalent effects” to custom duties, as prohibited by Article 25 EC. In addition, free movement rules in the past have displayed sufficient flexibility to tackle protectionist measures by State-related entities.<sup>113</sup> As a result, it is argued that from the point of view of legal orthodoxy, protectionist abuses in the form of discriminatory practices on grounds of nationality should preferably be dealt with under the free movement rules of the EC Treaty (or Article 86 EC). In case the Commission would consider that accepting such reasoning would entail unduly high enforcement costs, it should clarify that the only situation where harm to competition can be “assumed” to result from price discrimination is the application of dissimilar conditions to trading parties of different nationalities by State-related entities.<sup>114</sup>

D. Discrimination having the effect of partitioning the common market

A different, although somewhat related, issue is discrimination having the effect of partitioning the common market. That category of abuse was established by the ECJ in two well-known cases, *United Brands* and *Tetra-Pak II*, where the dominant companies charged widely different prices for their products, bananas and packaging machines/material, respectively, across national markets within the EU. The Commission and the EU courts shared the opinion that “*those disparities in price could not be attributed to objective market conditions*” but to the existence of business policies aimed at artificially maintaining different trading conditions among Member States.<sup>115</sup> A close

---

<sup>111</sup> See, e.g., Case C-18/93, *Corsica Ferries*, [1994] E.C.R. I-1783.

<sup>112</sup> Temple Lang and O'Donoghue also acknowledge that “it is not easy to visualize a situation in which a company that was not State-owned would have an interest in charging significantly different prices in genuinely similar transactions to customers that were in competition with one another” (see J. Temple Lang and R. O'Donoghue, *supra* note 50.)

<sup>113</sup> In *Foster*, the ECJ held that an entity will constitute a public body, or “emanation of the state”, where it is “*subject to the authority or control of the State or [has] special powers beyond those which result from the normal relations between individuals*” (see Case C-188/89, *Foster v British Gas plc*, [1990] E.C.R.-I 3313, para. 19). Under the EU courts case-law, a number of characteristics and features tend to suggest an entity should be deemed to have public rather than private status, including (i) its funding by public money; (ii) the appointment of its members by government; (iii) the existence of statutory obligations or statutory functions; and (iv) state support or ‘underpinning’.

<sup>114</sup> Temple Lang reports that Article 82(c) EC was introduced within the EC Treaty because “it was feared that dominant enterprises would discriminate in favour of companies in their own Member States, and so perpetuate the division of the Community into separate national markets” (see J. Temple Lang, *op.cit.*).

<sup>115</sup> See Case T-83/91, *Tetra Pak v. Commission*, [1994] E.C.R. II-755, 170.

reading of the two cases leads to the conclusion that the source of the market partitioning effects of the practices at issue did not lie so much with the alleged discrimination than with contractual clauses that prevented cross-border arbitrage.

In *United Brands*, the ECJ obliquely acknowledged that the anticompetitive effects of the observed discriminatory prices resulted from or was intensified by “*the clause forbidding the resale of bananas while still green*”.<sup>116</sup> Various resale restrictions were also present in contracts between Tetra Pak and its customers.<sup>117</sup> As a result, the mere fact that a dominant company applies dissimilar conditions for equivalent transactions (sic) with trading parties located in different Member States should not be considered abusive, as such, under Article 82(c) EC. Indeed, charging different prices may enable that company to significantly expand output beyond levels that would probably prevail under flat price constraints. As a matter of principle, if price differences exist among Member States, for whatever reasons, economic actors should also be free to take advantage of them, to the extent that they do not distort secondary line competition. The legality of resale restrictions, on the other hand, is an issue that traditionally has been addressed under Article 81 EC in the context of vertical agreements.<sup>118</sup>

## V. Policy Recommendations

In his well-known industrial organization textbook, Cabral wonders “is price discrimination legal? Should it be?”<sup>119</sup> A positive answer emerges from the above discussion, despite the acknowledged ambiguous effects of price discrimination on consumer welfare. That positive conclusion stems, first of all, from a need to reconcile price discrimination, as a legal concept, with the other clauses of Article 82 EC, which would have four important implications:

- (i) first, the notion of “competitive disadvantage” within Article 82(c) EC should be understood as requiring that competition be distorted by the discriminatory practice rather than competitors be simply “disadvantaged” in one way or another. In turn, a discriminatory abuse could not simply result from a mere observed difference in price but the existence of a “competitive disadvantage”, *i.e.* harm to competition, should be assessed as an autonomous criterion;
- (ii) second, first line discrimination, *i.e.* discriminatory practices which affect competition at the dominant firm level, should be treated under Article 82(b) EC like any other foreclosure-type abuses, so as to avoid the development of artificial double standards;

---

<sup>116</sup> See Case 27/76, *United Brands v. Commission*, [1978] E.C.R. 207, 232.

<sup>117</sup> See Case T-83/91, *Tetra Pak v. Commission*, [1994] E.C.R. II-755, 12.

<sup>118</sup> See in particular Commission Regulation 2790/99 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, (1999) O.J. L 336/31.

<sup>119</sup> L.M.B. Cabral, *supra* note 11 at p.180.

- (iii) third, price discrimination should be regarded as a distinct type of abuse under Article 82(c) EC in relation to secondary line effects, *i.e.* effects on competition between the dominant firm's trading parties, to the extent that it leads either to excessive prices, which should be assessed under the same standards as under Article 82(a) EC, or to exclusionary practices in the access to essential inputs;
- (iv) fourth, discrimination on grounds of nationality or with the aim of partitioning the common market should be assessed under the same standards as any type of abuse. Firms should be recognized the freedom to profit from different conditions prevailing on different national markets within the EU and it should be acknowledged that differences of treatment on grounds of nationality could be potentially abusive only on the part of State-related economic entities.

Second, it has been explained how uniform prices or commercial terms are impracticable for companies and carry the risk of resulting in anti-competitive outcomes. Moreover, from an economic perspective, there is a large number of possible objective reasons to price discriminate, including the necessity to recover fixed costs in the most efficient way.

- (v) For this reason the Commission should broaden the notion of objective justification under Article 82(c) EC and accept that conditions specific to the buyer could render transactions "dissimilar". From a legal perspective, this would rebalance the burden of proof so that it would be for the Commission to demonstrate the existence of a *prima facie* distortion of competition as a result of a difference in prices for similar transactions and not for the dominant firm to justify upfront differences in price on the narrow basis of corresponding differences in costs.

In general, price competition, by whatever means, should be encouraged rather than inhibited by overtly restrictive rules. Dominant companies, which by nature have the power to apply supra-competitive prices, should be encouraged to compete on prices and to expand output. Discriminatory prices actually can provide incentives for them to do so. As Posner wrote, "it would be infeasible to draft a decree forbidding systematic price discrimination that did not contain or inhibit legitimate pricing behavior as well".<sup>120</sup> Yet clearing up the main ambiguities surrounding the assessment of price discrimination under Article 82(c) EC would already achieve a great deal in avoiding the inhibition of legitimate pricing behavior.

---

<sup>120</sup> R. Posner, *supra* note 19 at p.86.

# Refusal to Deal

Christophe Humpe and Cyril Ritter\*

## I. Introduction

The circumstances in which a refusal to supply infringes Article 82 EC are controversial. The position is complicated by the fact that there are different types of refusal to supply and because such refusals may take a number of different forms.

In particular, a refusal to supply may be “unilateral” or “concerted” (as in *Terminal Railroad*,<sup>1</sup> *Associated Press*,<sup>2</sup> or collective boycott cases). The refusal may be a refusal to supply a *competitor* or a customer who is not an actual or potential competitor (in which case the refusal would in general be “conditional”). A refusal to supply a competitor may be a “first-time” refusal to supply (as in *Magill*,<sup>3</sup> *Bronner*,<sup>4</sup> *Ladbroke*,<sup>5</sup> *IMS*,<sup>6</sup> *Otter Tail Power*,<sup>7</sup> and *Trinko*)<sup>8</sup> or may consist in the termination of an existing business relationship (*Commercial Solvents*,<sup>9</sup> *Télémarketing*,<sup>10</sup> *Aspen*).<sup>11</sup> In each of these different scenarios, the firm in question may flatly refuse to supply, or it may make an offer on terms that are so disadvantageous that effectively they amount to a refusal to supply. This is known as a “constructive” refusal to supply.<sup>12</sup> The refusal may be a refusal to supply

---

\* Christophe Humpe is an Associate, SJ Berwin LLP, Brussels; Cyril Ritter is an Associate, Morrison Foerster, Brussels. We are grateful for the comments received from various members of our working group and we would like to express our gratitude in particular to Christian Ahlborn, Onno W. Brouwer, Damien Geradin, David Hull, and Simon Topping.

<sup>1</sup> 224 U.S. 383, 56 L. Ed. 810, 32 S.Ct. 507 (1912).

<sup>2</sup> 326 U.S. 1, 89 L. Ed. 2013, 65 S.Ct. 1416 (1945).

<sup>3</sup> Joined Cases C-241/91 P and C-242/91 P, *Magill*, [1995] E.C.R. I-743.

<sup>4</sup> Case C-7/97, *Bronner*, [1998] E.C.R. I-7791.

<sup>5</sup> Case T-504/93, *Ladbroke*, [1997] E.C.R. II-923.

<sup>6</sup> Case C-418/01, *IMS*, not yet reported.

<sup>7</sup> 410 US 366, 35 L. Ed. 2d 359, 93 S.Ct. 1022 (1973).

<sup>8</sup> 540 U.S. 398 (2004).

<sup>9</sup> Joined Cases 6/73 and 7/73, *Commercial Solvents*, [1974] E.C.R. 223.

<sup>10</sup> Case 311/84, *Télémarketing*, [1985] E.C.R. 3261.

<sup>11</sup> 472 U.S. 585 (1985).

<sup>12</sup> See Commission decision of 25 July 2001, *Deutsche Post – Interception of cross-border mail*, (2001) O.J. L 331/40, para. 141 (defining the notion of “constructive” refusal to supply); and Commission decision of 16 September 1998, *Trans-Atlantic Conference Agreement (TACA)*, (1999) O.J. L 95/1, para. 553 (same).



tangible products, to provide services, to provide access to certain physical infrastructure, or to license intellectual property rights (IPRs).

The main criticism levelled at the law in this area is that it lacks a proper conceptual framework and economic rigour. As a result, there is a significant amount of legal uncertainty. Accordingly, we welcome the announcement that the Commission is considering issuing draft Guidelines on the application of Article 82.<sup>13</sup> The Commission must seize the opportunity in these guidelines to clarify the analytical framework underpinning the application of Article 82 to refusals to supply cases.

In so doing, the Commission must aim to formulate clear and simple rules that minimise the cost of enforcement.<sup>14</sup>

The clarity requirement means that, in the interest of legal certainty, the rules must be predictable. This is a firmly established principle of EC law.<sup>15</sup> The rationale is that (a) businesses cannot operate in an environment where they do not know whether a particular course of conduct might attract antitrust liability; and (b) legal uncertainty may discourage businesses from competing aggressively.

The cost of enforcement consists of (i) the actual costs incurred by antitrust agencies, the judicial system and private parties, and (ii) the cost of errors, e.g., mistakenly clearing conduct which is anti-competitive ("false acquittals") or mistakenly finding antitrust liability ("false convictions"). Formulating a "better" and more administrable legal test aims at lowering the risk of false acquittals and false convictions. The latter can deter aggressive competition and instead encourages frivolous and rent-seeking litigation. This can have industry-wide chilling effects by discouraging the very conduct the antitrust laws are designed to protect – aggressive competition.<sup>16</sup> As a result, several authors and courts have warned that false convictions are "especially costly",<sup>17</sup> while false acquittals

---

<sup>13</sup> Speech by Philip Lowe at the International Bar Association/European Commission conference on modernisation, Brussels, 11 March 2005.

<sup>14</sup> D. Evans and J. Padilla, "Designing Antitrust Rules for Assessing Unilateral Practices: A Neo-Chicago Approach", AEI-Brookings Joint Center for Regulatory Studies paper # 04-20 and CEPR Discussion Paper # 4625, September 2004, at page 3: "*Socially desirable antitrust rules should minimize the expected cost of errors resulting from condoning harmful practices or condemning beneficial ones, while maintaining a degree of probability for businesses and administrative ease for the courts*". A shorter version of this article is forthcoming in the *University of Chicago Law Review*, Volume 72, Number 1, Winter 2005. An even shorter version was published in (2005) 28 *World Competition* 93 under the title "How Economists Can Help Courts Design Competition Rules: an EU and US perspective".

<sup>15</sup> See, e.g., Case 70/83, *Kloppenburg*, [1984] E.C.R. 1075, para. 11: "*it is necessary to emphasize, as the Court has already done on several occasions, that Community legislation must be unequivocal and its application must be predictable for those who are subject to it.*"

<sup>16</sup> *Matsushita v. Zenith*, 475 U. S. 574 (1986) at 594; *Brooke Group v. Brown & Williamson*, 509 U.S. 209 (1993) at 226; and *Verizon v. Trinko*, 540 U.S. 398.

<sup>17</sup> See for example *Barry Wright v. ITT Grinnell*, 724 F.2d 227 (1st Cir. 1983) at 231-232; *Matsushita v. Zenith*, 475 U.S. 574 (1986) at 594; *Cargill v. Monfort of Colorado*, 479 U.S. 104 (1986) at 122, n. 17; *Brooke Group v. Brown & Williamson*, 509 U.S. 209 (1993) at 226; and *Verizon v. Trinko*, 540 U.S. 398. There is a thorough discussion of error costs (arguing that false positives are especially costly and probably more costly than false negatives) in R. Cass and K. Hylton, "Preserving Competition:

can be expected to be corrected by market forces (on the assumption that profits attract entry). It is submitted, however, that false acquittals can also produce industry-wide chilling effects (both in terms of price and innovation) which may not always be corrected by the market mechanism as is sometimes claimed.

These enforcement costs must be analysed taking into account the underlying economic considerations and the assessment of economic efficiencies in refusal to supply cases. A very basic “static” economic market model suggests that, on the basis of certain assumptions, allocative efficiency can be improved from the position of monopoly supply, by increasing competition to allow market equilibrium. Translated into the terms of the refusal to supply issue, this “*ex post*” analysis does at first sight imply that an obligation to supply and to allow competitors to compete on price would always be more efficient than allowing the monopolist to refuse to supply. However, this static analysis ignores the *ex ante* “dynamic” efficiencies in terms of the incentive to invest. These incentives are spurred by the *prospect* of gaining a certain degree of market power and earning supra-competitive profits. Mandating an obligation to supply invariably undermines the firm’s ability to appropriate some of the rewards of its investment, thus harming the incentive to invest. This may have important consequences in particular where research, development, and investment efforts are skewed due to the risk and large number of failures. Moreover, imposing compulsory access too lightly may reduce the incentive of third parties to invest in their own inputs (and thereby create competition at the input level); instead, they would seek access to existing inputs through antitrust enforcement.

Dynamic efficiency – generated by investment incentives – is recognised to be generally more important to the economy, and generally to outweigh any static efficiencies offered by an obligation to supply or to license IPRs.<sup>18</sup> However, the impact that an obligation to supply has on dynamic efficiencies is not the same in all cases, and certain limitations on a property owner’s right to exclude may have only a marginal effect on investment decisions. Indeed, “[a]cknowledging that the long-term welfare effects of dynamic efficiency gains are far more significant than short-term allocative efficiency gains does

---

Economic Analysis, Legal Standards, and Microsoft”, (1999) 8 *George Mason Law Review* 1 at 30-34. See also F. Easterbrook, “The Limits of Antitrust”, (1984) 63 *Texas Law Review* 1 reprinted in (2005) 1 *Competition Policy International* 179 at 192 (“In which direction should these rules err? For a number of reasons, errors on the side of excusing questionable practices are preferable. ... in many cases the costs of monopoly wrongly permitted are small, while the costs of competition wrongly condemned are large”). On this topic, see also R. Posner, “An Economic Approach to Legal Procedure and Judicial Administration”, (1973) 2 *Journal of Legal Studies* 399; I. Ehrlich and R. Posner, “An Economic Analysis of Legal Rulemaking”, (1974) 3 *Journal of Legal Studies* 257; and F. Beckner III and S. Salop, “Decision Theory and Antitrust Rules”, (1999) 67 *Antitrust Law Journal* 41.

<sup>18</sup> See J. Brodley, “The Economic Goals of Antitrust: Efficiency, Consumer Welfare, and Technological Progress”, (1987) 62 *New York University Law Review* 1020 at 1026: “Innovation efficiency or technological progress is the single most important factor in the growth of real output [and is] the largest single source of social wealth enhancement”. See also L. Peeperkorn, “IP Licenses and Competition Rules: Striking the Right Balance”, (2003) 26 *World Competition* 527 at 532 (the view that innovation, as opposed to static efficiency, is the main source of increases in economic welfare is “generally accepted and well substantiated”).

*not mean that any possible diminution in incentives, no matter how remote, ought to trump significant and certain short-term gains”*.<sup>19</sup>

Account must also be taken of the static and dynamic efficiency losses from competitors who may be foreclosed from the market. These competitors or potential competitors may be prevented from introducing their own valuable innovations by the refusal, they may have little incentive to invest in follow-on innovation, and this situation could ultimately result in a reduction of incentive to innovate on the part of the dominant company. The presence of competitors on the market or of potential competitors, with an incentive to enter the market, can also be important in encouraging innovation. However, while many static and dynamic efficiency effects may be identified, quantifiable assessment of these effects is invariably lacking, making any real assessment of the trade-off between static and dynamic efficiencies, or between different dynamic efficiencies particularly difficult if not impossible.

It is against this background that this chapter examines how Article 82 should be applied to refusal to supply cases. As a starting point, and for the sake of clarification, this paper explains (a) why the antitrust analysis of refusals to supply *customers* differs from the analysis of refusals to supply *competitors* (Part II), and (b) why a distinction must also be made between *unilateral* and *concerted* refusals to supply (Part III).

The paper then deals with unilateral refusals to supply competitors. In this connection, there are two preliminary issues, namely (a) whether a distinction should be made between a “first-time refusal to supply” and the termination of an existing supply relationship; and (b) whether a distinction should be made between refusal to deal involving tangible property rights and refusal to licence IPRs. These issues are addressed in Part IV and Part V respectively.

Part VI considers the respective merits of the various possible ways to apprehend unilateral refusals to supply under Article 82 (*per se* legality v. rule of reason approach v. the “screens” approach v. the exhaustive “checklist” approach). In Part VII an attempt is made to formulate a multi-pronged legal test. Part VIII briefly deals with the relationship between refusal to supply abuses and other types of potentially abusive conduct under Article 82. Finally, Part IX concludes by making a number of recommendations.

This analysis is conducted against the background of the existing case-law of the Community courts and previous decisions of the Commission. Reference is also made to U.S. case-law where appropriate.

---

<sup>19</sup> R. Brunell, “Appropriability in Antitrust: How Much is Enough?”, (2001) 69 *Antitrust Law Journal* 1 at 20.

## II. Refusal to Supply Competitors v. Refusal to Supply Customers

Refusals to supply competitors and refusals to supply customers can both have exclusionary effects. Yet these two situations are clearly distinct and should not be treated under the same rules and principles. There are two principal reasons for this.

First, a dominant firm is not under a general duty to assist its competitors. Firms are meant to compete and to develop rival technologies, assets and products. As a rule, this applies also to dominant firms. It is against this background that refusals to supply competitors must be considered. Refusing to supply a competitor should as a result only be illegal in certain limited and narrowly defined circumstances. The fact that there is no duty to assist *competitors* is, however, of no great relevance to the analysis of refusals to supply *customers*, which by definition do not compete (actually or potentially) with their dominant supplier.

Second, while the issue in both cases is one of foreclosure, the mechanisms for inflicting anti-competitive harm are different:

- Refusing to supply a competitor can have anti-competitive effects where the dominant firm controls/gains access to an input or “bottleneck” facility that cannot be replicated. In these situations, often described by reference to the “essential facility” label, the dominant firm seeks to reserve to itself access to the input/facility in order to eliminate competition on a downstream market by foreclosing rivals.<sup>20</sup> The question is whether and under what circumstances a “duty to deal” should be imposed.
- By contrast, a refusal to supply customers who are not competitors can produce anti-competitive effects where the refusal is in reality a threat or punishment (as in

---

<sup>20</sup> The Commission defined the essential facility theory in the *Port of Holyhead* case (Commission decision of 21 December 2003, *Sea Containers v. Stena Sealink* (interim measures), (1994) O.J. L 15/8, para. 66): “An undertaking which occupies a dominant position in the provision of an essential facility and itself uses that facility (i.e. a facility or infrastructure, without access to which competitors cannot provide services to their customers), and which refuses other companies access to that facility without objective justification or grants access to competitors only on terms less favourable than those which it gives its own services, infringes Article 86 if the other conditions of that Article are met.” In the U.S., the doctrine has been defined as a “the duty to deal of a monopolist who is able to supply an input for itself in a fashion that is so superior to anything else available that others cannot succeed unless they can access this firm’s input as well” (Areeda and Hovenkamp, *ANTITRUST LAW*, volume IIIA, 2nd ed., 2002, para. 771a, at page 171). According to *MCI Communications v. AT&T*, 708 F.2d 1081 (7th Cir. 1983) at 1132-1133, there are “four elements necessary to establish liability under the essential facilities doctrine: (1) control of the essential facility by a monopolist; (2) a competitor’s inability practically or reasonably to duplicate the essential facility; (3) the denial of the use of the facility to a competitor; and (4) the feasibility of providing the facility”. More recent case-law reformulates the test as follows: “the elements of an antitrust claim for denial of access to an essential facility are: (1) a monopolist who competes with the plaintiff controls an essential facility; (2) the plaintiff cannot duplicate that facility; (3) the monopolist denied plaintiff the use of the facility; and (4) the monopolist could have granted the plaintiff use of the facility.” See *Caribbean Broadcasting System v. Cable & Wireless*, 148 F.3d 1080, 1088 (D.C. Cir. 1998).

*United Brands* and *Lorain Journal*)<sup>21</sup> or inducement designed to make a customer adopt a particular course of action. Here, the theory is that a dominant firm would rely on its privileged market position as a bargaining tool to induce customers to accept certain trading conditions which in practice are likely or have the potential to foreclose rival producers' access to the market (a typical example is "single branding", where a dominant firm refuses to sell, or to continue to sell, a "must-stock" product to a supermarket chain because the customer also stocks a rival product. Faced with this choice, the supermarket chain may have more to gain by discontinuing purchases of the rival product and buying only the "must-stock" brand). Tying/bundling practices also belong to this category of cases. In all these situations, the refusal to supply is in fact *conditional*. The so-called "essential facilities" doctrine is not relevant here. The potential for anti-competitive harm arises because a firm has sufficient market power to bully its customers, not because it controls an "essential facility".

Clearly, there is a difference between a refusal to supply a competitor and a refusal to supply a customer who is not an actual or potential competitor. The guidelines should therefore, in our opinion, acknowledge that these cases raise different legal and economic issues.

### III. Unilateral v. Concerted Refusals to Supply

The guidelines should also allude to the distinction between unilateral and concerted refusals to supply. Again, these cases raise different economic and legal issues. Concerted behaviour is generally more likely to create competitive harm. As a result, the threshold of anti-competitive harm is different under Article 81 and 82 and the law treats collective action more harshly than single-firm action. Article 81 thus applies where a restriction of competition is *appreciable*. There is no requirement for competition to be *eliminated* on the market. This has been confirmed by the case-law. Thus, for example, in deciding whether a refusal to admit resellers to a selective distribution network infringes Article 81(1), the Commission and the Court have not examined whether it is "essential" to belong to such a system.<sup>22</sup> Further, in a number of cases the Commission has found that certain practices whereby firms had sought to prevent competitors from accessing retail shelves or freezer space had violated Article 81(1).<sup>23</sup> None of these cases were decided on the basis of the "essential facilities" doctrine.

---

<sup>21</sup> In *Lorain Journal*, 342 U.S. 143 (1951), the only newspaper in town refused to sell newspaper advertising to persons who also advertised on a competing radio station. This was held to be an attempt to monopolize the advertising market, and to violate para. 2.

<sup>22</sup> See for example Case 26/76, *Metro v. Commission*, [1977] E.C.R. 1875.

<sup>23</sup> See Commission decision of 23 December 1992, *Schöller*, (1993) O.J. L 183/1 and Commission decision of 23 December 1992, *Langnese*, (1993) O.J. L 183/19. Both these decisions were upheld by the CFI, see cases T-7/93 *Langnese Iglo* [1995] E.C.R. II-1533 and T-9/93 *Schöller* [1995] E.C.R. II-1611. See also case T-65/98, *Van den Bergh Foods*, [2003] E.C.R. II-4653.

#### IV. Interruption of Supply v. First-time Refusal to Supply

It has been suggested that the case-law imposes different obligations on dominant firms depending on whether the refusal to supply is a “first-time” refusal to supply or involves the *termination* of an existing supply relationship.<sup>24</sup> The position is, however, not entirely clear and the case-law can be interpreted in different ways. The principal issue is whether the *Commercial Solvents* doctrine differs from later cases relating to first-time refusal of access to physical property (*Bronner*) and intellectual property (*Magill*, *IMS*) (hereafter, for the sake of simplicity, “essential facility cases”).

There is a view that the *Commercial Solvents* line of case-law and the “essential facility” line of case-law belong to two different categories. This is because (a) the elements of the offence as formulated in “essential facility” cases can be seen as being different from the refusal to deal case-law and (b) the abuse in *Commercial Solvents* was based on a finding of an *abrupt* termination of supply, which should properly be viewed as unlawful extension/leveraging of market power from one market to another (whereas “essential facility” cases do not involve a “behavioural” problem but rather a “structural” problem in the market which creates an affirmative *duty* to deal). Overall, it could be argued that the ECJ applied a less stringent test in *Commercial Solvents* and in *Télémarketing* (both of which were “termination” cases) than in later cases dealing with first-time requests. This could imply that there are different rules for existing customers and new customers.<sup>25</sup>

It is respectfully suggested, however, that there is instead a single body of case-law from *Commercial Solvents* to the “essential facility” cases of the 1990s. The fact that *Commercial Solvents* and *Télémarketing* were “termination” cases whereas *Bronner* was a “first-time refusal” case is not and should not be decisive.<sup>26</sup> The *Commercial Solvents* line of case-law should be viewed as having evolved over time towards more economic rigour and a stricter stance towards complainants. Moreover, the assessment of indispensability, the existence of a serious competition problem on the downstream market, and the absence of objective justification were already taken into account in the case-law well before the ECJ ruling in *Bronner*.<sup>27</sup>

---

<sup>24</sup> B. Sher, “The Last of the Steam-Powered Trains: Modernising Article 82”, (2004) 25 *E.C.L.R.* 243 (in the area of refusal to deal, “*we have one rule for existing customers, another for new customers*”). See also *Genzyme* [2004] CAT 4, para. 571, where the UK Competition Appeal Tribunal distinguished between *Bronner* on the one hand and the *Commercial Solvents* and *Télémarketing* judgments on the other; and the Opinion of A.G. Jacobs in case C-53/03 *SYFAIT v. Glaxosmithkline*, at para. 66 (the ECJ subsequently declined jurisdiction in this case: see the judgment of 31 May 2005).

<sup>25</sup> See, e.g., Sher, *supra* note 24. See also *Trinko*, *supra* note 8, where Justice Scalia suggested that the facts in *Aspen* could be distinguished from those in *Trinko* because in the former case the dominant firm had discontinued an existing commercial relationship.

<sup>26</sup> See G. Abbamonte and V. Rabassa, “Foreclosure and Vertical Mergers – The Commission’s Review of Vertical Effects in the Last Wave of Media and Internet Mergers: AOL/Time Warner, Vivendi/Seagram, MCI Worldcom/Sprint”, (2001) 22 *E.C.L.R.* 214, at 215 (“*in economic terms ... there is no difference between the two*”).

<sup>27</sup> C. Ritter, “Refusal to Deal and ‘Essential Facilities’: Does Intellectual Property Require Special Defence Compared to Tangible Property?”, forthcoming in the September 2005 issue of *World Competition* and available at [ssrn.com/abstract=726683](http://ssrn.com/abstract=726683).

- Just like in *Bronner*, the *Commercial Solvents* and *Télémarketing* judgments refer to the risk of “eliminating all competition on the part of” the party requesting supplies.<sup>28</sup>
- The *Commercial Solvents* and *Télémarketing* judgments both examine whether there were any alternative sources of supply. Admittedly, in *Commercial Solvents*, this analysis was done in the context of dominance; but in the summary of *Commercial Solvents* at paragraph 38 of the *Bronner* judgment, the Court specifically stated that *Commercial Solvents* concerned raw materials which were “indispensable” to the downstream rival. And in *Télémarketing* the Court clearly noted that the input at issue was “indispensable” to the downstream competitor.<sup>29</sup>
- Finally, the issue of justification was in fact examined in both judgments. In *Commercial Solvents* both the Commission and the Court considered whether *Commercial Solvents* could actually “satisfy Zoja’s needs”.<sup>30</sup> And in *Télémarketing* the Court recognised that there would be no abuse if the refusal was “justified by technical or commercial requirements”.<sup>31</sup>

Therefore, it is submitted that the case-law of the Court does not necessarily preclude the Commission from treating first-time refusals and termination cases under the same test.

A distinction between dominant firms’ duties towards new and existing customers is moreover in many ways arbitrary.<sup>32</sup> Apart from the issue of reconciling precedent with future practice, there is a *policy* argument which is central to the analysis: if there were a distinction between first-time refusals and termination cases, once a dominant company has begun to deal with a third party, Article 82 could be invoked to prevent it from discontinuing supplies even where an obligation to deal did not exist in the first place. In our opinion, this cannot be right – even though the termination of an existing commercial relationship may give rise to a certain degree of suspicion. The fact is that there are often genuine commercial and pro-competitive reasons as to why a firm may decide to terminate a relationship that may once have been profitable (such as, for example, the possibility to realise efficiency gains through vertical integration). It may therefore be unwise to adopt a less stringent legal test, i.e., a stronger presumption of illegality, in relation to the severance of a prior course of dealing (as opposed to a first-time refusal to supply). No one wants to be locked into a relationship after it has ceased to be useful simply because legal consequences would follow its termination. Such legal consequences could deter firms from dealing at all, which could be damaging to the economy.

<sup>28</sup> *Commercial Solvents*, para. 25, and *Télémarketing*, para. 26.

<sup>29</sup> *Télémarketing*, para. 26.

<sup>30</sup> *Commercial Solvents*, para. 28.

<sup>31</sup> *Télémarketing*, para. 26.

<sup>32</sup> R. Subiotto and R. O’Donoghue, “Defining the Scope of the Duty of Dominant Firms to Deal with Existing Customers under Article 82 EC”, (2003) 24 *E.C.L.R.* 683 (a distinction between dominant firms’ duties towards new and existing customers seems “arbitrary”; both new customers and existing customers are subject to the requirement that the requested input or facility be “essential”).

Proponents of the distinction between first-time refusals and termination cases argue that in termination cases there is the added dimension of *abrupt* disruption of competition, at least in the short run. It may be argued however that this can be dealt with within the province of contract law or unfair competition law and that it is not the role of competition law to assist a company that has failed to secure a steady source of supply. More fundamentally, perhaps, such a legal distinction fails to take into account that a firm is not generally under an obligation to make it easier for its competitors to compete. The law should not encourage firms to rely on their rivals.

It is therefore suggested that the “essential facility” reasoning – which is, in effect, a rule on the circumstances in which there exists a “duty to deal” (rather than a new or distinct rule under Article 82) – applies equally to existing customers and first-time access requests.

## **V. Intellectual Property Rights v. Tangible Property Rights**

The interface between competition law and IPRs is a controversial area. There have been calls for the adoption of a stricter legal test for refusal to license IPRs than for refusal to deal involving tangible property;<sup>33</sup> or, going even further, for the adoption of a *per se* legality rule in favour of refusals to license IPRs, on the ground that the prerogatives inherent in IPRs always provide an “objective justification”.<sup>34</sup>

The case-law of the ECJ, and in particular the *IMS* judgment, partially reflects this “higher standard” approach. The *IMS* judgment can be interpreted as setting a higher standard for compulsory licensing cases than for compulsory access to “physical” property. While in the case of physical property, the test is one of indispensability/elimination of competition on a downstream market, where IPRs are involved, the *IMS* case-law appears to go beyond these requirements by requiring the presence of an additional element such as the prevention of the emergence of a “new” product.

It may be noted that this issue has also been extensively debated in the U.S. Following the Federal Circuit judgment in *CSU v. Xerox* (2000), the position there seems to be that there can never be a free-standing duty to license “[i]n the absence of any indication of illegal tying, fraud in the Patent and Trademark Office, or sham litigation”.<sup>35</sup>

---

<sup>33</sup> See the Opinion of A.G. Jacobs in *Bronner*, supra note 4, at para. 62.

<sup>34</sup> See J. Temple Lang, “Anti-Competitive Abuses Under Article 82 Involving Intellectual Property Rights”, in *European Competition Law Annual 2003: What is an Abuse of a Dominant ?*, C.D. Ehlermann and I. Atanasiu (eds), Hart Publishing, forthcoming in November 2005. See also A. Lipsky and G. Sidak, “Essential Facilities”, (1999) 51 *Stanford Law Review* 1187.

<sup>35</sup> *CSU v. Xerox*, 203 F.3d 1322 (Fed. Cir. 2000). See also *Townshend v. Rockwell*, 2000-1 Trade Cas. (CCH) 72,890 (N.D. Cal. 2000) and *Minebea v. Papst*, 229 F. Supp. 2d 1 (D.D.C. 2002) (applying *CSU v. Xerox*). Under *Nobelpharma*, 141 F.3d 1059, 1068 (Fed. Cir. 1998) (en banc) and *Unitherm*, 375 F.3d 1341, 1355 (Fed. Cir. 2004), Federal Circuit law governs all antitrust claims “premised on the abuse of a patent right” or “on the bringing of a patent infringement suit”.



The following arguments are generally invoked to justify greater deference to IPRs: (a) intrusion into IPRs is inconsistent with the exclusive nature of these rights;<sup>36</sup> (b) IPRs are more valuable than rights in physical property because they incorporate *moral rights*;<sup>37</sup> (c) IPRs are more vulnerable to replication/free-riding than rights in physical property;<sup>38</sup> (d) the exclusive right over IP is only for a limited, carefully calibrated duration and therefore compulsory licensing would upset that delicate calculation;<sup>39</sup> (e) Article 82 should not be used as a repair mechanism for allegedly flawed IPRs;<sup>40</sup> and (f) compulsory licensing of IPRs would dampen innovation incentives.<sup>41</sup>

Notwithstanding the above, however, it is submitted that the goals of competition law and IPRs are in many ways complementary rather than contradictory and that it is ultimately unwise to distinguish between IPRs and other property rights in the area of refusal to deal.<sup>42</sup> There are a number of arguments supporting this.

First, IPRs and tangible property rights are both proprietary interests, which share the same principal prerogative – the right to exclude others. This does of course not mean

---

<sup>36</sup> Lipsky and Sidak, *supra* note 34; J. Gleklen, “Per Se Legality for Unilateral Refusals to License IP Is Correct as a Matter of Law and Policy”, *The Antitrust Source*, July 2002; J. Temple Lang, *supra* note 34.

<sup>37</sup> E. Derclaye “Abuses of dominant position and intellectual property rights: a suggestion to reconcile the Community courts case-law”, (2003) 26 *World Competition* 685 at 700-701.

<sup>38</sup> See, e.g., the 1995 DOJ/FTC Antitrust Guidelines for the Licensing of Intellectual Property, section 2.1: “*Intellectual property has important characteristics, such as ease of misappropriation, that distinguish it from many other forms of property*”.

<sup>39</sup> Opinion of A.G. Jacobs, *supra* note 4. See also Derclaye, *supra* note 37; R. Picker, “Copyright as Entry Policy: The Case of Digital Distribution”, (2002) 47 *Antitrust Bulletin* 423 (2002) (“*antitrust really is not about calibrating the returns from an innovation or copyrighted work that results in substantial market power and monopoly profits. ... In contrast, copyright is precisely about making careful trade-offs between creation incentives and subsequent use rights*”); and T. Cotter, “Intellectual Property and the Essential Facilities Doctrine”, (1999) 44 *Antitrust Bulletin* 211 at 244 (same) and 250 (antitrust enforcement would upset the “delicate balance between incentive and access” as codified in IP law).

<sup>40</sup> J. Temple Lang, “Intellectual Property and Competition Policy – Mandating Access: The Principles and the Problems”, British Institute of International and Comparative Law, May 2004; F. Lévêque, “Innovation, Leveraging and Essential Facilities: Interoperability Licensing in the EU Microsoft Case”, (2005) 28 *World Competition* 71 at 80 and 91; M. Katz, “Intellectual Property Rights and Antitrust Policy: Four Principles for a Complex World”, (2002) 1 *Journal on Telecommunications & High Technology Law* 325 at 351; Cotter, *supra* note 39, at 214 and 250.

<sup>41</sup> See, e.g., D. Carlton, “A General Analysis of Exclusionary Conduct and Refusal to Deal – Why *Aspen* and *Kodak* are Misguided”, (2001) 68 *Antitrust Law Journal* 659 at 674. See also the opinion of A.G. Jacobs in *Bronner*, *supra* note 4 at para. 62. See further the Order of the President of the Court of First Instance in T-184/01 R *IMS Health* [2001] E.C.R. II-3193, at para. 125. The views expressed by A.G. Jacobs and President Vesterdorf echo similar concerns in the U.S.: see, e.g., *Data General v. Grumman*, 36 F.3d 1147, 1186 (1st Cir. 1994) (“*exposing patent activity to wider antitrust scrutiny would weaken the incentives underlying the patent system, thereby depriving consumers of beneficial products*”); and *SCM v. Xerox*, 645 F.2d 1195, 1209 (2d Cir. 1981) (same).

<sup>42</sup> See for example Katz, *supra* note 40, at 349: “*the arguments for special treatment of intellectual property are incomplete. Indeed, the arguments for imposing less of a duty to deal on intellectual property than on other forms of property have been disappointingly superficial to date. ... [M]ore rigorous analysis is needed if one is to take seriously arguments that intellectual property is deserving unique treatment.*”

that there are no differences between tangible property rights and IPRs.<sup>43</sup> However, these differences are arguably reflected in the design and characteristics of intellectual and tangible property rights respectively.<sup>44</sup> Thus, from the perspective of competition law enforcement, these property rights can be treated equally.<sup>45</sup> In other words, there is no overriding reason to distinguish between different sources of monopoly power for the purpose of the application of Article 82.

Second, it is also submitted that it would be excessive to confer blanket immunity on IPRs on the basis that the limited duration and scope of these rights already reflects a trade-off between the exclusion of competition and the promotion of innovation. Indeed, although the scope and duration of the exclusive right is the same in each category of IPRs, there are important differences in the “value” of the underlying investments protected by these rights. The trade-off that is achieved by IPRs is thus largely indiscriminate and perhaps more theoretical than real, with the result that a particular IPR can afford a degree of protection which is out of proportion with the initial investment that it required. It is therefore unwise to generally immunise IP rights from antitrust interference.<sup>46</sup>

Third, and following from the above, any difference in treatment favouring IP compared to physical facilities is counter-productive in that it could threaten to skew the allocation of resources and distort business behaviour. For instance, it could induce dominant firms to incorporate *some* IP into their valuable input, facility or interface in order to claim the benefit of a higher standard of protection. As has been written elsewhere, “*it would be a trivial matter for firms, on advice of counsel, to modify their designs in order to incorporate protected components.*”<sup>47</sup> The application of the law should not depend on such forensic devices.

---

<sup>43</sup> For a comparison of IP and tangible property, see R. Gilbert and W. Tom, “Is Innovation King at the Antitrust Agencies? The Intellectual Guidelines Five Years Later”, 69 *Antitrust Law Journal* 43 (2001) and J. Langenfeld, “Intellectual Property and Antitrust: Steps Toward Striking a Balance”, (2001) 52 *Case Western Reserve Law Review* 91; P. Régibeau and K. Rockett, “The Relationship Between Intellectual Property Law and Competition Law: An Economic Approach”, University of Essex Department of Economics Discussion Paper no. 581 (2004); Mark Lemley, “Property, Intellectual Property and Free Riding”, (2005) 83 *Texas Law Review* 1031.

<sup>44</sup> Régibeau and Rockett, *supra* note 43, at page 30.

<sup>45</sup> See also the 1995 DOJ/FTC Antitrust Guidelines for the Licensing of Intellectual Property, section 2.0: “*for the purpose of antitrust analysis, the Agencies regard intellectual property as being essentially comparable to any other form of property.*”

<sup>46</sup> Note that the DOJ opposed categorical antitrust immunity for refusals to license in its brief to the Supreme Court opposing certiorari in *CSU v. Xerox*. See amicus brief for the United States at 10 (expressing “serious concerns about such a holding” and stating that the U.S. “would not be prepared to endorse it”). See also W. Cornish and D. Llewellyn, *Intellectual Property: Patents, Copyright, Trade Marks and Allied Rights*, Sweet & Maxwell, 5th Ed, London, (2003) at 755. “[i]n a period when intellectual property rights are being rapidly expanded, it must be wise for competition authorities to retain some ultimate means of curbing their range in egregious cases, which, in the scramble to satisfy industrial lobbies, legislatures may not have sufficiently cogitated.”

<sup>47</sup> J. MacKie-Mason “Antitrust Immunity for Refusals to Deal in (Intellectual) Property Is a Slippery Slope”, *The Antitrust Source*, July 2002. See also D. Melamed and A. Stoepplwerth, “The *CSU* Case: Facts, Formalism and the Intersection of Antitrust and Intellectual Property Law”, (2002) 10 *George Mason Law Review* 407: “*There is no reason to think that AT&T should have been permitted to engage*

Fourth, the argument that compulsory licensing would dampen investment incentives is not specific to IPRs:

- IPRs are not alone in requiring an incentive/reward for investment. There is not necessarily an intrinsic correlation between the type of property right and the amount of investment incurred in the creation of that property right. Arguably, investments in physical property display lower failure rates than investments in IPRs. That does not, however, mean that the amount of investment that goes into intellectual property rights is greater but merely that the cost of failed projects may have to be taken into account in calculating the “real” cost of the investment.<sup>48</sup>
- Tangible property, just like IP, requires commensurate incentives/rewards (consider, e.g., port and airport facilities, railway infrastructure, ski lifts, etc).<sup>49</sup> Why should a newspaper that starts a home delivery network (thereby “innovating” just as much as IP-based companies) be more exposed to the application of Article 82 than an IP-based company – or indeed a company that has secured IP protection for what is merely a by-product of another activity (such as the copyright over TV program listings in *Magill*)? IPRs are not demonstrably superior to other property rights.
- It is worth bearing in mind that more financial incentives in the form of a broader exclusive right (than if the IP right was curtailed by a compulsory licence) do not necessarily translate into more innovation. The IP-related financial incentive

---

*in the conduct at issue there if only the interfaces used by MCI to connect with AT&T's network had been patented – especially since AT&T's market power was a result of its ubiquitous local network, not its interfaces. ... [S]afe harbors distort business behaviour. Antitrust counsel would advise an AT&T of today, for example, that it could immunize its anti-competitive refusal to deal from the antitrust laws by contriving to design its system so that firms like MCI that need access to its network would have to use patented or copyrighted interfaces that, under CSU, it may refuse to license.”*

<sup>48</sup> See in this context the Commission Guidelines on Technology Transfer Agreements, (2004) O.J. C 101/2, at para. 8, where it is noted that “the innovator should normally be free to seek compensation for successful projects that is sufficient to maintain investment incentives taking failed projects into account.”

<sup>49</sup> See B. Doherty, “Just What Are Essential Facilities?”, (2001) 38 *C.M.L.Rev.* 397 at 429: “IP rights are not the only investment which requires significant capital. A dominant undertaking could also claim to have invested large sums in a port or a bridge or a telephone network, and argue that the principles which protect IP owners (i.e. the need to encourage investment) also apply to investment in other property. ... It would certainly be strange if there were an automatic protection for IP (however trivial) but a harsher rule for other forms of property.” See also E. Elhauge, “Defining Better Monopolization Standards”, (2003) 56 *Stanford Law Review* 253 at 276; A. Heinemann, “Compulsory Licences and Product Integration in European Competition Law – Assessment of the European Commission’s *Microsoft* Decision”, (2005) 36 *International Review of Intellectual property and Competition Law (IIC)* 63 at 71 (“no sufficient reason to protect tangible property less than intellectual property”); Régibeau and Rockett, *supra* note 43; Katz, *supra* note 40; and H. Hovenkamp, “United States Antitrust Policy in an Age of IP Expansion”, Fordham Corporate Law Institute 31th Annual Conference on International Antitrust Law and Policy, October 2004, available at [ssrn.com/abstract=634224](http://ssrn.com/abstract=634224).

- curve – i.e., the return per invention which is attributable to IP protection, or “patent premium” – and the innovation curve are not indefinitely parallel: at some point, the innovation curve diverges. This means that total appropriation of *all* possible returns does not necessarily foster innovation.<sup>50</sup>
- There is also some evidence that the “patent premium” is actually not as important to innovators as other factors of success:<sup>51</sup> patents are merely one of several devices that firms use to “capture” or “appropriate” the returns from an invention, such as the first-mover advantage, successful marketing, maintaining the secrecy of the invention, the ability to move quickly down the learning curve, superior service, or network effects.<sup>52</sup>
  - Assuming that a firm’s decision to invest in R&D is rational *and* factors in the probability that the result of its R&D will be subject to a compulsory licence,<sup>53</sup> that probability is in any event negligible: compare the number of compulsory licences ordered by antitrust enforcers with the total amount of IP produced in any given timeframe. It may be doubted therefore whether it is correct to take for granted that a compulsory licence will *always* discourage investment in innovation. The evidence suggests that this is not the case if an obligation to license is only imposed in exceptional and carefully defined circumstances.<sup>54</sup> Moreover, the argument that compulsory licensing necessarily undermines

<sup>50</sup> Lemley, supra note 43, at 1057: “*Sufficient incentive ... is something less than perfect control*” (citing Lawrence Lessig, “Intellectual Property and Code”, (1996) 11 *Saint John’s Journal of Legal Commentary* 635. See also Brunell, supra note 19, and further, W. Landes and R. Posner, “An Economic Analysis of Copyright Law”, (1989) 18 *Journal of Legal Studies* 325.

<sup>51</sup> See the sources cited in Peepkorn, supra note 18.

<sup>52</sup> A “network effect” exists when the utility that a user derives from a product varies with the number of users of that product.

<sup>53</sup> See however Katz, supra note 40 at 346 (speaking of “*the high degree of uncertainty that innovation often entails*”). See also, generally, F. Scherer, “The Innovation Lottery”, in Dreyfuss et al., eds., *Expanding the Boundaries of Intellectual Property*, Oxford University Press, 2001, page 3.

<sup>54</sup> Melamed and Stoepelwerth, supra note 47, express the same opinion at 422: “*plaintiffs rarely succeed under this doctrine, so the risk that intellectual property might be deemed to be an essential facility is not likely materially to diminish ex ante incentives for innovation and thus should not undermine the purposes of the intellectual property laws.*” They cite F. Scherer, *Innovation and Growth: Schumpeterian Perspectives*, MIT Press, 1984, page 216 (“no evidence” that compulsory licensing in antitrust decrees led to reduced development in R&D). See also D. Turner, “Basic Principles in Formulating Antitrust and Misuse Constraints on the Exploitation of Intellectual Property Rights”, (1985) 53 *Antitrust Law Journal* 485 at 489 (noting the “*flaw in the supposition that any antitrust rules limiting the patentee’s reward would have a significant effect on decisions to embark on inventive activity*”); S. Genevaz, “Against Immunity for Unilateral Refusals to Deal in Intellectual Property: Why Antitrust Law Should Not Distinguish between IP and Other Property Rights”, (2004) 19 *Berkeley Technology Law Journal* 741 cites “*empirical evidence showing that compulsory licensing [has] little, if any, effects on the incentives to innovate*”, also referring to F. Scherer, *The Economic Effects of Compulsory Patent Licensing*, New York University Monograph Series in Finance and Economics, 1977, page 63 (“*no indication that mandatory licensing ha[s] an adverse effect on R&D investment*”). See also the statement by Scherer in the transcripts of the FTC hearings on Global and Innovation-Based Competition on November 29, 1995, available at [ftc.gov/ftc/hearings.htm](http://ftc.gov/ftc/hearings.htm).

innovation also fails to account for “second-generation” innovations which are made possible, or “unlocked”, by the compulsory licence.<sup>55</sup>

It may therefore be questioned whether special deference to IPRs would be beneficial or indeed serve the objectives underlying the grant of IPRs. On the contrary, based on the arguments outlined above, the better view, it is submitted, is that IPRs should *not* be granted special treatment in the enforcement of competition rules.<sup>56</sup>

## VI. The Proper Legal Test for Unilateral Refusal to Supply – Conceptual Issues

A unilateral refusal to supply can be analysed in a number of different ways. For example, one possible approach would be that a firm should not be penalised for refusing to deal. The opposite position is to conduct a case-by-case assessment of the positive and negative effects of antitrust interference on competition. A third – and intermediate – position is to adopt a “checklist” approach. This third option can be further subdivided into at least two approaches. The first is to adopt an exhaustive “checklist” of the conditions that must be met, these conditions being both necessary and sufficient. The second is to retain a certain degree of flexibility by identifying only *some* requirements that must be met in each case (effectively, a series of “screens”) while recognising that the decisive factor in the analysis may lie in a case-by-case assessment of the positive and negative effects of antitrust intervention.

---

<sup>55</sup> See J. Stiglitz, speech at the opening of the 1995/1996 FTC Hearings on Competition Policy in the New High-Tech, Global Marketplace, 1995; Peter Menell, “An Epitaph for Traditional Copyright Protection of Network Features of Computer Software”, (1998) 43 *Antitrust Bulletin* 651 at 677; Landes and Posner, *supra* note 50; C. Fazio and S. Stern, “Innovation Incentives, Compatibility, and Expropriation as an Antitrust Remedy”, 68 *Antitrust Law Journal* 45 (2000); J. Baker, “Promoting Innovation Competition Through The Aspen/Kodak Rule”, (1999) 7 *George Mason Law Review* 495 at 514; S. Salop and C. Romaine, “Preserving Monopoly: Economic Analysis, Legal Standards, and Microsoft”, (1999) 7 *George Mason Law Review* 617 at 664; and Brunell, *supra* note 19, at 24-25: “Because technological advance is often an interactive, cumulative process, strong protection of individual achievements may slow the general advance. When innovations are ‘building blocks,’ weaker appropriability may in fact increase overall R&D, not only by increasing the incentives and productivity of follow-on innovators, but by increasing the incentives of the first-generation innovator as well. The ‘first generation’ innovator may itself be a borrower from previous generations, may find that the follow-on innovation complements or improves its own innovation, or may be spurred by follow-on innovators to improve its own innovation.” (Internal footnotes and quotation marks omitted.)

<sup>56</sup> See also (supporting this point of view): Ritter, *supra* note 27; Elhauge, *supra* note 49; Doherty, *supra* note 49; Baker, *supra* note 55; Brunell, *supra* note 19; Salop and Romaine, *supra* note 55; Régibeau and Rockett, *supra* note 43; Melamed and Stoepelwerth, *supra* note 47; Genevaz, *supra* note 54; MacKie-Mason, *supra* note 47; Turner, *supra* note 54; Langenfeld, *supra* note 43; Heinemann, *supra* note 49; Katz, *supra* note 40; and also T. Eilmansberger, “How to Distinguish Good From Bad Competition Under Article 82 EC: In Search of Clearer and More Coherent Standards For Anti-Competitive Abuses”, (2005) 42 *C.M.L.Rev.* 129 at 158; T. Gallagher, “Copyright, Compulsory Licensing and Incentives”, Oxford Intellectual Property Research Centre Working Paper Series, 2001; B. Dumont and P. Holmes, “The Scope of Intellectual Property Rights and Their Interface With Competition Law and Policy: Divergent Paths to the Same Goal”, *Economics of Innovation and New Technology*, Volume 1, Issue 11, 2002.

Legal precedent or economic justification does not support a *per se* rule against antitrust intervention. Even prominent critics of the essential facility theory such as Areeda have conceded that it is correct as a matter of antitrust policy to punish a refusal to deal in exceptional circumstances.<sup>57</sup> There is little doubt therefore that in “certain circumstances”, a refusal to deal does harm competition and therefore should constitute an antitrust offence (as the Supreme Court held in *Trinko*). A blanket *per se* legality rule under competition law cannot be justified as a matter of law or policy.<sup>58</sup> Rather, the issue is how to clearly delineate these “circumstances”.

Examining each case on its own merits by focusing on its impact on consumer welfare may *theoretically* be a more attractive proposition. Indeed, while a duty to deal can reduce incentives to innovate (and thus distort competition), the magnitude of that risk varies from case to case. Additional *ex post* competition can outweigh a lessening of *ex ante* incentives to innovate. The rewards flowing from the right to exclude can also, in practice, exceed what is required to induce the necessary investment. There is therefore an argument that the *ex post*/*ex ante* trade-off should not be skewed in favour of the latter. Instead, *ex post* allocative efficiency gains, which can be maximised by an obligation to deal, should be balanced against the *ex ante* dynamic efficiency gains, which can best be maximised by not imposing such an obligation. This test (essentially a so-called “rule of reason” approach) balances the expected short-term harm to consumers against the expected long-term benefits to consumers. On this view, a refusal to supply should be caught by Article 82 where the exclusionary effects of the refusal prevail over dynamic efficiency gains. Accordingly, the fact, in particular, that competition is not eliminated by a refusal to supply or that indispensability has not been established would be a relevant but by no means conclusive factor.

Another possible aspect of a case-by-case assessment would be to take account of “overriding considerations”, for example the pro-competitive aspects of “accepted industry practice”, which could justify an obligation to deal even where the indispensability requirement is not met. For example, in the *British Midland/Aer Lingus* case, the Commission found that a refusal by Aer Lingus to interline with British Midland was abusive although there was no evidence that the refusal would eliminate competition but merely that it “*would impose a significant handicap on British Midland*”. The fact was that “*interlining ha[d] for many years been accepted industry practice, with widely acknowledged benefits for both airlines and passengers*”.<sup>59</sup>

---

<sup>57</sup> P. Areeda, “Essential Facilities: An Epithet in Need of Limiting Principles”, (1989) 58 *Antitrust Law Journal* 841 at 853, noting that it is probably correct to hold that “*a monopolist must, when feasible, make its essential facility available to a competitor who is unable to duplicate it.*”

<sup>58</sup> Actually, the wisdom of compelling access to certain resources is illustrated by the numerous legislative compulsory access schemes that the EU legislature has adopted over the years (e.g., compulsory access to the railway infrastructure, to the electricity grid, to the telephone directory, to the telecom infrastructure, etc).

<sup>59</sup> See Commission decision of 26 February 1992 (*British Midland v. Aer Lingus*), (1992) O.J. L 96/34. See also Commission decision of 4 November 1988, *London European/Sabena*, (1988) O.J. L 317/47. Compare with *Alaska Airlines v. United Airlines*, 948 F.2d 536, 544 (9th Cir. 1991) (holding that access to a computer reservation system is not indispensable).

However, the ability of competition authorities or indeed courts to determine the optimal degree of protection, and to strike the best balance between static and dynamic efficiency, may be seriously questioned.<sup>60</sup> Indeed, we have argued above that this balancing may even be impossible. A case-by-case assessment of the positive and negative effects of antitrust intervention in terms of *ex ante* incentives v. *ex post* benefits to competition is fraught with difficulties.<sup>61</sup> Moreover, there is a danger that the application of the law will become unpredictable and produce largely inconsistent results. The resulting uncertainty could discourage aggressive competition on the merits. Moreover, while property rights are not absolute, interference with such rights must comply with the requirements of legal certainty and predictability. Expensive, time-consuming, complicated and uncertain litigation should be avoided.<sup>62</sup> *Ex post* efficiencies are also more tangible and easier to measure than *ex ante* dynamic efficiencies, which could result in a bias in favour of *ex post* benefits.<sup>63</sup> This is especially so where the *ex post* reward exceeds the initial expectation of return. There is also a risk that such an assessment would in practice stretch Article 82 beyond its proper scope by shifting its focus from the *prohibition of reprehensible conduct* to a detailed analysis of markets resulting in a finding of liability whenever the market *could be made* more competitive – even in the absence of any clearly reprehensible conduct. As Justice Scalia wrote in *Trinko*, antitrust law “*does not give judges carte blanche to insist that a monopolist alter its way of doing business whenever some other approach might yield greater competition.*”

An unqualified case-by-case assessment therefore does not meet the requirements of predictability and administrability. We propose a clearly defined, multi-pronged legal test instead.

## VII. A Multi-Pronged Legal Test

Our starting point in seeking to formulate a predictable and administrable legal test is that a dominant firm is *not* under a general duty to assist its competitors.<sup>64</sup> The use of the

<sup>60</sup> See also Elhauge, *supra* note 49; and D. Geradin, “Limiting the Scope of Article 82: What Can the EU Learn From the U.S. Supreme Court’s Judgment in *Trinko* in the Wake of *Microsoft*, *IMS* and *Deutsche Telekom*?”, (2004) 41 *C.M.L.Rev.* 1519.

<sup>61</sup> Brunell, *supra* note 19.

<sup>62</sup> J. Temple Lang, “Mandating Access: the Principles and the Problems in Intellectual Property and Competition Policy”, (2004) 15 *European Business Law Review* 1087 at 1107.

<sup>63</sup> Régibeau and Rockett, *supra* note 43.

<sup>64</sup> B. Doherty, *supra* note 49, at 405. This is also true under U.S. law. See *Standard Oil*, 221 U.S. 1 (1910) (noting “*the freedom of the individual right to contract when not unduly or improperly exercised [is] the most efficient means for the prevention of monopoly*”); *Colgate*, 250 U.S. 300, 333 (1919) (a business is generally free to deal with whomever it chooses so long as that conduct is “[i]n the absence of any purpose to create or maintain a monopoly”); *Kodak*, 504 U.S. 451 (1992) (citing *Aspen*) (“*It is true that as a general matter a firm can refuse to deal with its competitors. But such a right is not absolute; it exists only if there are legitimate reasons for the refusal*”); *American Key Corp. v. Cole National Corp.*, 762 F.2d 1569, 1578 (11th Cir. 1985) (the “*antitrust laws do not compel a company to do business with anyone*”). See also R. Pitofsky, D. Patterson and J. Hooks, “The Essential Facilities Doctrine Under U.S. Antitrust Law”, 70 *Antitrust Law Journal* 443 at 451-452 (essential facility theory characterised “*as an exceptional incursion into the general rule that firms normally may choose their business partners without antitrust restraint*”).

“essential facility” label is not a “shortcut” to antitrust analysis and should not create the presumption that the facility holder is under a duty to deal.<sup>65</sup> Therefore, a unilateral refusal to deal can only infringe Article 82 in certain clearly defined circumstances. There are two principal reasons for this.

First, antitrust law is concerned with prohibiting certain types of conduct, not mandating a particular course of action. Imposing a duty to deal in certain circumstances is more akin to utility regulation than to antitrust.<sup>66</sup> Article 82 generally requires an element of reprehensible conduct, whereas the essential facility doctrine creates antitrust liability in order to solve a structural problem.

Second, in the EU as well as in the U.S., freedom to contract implies that, as a rule, firms are free to choose their business partners.<sup>67</sup> Forcing a firm to deal is an intrusion on that general principle.

In defining these “certain circumstances”, it is submitted that the Commission should take into account the following considerations, which are further explored and explained below:

- Competition must be eliminated on a downstream market distinct from the upstream market on which the dominant firm operates;
- There can be no infringement of Article 82 unless the refusal to supply eliminates (effective) competition (meaning that there is leveraging of dominance into the downstream market);
- Elimination of competition and indispensability constitute one and the same test;

---

<sup>65</sup> A. Kezsbom and A. Goldman, “No Shortcut to Antitrust Analysis: The Twisted Journey of the ‘Essential Facilities’ Doctrine,” (1996) 1 *Columbia Business Law Review* 1.

<sup>66</sup> H. Hovenkamp, M. Janis and M. Lemley, “Unilateral Refusals to License”, Ecole des Mines/Berkeley Conference on Antitrust, Patent and Copyright, Paris, 15-16 January 2004, at 14-15: “[t]he essential facilities doctrine is unique in that a monopolist’s status (as the owner of the facility and a competitor in the market that relies on the facility) rather than any affirmative conduct determines liability. The monopolist in an essential facilities case may be thought to have ‘acted’ in some sense, by refusing to deal or to continue dealing with a competitor. But generally speaking a unilateral refusal to deal is not the sort of affirmative anti-competitive conduct that the antitrust law is concerned with.”

<sup>67</sup> See the recently published decision in case COMP/38.096 *Clearstream* (2 June 2004), paragraph 217: “The system established by Community competition law recognises the principle of free enterprise and the freedom of undertakings to deal with other companies. The right to choose one’s trading partners and freely to dispose of one’s property are also generally recognised principles in the laws of the Member States.” See also the Opinion of A.G. Rozès in Case 210/81 *Demo-Studio Schmidt*, [1983] E.C.R. 3045 (referring to the “contractual freedom of traders”); A.G. Jacobs in *Bronner*, supra note 4, (referring to the freedom to contract); and Case 41/96 *Bayer*, [2000] E.C.R. II-3383, para. 180: “under Article [82], refusal to supply, even where it is total, is prohibited only if it constitutes an abuse. The case-law of the Court of Justice indirectly recognises the importance of safeguarding free enterprise when applying the competition rules of the Treaty where it expressly acknowledges that even an undertaking in a dominant position may, in certain cases, refuse to sell or change its supply or delivery policy without falling under the prohibition laid down in Article [82].”



- Elimination of competition is a necessary but by no means conclusive element that an abuse has been committed. Article 82 should not be applied to a refusal to supply where the dominant firm has invested in its own physical or intellectual property to bring new or improved products or services to the downstream market. Competition authorities and courts alike should abstain from seeking to determine whether the improvement offsets the inefficiency resulting from the *ex post* loss of competition;
- There are some objective justifications which can justify an otherwise actionable refusal to supply.

A. An upstream and a downstream market

There are two issues here: (1) whether the input or facility or IP licence to which access is sought must be marketed, on its own, as a product or service, by the facility holder (i.e. whether there needs to be an “actual” upstream market) and (2) whether the firm refusing to supply and the firm requesting supply must both be present on the same downstream market.

1. The “two markets” requirement

Refusal to supply cases generally involve situations where two markets can be identified, i.e. an upstream market and a downstream market. Although the ECJ noted in *IMS* that there should be an upstream market distinguishable from a (secondary) downstream market, it then deprived this requirement of any substance by accepting that a “potential” or even “hypothetical” upstream market would be sufficient.<sup>68</sup> Such a market exists where “*two different stages of production may be identified and ... they are interconnected, inasmuch as the upstream product is indispensable for the supply of the downstream product*”.<sup>69</sup> It is therefore enough to identify “two different stages of production” rather than two *actual* markets.

There are, however, in our view pitfalls in applying Article 82 where no “actual” upstream market exists.

First, it is somewhat artificial to consider that an upstream market exists merely because different stages of production can be identified (unless perhaps inputs are traded between separate entities within the same corporate group). The application of such a test is also unpredictable and there is a danger that dominant firms may be forced to share their production facilities as a result of overzealous enforcement. This danger is perhaps most acute in relation to IPRs since these rights are all generally capable of being licensed on a stand-alone basis.<sup>70</sup>

---

<sup>68</sup> *IMS*, para. 44.

<sup>69</sup> *IMS*, para. 45.

<sup>70</sup> Geradin, *supra* note 60, at 1523.

Second, Article 82 does not prohibit the *existence* of a dominant position, but only the *abuse* thereof. The application of Article 82 on the mere basis that there is a hypothetical upstream market for the facility implies that a dominant firm may be forced to share its competitive advantage.<sup>71</sup> In such a situation, there is no leveraging: a dominant firm would effectively be obliged to create competition in its own market – as opposed to being punished for unlawfully extending its dominant position and eliminating competition in a related downstream market. We believe that this goes beyond the scope of Article 82. Obliging a firm to create competition in its own market is also likely to have a more drastic impact on the incentive to innovate and invest. In many cases investment and innovation will be predominantly aimed at the market in which the company is competing or is expecting to compete, and the possibility of appropriating rewards in this market may constitute a minimum or threshold expectation. The possibility to leverage into a downstream or adjacent market may be less of an incentive in such cases, particularly where such a market may not have existed, or been conceived of at the time when investment or innovative effort is being considered. On the other hand, knowing that there is a risk that rewards will not be fully appropriated in the only market at which the investment or innovative efforts are aimed is more likely to have significant disincentive effects.

Third, market definition in the absence of an “actual” upstream market is an uncertain exercise. This may be overcome where an “actual” market has existed in the past or where a useful comparison exists in a different geographic market. There is also an argument that a finding that a certain input or facility is indispensable entails a finding that the firm controlling that input or facility holds a dominant position. In practice, this, however, amounts to establishing dominance without any prior market definition. Sidestepping the issue of market definition may, however, not always be possible. However, the more fundamental concern is that identifying a relevant market in this way has little to do with market definition and more to do with market structuring.<sup>72</sup> Moreover, if dominance is assessed on that basis, the indispensability test would not only constitute one element of the abuse test but also dispose of the dominance requirement. Such an application of Article 82 would render the dominance requirement quasi automatic.

For all these reasons, we believe that competition authorities and courts should exercise a certain degree of caution before concluding that a hypothetical upstream market exists in circumstances where no “actual” upstream market has been identified.

2. Whether the firm refusing to supply and the firm requesting supply must both be present on the same downstream market

As indicated above, the dominant firm may not necessarily be present on the downstream market where the party requesting supplies is active. The Commission should therefore

---

<sup>71</sup> Temple Lang, *supra* note 34, at 17-18.

<sup>72</sup> See P. Larouche, *Competition Law and Regulation in European Telecommunications*, Hart Publishing, 2000.

indicate whether the firm refusing to supply and the requesting party must be competitors on the same downstream or related market.

Conventional wisdom suggests that a refusal to deal should only be actionable where it protects the market power of the firm that refuses to deal, meaning that the facility holder and the firm requesting access must be present on the same downstream market.<sup>73</sup> That view derives some support from the ruling of the CFI in *Ladbroke*<sup>74</sup> and from the opinion of A.G. Jacobs in *Bronner*.<sup>75</sup> U.S. case-law is also extremely stable on this point: see for example *MCI v. AT&T*, *Blue Cross*, *Caribbean Broadcasting*, and *Intergraph*.<sup>76</sup>

The “downstream presence” requirement is understandable, as (a) the essential facility theory is essentially about leveraging (which can be aggressive and/or defensive), and (b) in the interest of legal certainty, firms should be able to expect potential antitrust liability only in markets where they are present – removing the downstream presence requirement could open the floodgates. Therefore, where the firm refusing to supply is not present on the downstream market and has no plans to enter that market (for example by integrating forward as in *Commercial Solvents*), the refusal is in fact a refusal to supply a customer and should be analysed as such.

On the other hand, where the dominant firm is not present on the downstream market, it is not immediately obvious that this should *automatically* preclude the finding of an abuse. The firm requesting supply may be able to use the input in such an innovative way as to in fact develop a product which creates its own market. The firm refusing to supply would by definition not be present on this new market (although it may be able to enter that market in the future). It may not be rational to exclude as a matter of principle the application of Article 82 where there is a great leap of innovation while accepting that Article 82 could apply where the “new” (and possibly less innovative) product belongs to the downstream market on which the firm refusing to supply already operates. Such an outcome would appear to be counter-intuitive. It would in addition be very difficult to predict to which market a “new” product will belong; the application of Article 82 should arguably not depend on such an uncertain assessment.

---

<sup>73</sup> Doherty, *supra* note 49, at 411.

<sup>74</sup> At paras. 123 and 129-130.

<sup>75</sup> At para. 65: “It seems to me that intervention of that kind, whether understood as an application of the essential facilities doctrine or, more traditionally, as a response to a refusal to supply goods or services, can be justified in terms of competition policy only in cases in which the dominant undertaking has a genuine stranglehold on the related market.”

<sup>76</sup> See the definitions of the essential facility doctrine in *MCI Communications v. AT&T*, 708 F.2d 1081, 1132–1133 (7th Cir. 1983), *Blue Cross & Blue Shield United of Wisconsin v. Marshfield Clinic*, 65 F.3d 1406, 1412 (7th Cir. 1995), and *Caribbean Broadcasting System v. Cable & Wireless*, 148 F.3d 1080 (D.C. Cir. 1998) (making clear that the facility holder and the requesting party must be competitors). See also *Intergraph v. Intel*, 195 F.3d 1346 (Fed. Cir. 1999) (rejecting plaintiff’s essential facility claim on the ground that defendant Intel was not present on the related, downstream market for high-end workstations where Intergraph was active).

B. No infringement of Article 82 unless the refusal to supply eliminates competition

It is submitted that no infringement exists unless a refusal eliminates *effective* competition (see below) on the market (not just competition from the requesting party). The following points can be made here.

First, the need to encourage investment and to avoid disincentives makes it undesirable to impose an obligation to supply where it is possible for a competitor or competitors to reproduce the relevant facility or product, or to otherwise get around the effect of the refusal.

Second, in terms of logic, a refusal to deal where the “essential” facility or input is truly “indispensable” by definition eliminates competition in the market, rather than just competition from the requesting party. The *Bronner* judgment, in our view, fails to recognise this since it puts the “elimination of competition” test on the same par as the “indispensability” test and the “absence of justification” test.<sup>77</sup> This, in our opinion, cannot be right. The correct, logical approach is that the “indispensability” test also disposes of the “elimination of all competition” test.<sup>78</sup> Consequently, the level of competition in the downstream market does not constitute a test of its own – it is one element which goes to show that the indispensability test is met.

Third, it is submitted that the refusal to deal does not need to eliminate *all* competition in the downstream market. This would be going too far. Eliminating all *effective* competition is sufficient (rather than “eliminating all commercial presence”). It is suggested that the relevant question is whether the refusal to supply ultimately enables a firm that holds a monopolistic or dominant position upstream to gain a dominant position on the downstream market.

Fourth, account must be taken in applying the indispensability test, of the dynamic nature of an industry and, in particular, the likelihood of rapid dissipation of market power. There is a need for caution in markets that exhibit a strong degree of innovation or Schumpeterian competition. The greater the rate of innovation, the more a finding that competition will be eliminated should be based on strong and convincing evidence.

Against this background, the indispensability requirement can be sub-divided into three separate lines of enquiry: first, is the facility absolutely indispensable to the party requesting access or does it just make life easier? Second, are there alternatives that could

---

<sup>77</sup> *Bronner*, para. 41.

<sup>78</sup> See *City of Anaheim v. Southern California Edison Co.*, 955 F.2d 1373, 1380 n.5 (9th Cir. 1992) (a facility “controlled by a single firm will be considered ‘essential’ only if control of the facility carries with it the power to eliminate competition” in the related downstream market where the facility holder competes with the requesting party) (quoting *Alaska Airlines v. United Airlines*, 948 F.2d 536, 544 (9th Cir. 1991)); and *Aldridge v. Microsoft*, 995 F. Supp. 728, 753 (S.D. Texas 1998) (rejecting Aldridge’s essential facilities claim that Microsoft had violated §2 by making its operating system incompatible with a competitor’s product, because “a facility is essential under the antitrust laws only when it is vital to both the plaintiff’s individual competitive viability and the viability of the market in general”).

be used instead of the allegedly “essential” facility? Third, is it *impossible* or *unreasonably difficult* to reproduce the allegedly “essential” facility?

1. Is the facility indispensable or just convenient?

According to the 1998 Access Notice, “it will not be sufficient that the position of the company requesting access would be more advantageous if access were granted – but refusal of access must lead to the proposed activities being made either impossible or seriously and unavoidably uneconomic.”<sup>79</sup>

If the requesting party and/or other competitors are present on the downstream market, it is tempting to infer that access to the facility is not truly indispensable to them. This is, however, not always correct. The question is whether competitors of the facility holder can have a certain level of presence in the downstream market and nonetheless claim that access to the facility is indispensable to them. This question should be answered in the affirmative for at least two reasons.

First, it may be that the competitors’ presence is declining and *all* competition will be effectively eliminated in the foreseeable future. This might be the case in markets displaying network effects, where market shares evolve dramatically once “tipping” occurs.<sup>80</sup>

The second reason (as noted above) is that the relevant question in applying the indispensability requirement is whether a refusal to supply ultimately enables the dominant firm to gain a dominant position in the downstream market. Since dominance does not mean elimination of *all* competition, the degree of foreclosure that must be demonstrated to trigger the potential application of Article 82 does not necessarily require that the refusal causes the requesting party to go out of business.<sup>81</sup>

2. Are there possible alternatives?

This point is relatively straightforward. A useful illustration of this requirement can be found in the *Bronner* judgment, where the ECJ performed an examination of the possible alternatives.

---

<sup>79</sup> Commission Notice on the application of the competition rules to access agreements in the telecommunications sector, (1998) O.J. C 265/2, para. 91(a).

<sup>80</sup> See D. Ridyard, “Compulsory Access Under EC Competition Law – A New Doctrine of ‘Convenient Facilities’ and the Case for Price Regulation”, (2004) 25 *E.C.L.R.* 669 at 670: “*Conceivably, one might argue that, taking an appropriately dynamic view of the market, and in view of the tendency for some high tech markets to ‘tip’, failure to provide access to interoperability information today will condemn the server software market to near-certain monopolisation by Microsoft in the foreseeable future. If this outcome can be forestalled only by prompt action today, then it is just arguable that the alternative to intervention today is indeed the ‘elimination of all competition’ that is laid down as a requirement in the IMS judgment.*”

<sup>81</sup> See Pitofsky et al., note 64 above, at 449: “*this element does not go so far as to require that the restriction cause the party denied access to go out of business*” (relying on *Aspen* and *Associated Press*).

3. Is it “impossible” or “unreasonably difficult” to replicate the facility?

Useful guidance on this point can be found in the Opinion of Advocate General Jacobs in *Bronner*, paragraph 66 of which refers to circumstances “*where duplication of the facility is impossible or extremely difficult owing to physical, geographical or legal constraints or is highly undesirable for reasons of public policy.*”

According to the *Bronner* judgment, “*in order to determine whether a product or service is indispensable for enabling an undertaking to carry on business in a particular market, it must be determined ... whether there are technical, legal or economic obstacles capable of making it impossible or at least unreasonably difficult for any undertaking seeking to operate in the market to create, possibly in cooperation with other operators, the alternative products or services.*”<sup>82</sup>

In terms of economic obstacles, the principle line of enquiry is likely to be whether a firm that is at least equally efficient as the dominant firm is capable of replicating the facility, that is to say, as was noted by the Court in *IMS*, whether “*the creation of those products or services is not economically viable for production on a scale comparable to that of the undertaking which controls the existing product or service.*”<sup>83</sup>

We suggest that the Commission indicate that the requirement of “impossibility of replication” is met in cases involving:

- a natural monopoly<sup>84</sup> (e.g., owing to the geographic characteristics of an area, as in the port cases or in *Terminal Railroad*,<sup>85</sup> or because of network effects);<sup>86</sup>
- government-granted monopolies; and
- “single-source” information (e.g., stock market data, train and airline schedules, sports scores, telephone listings,<sup>87</sup> TV listings,<sup>88</sup> etc).

---

<sup>82</sup> This is a summary of the relevant paragraphs of the *Bronner* judgment in the *IMS* judgment, para. 28.

<sup>83</sup> Ibid.

<sup>84</sup> *Blue Cross & Blue Shield United of Wisconsin v. Marshfield Clinic*, 65 F.3d 1406, 1412 (7th Cir. 1995) (per Judge Posner): “*the concept of essential or bottleneck facilities has been used from time to time to require a natural monopolist to cooperate with would-be competitors*”. A natural monopoly is a persistent situation where a single company is the only supplier of a particular kind of product or service due to the fundamental cost and demand structure of the industry.

<sup>85</sup> Where the defendant association had bought the only three possible railway bridges across the Mississippi River.

<sup>86</sup> Some markets that display so-called “network effects” can have a tendency to evolve towards monopoly, so that once the monopolist is entrenched, it is very difficult if not impossible for another product (even an objectively better product, in terms of quality and/or price) to attract enough users to effectively compete with the entrenched product. Where a firm seeks access to an input which is subject to network effects, that input may be effectively impossible to replicate. See M. Lemley and D. McGowan, “Legal Implications of Network Economic Effects”, (1998) 86 *California Law Review* 479.

<sup>87</sup> In the EU, there is now a Directive dealing specifically with compulsory access to telephone listings. See recital 35 of the Universal Service Directive (no. 2002/22), (2002) O.J. L 108/51: “*All service*

The alternative requirement of “unreasonable difficulty” applies where it is actually possible to replicate the essential facility but only at such a cost that the expected demand for the newly-built facility would fail to generate a reasonable return (from the point of view of a reasonable investor).<sup>89</sup>

C. Elimination of competition is a necessary but by no means sufficient element that an abuse has been committed

The key point here is that an allegedly indispensable facility may in fact reflect the facility holder’s superior business performance. An obligation to share this with competitors could distort competition and the competitive process,<sup>90</sup> as it basically (a) penalises the firm in question for competing on the merits and (b) assists the requesting party, which no longer needs to create its own competing input (hence a loss of potential competition). There can thus be little doubt that forcing a firm to supply may harm innovation and result in a cost to competition and social welfare.<sup>91</sup> On the other hand, an obligation to supply can (although this does not necessarily hold in every case) improve static welfare by preventing the facility holder from maintaining prices above the competitive level. Also, an obligation to supply may encourage greater innovation across

---

*providers which assign telephone numbers to their subscribers are obliged to make relevant information available in a fair, cost-oriented and non-discriminatory manner.”* See also Article 6(3) of Directive 98/10 on the application of open network provision (ONP) to voice telephony and on universal service for telecommunications in a competitive environment, 1998 OJ L 101/24: “*In order to ensure provision of [directory enquiry services], Member States shall ensure that all organisations which assign telephone numbers to subscribers meet all reasonable requests to make available the relevant information in an agreed format on terms which are fair, cost oriented and non-discriminatory.*” For U.S. case-law dealing with compulsory access to phone listings, see *Bellsouth v. Donnelley*, 719 F. Supp. 1551 (S.D. Fla. 1988) at 1556 (“*although the doctrine of essential facilities has been applied predominantly to tangible assets, there is no reason why it could not apply, as in this case, to information wrongfully withheld. The effect in both situations is the same: a party is prevented from sharing in something essential to compete*”), reversed on other grounds, 999 F.2d 1436 (11th Cir. 1993), cert. denied, 520 U.S. 401 (1994); *Feist*, 737 F. Supp. 610, 617-20 (D. Kan. 1990) (analysing essential facilities doctrine in context involving allegedly copyrighted telephone listings), reversed on other grounds, 506 F.2d 765 (10th Cir. 1992); 499 U.S. 340 (1990) (finding that telephone listings at issue were not copyrightable).

<sup>88</sup> As regards TV listings, see the ECJ judgment in *Magill*, supra note 3, and *NOS v. NMA* (the “Dutch *Magill* case” – judgment of the College van Beroep voor het Bedrijfsleven’s-Gravenhage of 15 July 2004 in case no. AWB 03/132 *Nederlandse Omroep Stichting (NOS) v. Nederlandse mededingingsautoriteit* (Dutch Competition Authority)).

<sup>89</sup> See the Opinion of A.G. Jacobs in *Bronner*, supra note 4, at para. 66: “*if the cost of duplicating the facility alone is the barrier to entry, it must be such as to deter any prudent undertaking from entering the market.*”

<sup>90</sup> T. Eilmansberger, supra note 56, at 158: “*The indispensability criterion does not take sufficiently into account that the erection of an essential facility may in itself be an expression of superior business performance and thus a manifestation of competition on the merits. As a result, an obligation to share the facility with competitors on a downstream market might have the effect of introducing rather than eliminating a distortion of competition, and of ultimately merely aiding competitors and not the competitive process.*”

<sup>91</sup> See also Opinion of A.G. Jacobs in *Bronner*, supra note 4.

the industry. Although, the trade offs are “*deceptively simple*”, it is evidently difficult or even impossible to determine on which side of the line a case falls.<sup>92</sup>

A simple solution would be to restrict the application of Article 82 only to those cases where the refusal to supply prevents the emergence of a new product for which there is clear consumer demand that is not currently being satisfied. It may be felt that the advantage of such an approach is to confine the application of Article 82 only to those cases where there is a demonstrable scope for value-added, innovation-based competition rather than merely price competition and imitation. There are, however, a number of weaknesses to such a test:

- It is difficult to apply in practice (e.g., how should the “new product” compare with the “old product”,<sup>93</sup> at what stage of development must that product be, how are new product claims to be evaluated without in practice obliging the requesting party to disclose its plans to the facility holder, does it matter that the facility holder is contemplating bringing this “new product” to the market, etc);
- It is based on the assumption that dynamic efficiency *always* outweighs static efficiency. However, imposing an obligation to supply, even though the refusal does not prevent the emergence of a “new product”, can in certain, admittedly narrow circumstances, have only a marginal impact on investment incentives. It may be going too far to accept that short-term allocative efficiency gains, no matter how significant, should always be discarded, no matter how remote the diminution of the incentives to innovate.<sup>94</sup> For example, where access is sought to the electricity grid it arguably makes little sense to ask the requesting party to demonstrate that it intends to bring a “new product” to the market. The same could be said about other utilities that derive their dominant position from their former position of public monopoly as opposed to successful innovation (although not all utilities are “idle monopolists”). The “new product” requirement could confer on such firms a degree of immunity from the application of Article 82 that is excessive;
- Lastly, the “new product” test fails to recognise that the negative effect on the facility holder’s dynamic efficiency may outweigh the positive effect of the requesting party’s dynamic efficiency (i.e., its “new product”). The point is that the “new product” test does not take into account the value of the input that is requested. It may be that little investment has been made into this input; conversely, it may be that this input represents the outcome of enormous investment. The firm that has made that investment may claim that imposing an obligation to supply on it reduces its investment incentive in the future and that it sends the wrong message to the industry. There is ultimately an argument that this

---

<sup>92</sup> “Innovation and Competition Policy, Part I – Conceptual Issues”, Economic Discussion Paper 3, March 2002, Office of Fair Trading, at 5.100.

<sup>93</sup> See Ridyard, *supra* note 80, at 670, noting that it would be “trivially easy” to a potential licensee to implement some product change to render its product “innovative”.

<sup>94</sup> See also Brunell, *supra* note 19, at 20.



may have more of a negative impact on investment incentives and dynamic efficiency than the positive impact of a “new product” being supplied on the market. In summary, one of the flaws of the “new product” test is that it is fairly indiscriminate, and therefore it does not solve the dynamic efficiency v. dynamic efficiency balancing issue.

These weaknesses reflect the fact that it is in many ways elusive to attempt to divine a bright line for distinguishing those cases where a refusal to supply is detrimental to consumer welfare in the long term from those cases where it is not.

A different approach is to examine whether the dominant firm has invested in its own physical or IP input in order to develop new or improved products or services for the downstream market. If so, a refusal to share that property or to licence the underlying technology should not be caught by Article 82. In this case, the dominant firm has increased its own efficiency, and the fact that rivals are worse off is simply a natural consequence thereof.<sup>95</sup> Thus, this should be regarded, from a competition law perspective, as a lawfully acquired competitive advantage and competition authorities and courts should abstain from seeking to determine whether the improvement really offsets the inefficiency resulting from the *ex post* loss of competition.

By way of example, in a situation where Firm A’s product (which includes A’s revolutionary technology) is so superior that customers in the market will simply refuse to buy anything else, it would be an error to order Firm A to license its revolutionary technology simply because its rivals failed to come up with the same innovation and find themselves struggling to survive in the market. As the District Court held in *Data General*, “a better mousetrap is not necessarily an essential facility”.<sup>96</sup> Crucially, an IP-protected invention or artistic expression is in general not indispensable, as other companies are free to come up with their own competing inventions. If rivals find that they are being eliminated from the market because they cannot come up with a competing invention, they are arguably the victims of competition on the merits. Thus it is difficult to imagine how a highly successful pharmaceutical compound (for example) could be considered to be an “essential facility”.<sup>97</sup>

By contrast, where the dominant firm’s position on the downstream market is entirely due to (a) vertical integration which it is impossible to replicate (e.g., in a case where an integrated ferry operator/port owner privileges its own ferry operations), or (b) links with an upstream “market” or production stage where the dominant firm’s strong position is impossible to replicate (e.g., due to network effects), and all the other conditions are met,

---

<sup>95</sup> See also Elhauge, *supra* note 49, *inter alia* at page 256: “the proper monopolization standard should focus on whether the alleged exclusionary conduct succeeds in furthering monopoly power (1) only if the monopolist has improved its own efficiency or (2) by impairing rival efficiency whether or not it enhances monopolist efficiency. ... [W]hen a defendant has increased its own efficiency by investing in its intellectual or physical property, a refusal to share that property with rivals should generally be legal because it rewards the improvement in the defendant’s efficiency in a way necessary to maintain *ex ante* incentives for investment.”

<sup>96</sup> *Data General v. Grumman*, 761 F. Supp. 185 (D. Mass. 1991), *affirmed*, 36 F.3d 1147 (1st Cir. 1994).

<sup>97</sup> See also *Lederle-Praxis Biologicals*, XXIVth Report on Competition Policy (1994) at 353.

the refusal to supply could be caught by Article 82. Here the dominant firm has not improved its position on the downstream market except by precluding its rivals from competing on the merits. For instance, in *Otter Tail Power*, refusing to grant access to its indispensable transmission grid did not improve the quality of the defendant's electricity; and in *Magill*, refusing to grant access to their proprietary information did not improve the defendants' TV guides over Magill's proposed new TV guide.

In the case of IP, one could imagine that there are at least two situations where Article 82 may create a duty to license: the first one is where (a) firm A seeks access to firm B's proprietary information (i.e., it is "single-source" information which is not available elsewhere); and (b) that information is automatically generated from firm B's other activities, meaning that it did not require any substantial *specific* investment.<sup>98</sup> The second situation is where (a) firm C seeks to obtain access to firm D's proprietary interface information or IP; and (b) the interface information or IP does not actually contribute to the quality of the downstream product. (Otherwise, requiring access to the interface information or IP input would erode firm D's legitimate competitive advantage based on its own improvement of the quality of the allegedly leveraged downstream product.) In other words, this calls for a factual assessment of whether the interface information is essentially in the nature of a by-product or whether instead investment has been expended in designing or developing the interface in order to improve the downstream product's functionality.

The underlying logic of the approach which is suggested here is that Article 82 should not condemn a dominant firm for conduct that enhance its own efficiency. Article 82 should only apply to conduct that creates or furthers monopoly power *only* by impeding the position and efficiency of rivals.<sup>99</sup>

As mentioned above in Part 4, it is submitted that this approach applies equally to first-time refusals to supply and the termination of existing supply relationships. In other words, the termination of an existing relationship should not amount to an abuse unless a first-time refusal to supply would also have been abusive.

---

<sup>98</sup> Note in this regard that the 1996 Database Directive contains a "dormant" compulsory licensing scheme. See Article 16(3): "... the Commission shall submit to the European Parliament, the Council and the Economic and Social Committee a report on the application of this Directive, in which, *inter alia*, on the basis of specific information supplied by the Member States, it shall examine in particular the application of the *sui generis* right, including Articles 8 and 9, and shall verify especially whether the application of this right has led to abuse of a dominant position or other interference with free competition which would justify appropriate measures being taken, including the establishment of non-voluntary licensing arrangements." This Commission report has not yet been finalised.

<sup>99</sup> Elhauge makes a similar point throughout his article (*supra* note 49) and for example at 312, footnote 178: "where a monopolist buys up property that is a necessary input for rivals and does not use the property itself but rather holds onto the property to keep it from rivals. Such an exclusionary suppression of inputs by a monopolist constitutes illegal monopolization under well-established antitrust law."

D. Absence of objective justification

In circumstances where a refusal to supply is abusive, the facility holder is under an obligation to start negotiating access terms with the requesting party without undue delay and in good faith, unless there is an objective justification for refusing to deal.<sup>100</sup> The mere existence of an IPR does not, as explained elsewhere in this paper, qualify as a justification for refusing to deal. Elements that could constitute justifications for refusing to deal (provided they are demonstrable in good faith) include:

- the fact that there is no available capacity or unsold inventory;
- doubts about the creditworthiness of the requesting party (see *British Midland/Aer Lingus*);
- the fact that the requesting party is not ready to pay a reasonable price; or
- the fact that the requesting party could engage in cherry-picking in such a way that the facility holder could no longer ensure the financial equilibrium of the universal service that it is required to provide (in the sense of the *Corbeau* line of case-law).<sup>101</sup>

Out of these possible justifications, the lack of available capacity warrants further discussion. First, “*where intellectual property is concerned there can be no such thing as a capacity constraint.*”<sup>102</sup> Second, where the facility holder denies third parties the possibility to use spare capacity or unsold inventory which is available, the facility holder is preventing the efficiency benefits which this increased use could have on the downstream market (“situation no. 1”). Moreover, the incursion on the facility owner’s property rights and freedom to contract is less grave than in a situation where the facility is fully used (or the requested products are all allocated to buyers), in which case there would be a strong flavour of expropriation (“situation no. 2”). In situation no. 2, the only way to accommodate the request would be for the facility holder to free up some of its own capacity or to re-direct products to the requesting party, as intensifying the use of the facility beyond 100% would degrade the quality of the output and/or increase costs. Moreover, it is doubtful whether agencies and judges are best equipped to make decisions about who should use capacity (and how much of it). In order to steer clear from such arcane calculations, it is suggested that the lack of available capacity or inventory should

---

<sup>100</sup> The “Access Notice” states at paragraph 95 that dominant telecom operators have a duty to deal with requests for access efficiently and that undue and inexplicable or unjustified delays in responding to a request may constitute an abuse. We note that the recent *Ferrovie Dello Stato* decision, para. 123, applies this requirement (“[a]n undue, inexplicable or unjustified delay in responding to a request for access to an essential infrastructure may also constitute an abuse”). See also the recently published *Clearstream* decision, supra note 67, at para. 223: “The concept of refusal to deal covers not only outright and final refusal ... but also protracted and dilatory tactics by a dominant company amounting in effect to a refusal to supply or deal within a reasonable period of time, without valid justification.”

<sup>101</sup> Case C-320/91, *Corbeau*, [1993] E.C.R. I-2533.

<sup>102</sup> Ridyard, supra note 80, at 670.

constitute an irrebuttable justification for refusal to grant access. Provided all other conditions are met, third party access should be limited to the *available* capacity.

### VIII. Relationship between Refusal to Supply Abuses and Other Abuses under Article 82

In this regard, we suggest that the Commission clarify three points.

First, where there is no obligation to supply a competitor, the dominant firm cannot be penalised for supplying at a price that denotes a margin squeeze.<sup>103</sup> An input that is not essential cannot be the subject of a margin squeeze. If there is no duty to deal at all, a dominant firm cannot be criticised for dealing on terms that would render non-integrated rivals unprofitable on a downstream market, and therefore, a margin squeeze should only be seen as a “constructive” refusal to deal. In sum, the only practical use of the term “margin squeeze” is that the price ceiling when determining reasonable and non-discriminatory (“RAND”) access terms cannot exceed the level at which there would be a “margin squeeze”.

Second, there should be a distinction between (i) the essential facility/duty to deal rule and (ii) compulsory dealing as a *remedy* (e.g., in tying cases,<sup>104</sup> in discrimination cases, or in patent ambush cases). In the latter cases, it is not the refusal to deal which is as such abusive. Hence the importance of distinguishing cases where the refusal to deal is an abuse in its own right from cases where compulsory dealing is used as a *remedy*.

Third, more guidance is needed in connection with the application of the non-discrimination principle in the context of a refusal to deal. In particular, the Commission should clarify whether and how the principle of non-discrimination applies where the facility holder has already granted access to its facility or supplied or licensed a competitor.

---

<sup>103</sup> We subscribe to Areeda and Hovenkamp’s point that “*it makes no sense to prohibit [margin squeeze] in circumstances where the integrated monopolist is free to refuse to deal*” (in ANTITRUST LAW, volume IIIA, 2nd ed., 2002, ¶ 767c5, at pages 129-130). See also D. Geradin and R. O’Donoghue, “The Concurrent Application of Competition Law and Regulation: the Case of Margin Squeeze Abuses in the Telecommunications Sector”, GCLC Working Paper 04/05, available at [ssrn.com/abstract=671804](http://ssrn.com/abstract=671804); J. Kallaugh, “The ‘Margin Squeeze’ under Article 82: Searching for Limiting Principles”, GCLC conference on margin squeeze, London, 10 December 2004, at footnote 48 of his paper: “*a margin squeeze (when it is effective) is no more than a sort of “slow motion” refusal to deal (a death by strangulation rather than by decapitation)*”; J. Bouckaert and F. Verboven, “Price Squeezes In A Regulatory Environment”, CEPR Discussion Paper no. 3824, available at [ssrn.com/abstract=405122](http://ssrn.com/abstract=405122); Oftel, *Investigation by the Director General of Telecommunications into the BT Surf Together and BT Talk & Surf Together Pricing Packages*, 4 May 2001 (margin squeeze rejected since alternative technologies competed on the retail market).

<sup>104</sup> See Article 3(5) of the Commission decision of 24 July 1991, *Tetra Pak II*, (1992) O.J. L 72/1, which orders Tetra Pak to disclose interoperability specifications, and point 139 of Case T-83/91, *Tetra Pak II*, [1994] E.C.R. II-755.

On the one hand, it may be suggested that discrimination cases do not require any assessment under the “essential facility” reasoning. It could be argued that if there is discrimination by a dominant firm, there is no need to enquire about “indispensability” and the other elements of the “essential facility” reasoning – only the requirements of the “discrimination” abuse apply (a similar situation and a competitive disadvantage). On this view, “first-time” and “subsequent” refusals to deal would be subject to different legal standards and the test of whether a subsequent refusal to supply infringes Article 82 would be less stringent than the test that applies to a “first time” refusal to deal. This warrants at least five observations:

- First, in practice there is a risk that the facility holder may have to supply all its competitors once it has given access or supplied one third party competitor. This would reduce the incentive to deal on a voluntary basis;
- Second, since the conditions for “first-time” access would be more stringent than for “subsequent” access, third parties may have an incentive to wait and rely on the discrimination theory rather than seek access under the essential facility theory. The risk of free-riding should not be exaggerated, however, as account must be made for the incentive to be the *first* to enter the market in order to gain the first-mover advantage and capture market shares;
- Third, it is one thing to oblige a dominant firm to deal with a single competitor and quite another thing to oblige it to deal with all potential third party competitors. The impact on investment incentives may be marginal in the first case but the same does not *necessarily* hold in the latter case; it does arguably depend on why an obligation to deal was initially imposed. A discrimination test is easier to justify where the obligation to deal was imposed because the dominant firm has not invested in the requested input in order to develop new or improve its existing products on the downstream market. The same test is perhaps more problematic, however, where an obligation to deal has been imposed in order to permit the emergence of a new product on the market. There is an argument that imposing yet another duty to deal could further reduce the incentive to innovate of the dominant firm;
- Fourth, if the Commission decides to adopt this approach (only the requirements of the “discrimination” abuse apply), we would stress that the non-discrimination principle applies not to every difference in treatment but only to a difference in treatment that is objectively unjustified. For example, we subscribe to Elhauge’s view that granting access to one firm should not necessarily open the door to discrimination claims by rivals who also want to obtain access, as it is perfectly legitimate for the facility holder to assign part of its facility, or the entire facility, to another firm which will be able to use it more efficiently than the facility holder itself;<sup>105</sup>

---

<sup>105</sup> Elhauge, *supra* note 49, at 313.

- Fifth, discrimination claims in relation to access to a physical infrastructure or tangible products would fail once the dominant firm no longer has enough capacity to supply and grant access to newcomers – therefore, the problem of unlimited discrimination claims from all-comers would only arise in relation to IPRs.

On the other hand, it could be argued that “subsequent” third party access requests must fulfil the conditions of the “essential facility” theory, that is to say, a duty to deal should only be imposed in circumstances where a “first time” refusal to supply would also have been contrary to Article 82.<sup>106</sup> There are also some flaws with this approach:

- First, this approach *de facto* entitles the dominant firm to restrict the intensity of competition on the downstream market in particular because the requirement of “elimination of competition” would be more difficult to meet once the facility holder has already granted access once (since, by definition, in this case, the facility holder has allowed a competitor into the downstream market). This may be criticised on the ground that it legitimises a restriction of competition on the downstream market in most cases. This may be going to far in particular where an obligation to deal has initially been imposed on a dominant firm that has not invested in the requested input in order to develop new or improve its existing products on the downstream market;
- Second, if the Commission decides to adopt this approach (that is, requiring “subsequent” third parties seeking access to fulfil the conditions of the essential facility theory), we suggest that the Commission should force access if it appears that the presence of the third party which was first to obtain access has failed to deliver competition. Indeed, a duopoly in the downstream market may not deliver much more competition than a monopoly. Looking at it this way, subsequent third parties should be allowed to make the “elimination of competition” argument even though there is already a third party in the market along with the facility holder;
- Third, as noted above, there may be a justification for restricting competition on the downstream market where an obligation to supply was initially imposed to permit the emergence of a new product on the market. If the Commission adopts the “new product” test (which we reject in Part VII above), there is, however, an issue of whether third parties seeking “subsequent” access would need to show that their product is “new” (i) compared to the facility holder’s product or (ii) compared to the previous third parties which have gained access.

---

<sup>106</sup> J. Temple Lang, “Anticompetitive Non Pricing Abuses Under European and National Antitrust Law” in Hawk (ed.), 2003 *Fordham Corporate Law Institute* (New York), 2004, at 254-257.

## **IX. Policy Recommendations**

In light of the above, the following recommendations are respectfully put forward:

- (i) The Commission should recognise that rules need to be practical, simple and predictable;
- (ii) The Commission should explain the distinction between refusals to supply *competitors* and conditional refusal to supply *customers*, which indirectly harm competitors;
- (iii) The Commission should explain the distinction between cases where refusal to supply is an abuse in its own right (so-called “essential facility” cases) and cases where there is an abuse which requires compulsory dealing as a remedy;
- (iv) In connection with the “essential facility” doctrine:
  - the Commission should not distinguish between “first-time refusals” and “termination” cases;
  - the Commission should not distinguish between cases involving IP and cases involving other types of property;
  - the Commission should take a position on the question whether the facility holder must be present on the related, downstream market;
  - the Commission should realise that a properly conducted “indispensability” test (as outlined above) also disposes of the “elimination of all competition” test;
  - the Commission should acknowledge that an input which is allegedly indispensable to competitors may actually result from the firm’s superior business performance; and
  - although it may not be necessary or even possible to calculate the exact RAND access terms, the Commission should set out some guidelines or a rough methodology for determining RAND access terms, even if these guidelines only indicate a floor price and a price ceiling (the price ceiling being the level at which there would be a margin squeeze).

# An Antitrust Analysis of Tying: Position Paper

Christian Ahlborn, David Bailey and Helen Crossley<sup>\*</sup>

## I. Introduction

This paper reviews the U.S. and EU approaches towards tying in the light of economic theory and factual evidence. It assesses, in particular, whether any of the three major legal rules for tying under U.S. and EU law (the modified *per se* approach under *Jefferson Parish*, the *per se* approach under *Hilti* and *Tetra Pak II* and the rule of reason approach of the Commission in the recent *Microsoft* decision) can be reconciled with economic analysis and factual evidence.

Section II provides some general comments on tying. It compares the concepts of tying and bundling and highlights the ubiquitous nature of tying in its various forms, i.e. contractual, economic and through technical integration.

Section III briefly sketches the development of economic analysis of tying from the classical approach to post-Chicago theories. The overview of economic analysis is followed by a summary of the legal analysis under both U.S. and EU law in Section IV, with particular focus on the modified *per se* approach developed in *Jefferson Parish*, the *per se* approach under EC law in *Hilti* and *Tetra Pak II* and the rule of reason approach developed by the Commission.

Section V sets out a decision theory framework which provides some guidance for the optimal policy approach towards tying in light of economic analysis and factual evidence and the final section assesses the three major approaches (U.S. modified *per se*, EC *per se* and EC rule of reason) against the conclusions drawn from the decision theory framework and also whether they can be reconciled with economic analysis and factual evidence.

---

<sup>\*</sup> The authors are competition lawyers with Linklaters. The paper is in part based on an earlier paper by C. Ahlborn, D.S. Evans and A. J. Padilla: "The Antitrust Economics of Tying: A Farewell to Per Se Illegality", (2004) 49 *Antitrust Bulletin* 287-341. The decision theory framework in Section V has been taken from K. N. Hylton and M. Salinger, Tying Law and Policy: A Decision Theoretic Approach, Boston University School of Law, Working Paper Series, Law and Economics, Working Paper No. 01-04.



## II. Tying: General Comments

### A. Tying and bundling: some definitions

At the outset, it may be helpful to clarify the definitions of tying and bundling, which are frequently used interchangeably.

Bundling is primarily an economic concept. It refers to the practice of selling two products together. One distinguishes “pure bundling” where products are made available as a package only and not separately and “mixed bundling” which occurs when products are offered both as a bundle and also individually.

Tying, by contrast, is a legal concept. Tying occurs when the purchase of one good (the tying good) is made conditional on the purchase of another good (the tied good). The tied good may be supplied either at the same time as the tying good, or at some time in the future.

Tying has generally had two explicit or implicit conditions. First, that the tie occurs between “separate products”. From an economic perspective, this is not a particularly meaningful distinction and the concept has in fact operated as a legal screen to filter out non-problematic cases. Secondly, tying has implied a degree of coercion. It is currently an open question in the EC whether tying requires an element of coercion which goes beyond the fact of not making available all components of a particular bundle. In the past, coercion was generally held to be present where bundling “[prevented] goods from competing directly for consumers’ choice on their merits, i.e. being selected as a result of ‘buyer’s independent judgement’.”<sup>1</sup> The Commission’s decision in the *Microsoft* case by contrast has taken the view that “not afford[ing] customers a choice as to whether to acquire the tying product without the tied product”<sup>2</sup> in itself amounts to coercion, independently of whether it affects the ‘buyer’s independent judgement’ in selecting competing products. According to this view, certain forms of bundling and tying are then indeed synonyms.

### B. Nature and Forms of Tying

#### 1. Ubiquitous nature

Tying is widespread throughout our economy. Earrings are sold in pairs; guesthouses often bundle the service of renting a room with breakfast; shops may offer free parking to their customers; clients of legal services do not have the choice to mix and match partners, associates and secretaries from different law firms; and sports shoes are rarely, if ever, supplied without a set of laces.

In a certain sense, as Robert Bork noted in his book, *The Antitrust Paradox*:

---

<sup>1</sup> US Court of Appeals for the District Court of Columbia in *Microsoft III*, 253 F3d 34, 346 U.S. App. D.C. 330.

<sup>2</sup> See Commission Decision of 24 March 2004, COMP/C-3/37.792, *Microsoft* at para.834.

“Every person who sells anything imposes a tying arrangement. This is true because every product or source could be broken down into smaller components capable of being sold separately, and every seller refuses at some point to break the market down any further.”<sup>3</sup>

## 2. Forms of tying

These “tying arrangements” may take a number of forms.

Frequently, tying practices are imposed by contractual means. So, for example, when concluding a contract to purchase product A, a customer may be required also to enter into a contract for product B. As will be seen below, product B may either be supplied with product A, or at some time in the future, or both.

Alternatively, tying may be a result of certain pricing practices. Where the price of products A+B together is so attractive to consumers compared to the individual prices of A and B, that consumers have no incentive to buy the products separately, even if ultimately they have no use for one of the products.<sup>4</sup>

Finally, products may be technically tied. This is a particular form of pure bundling, where components are technically integrated such that it is not possible or practical for a consumer to separate them.<sup>5</sup>

## 3. Timing dimension

From a timing perspective, tying may either be contemporaneous, temporal or in fact both.

Contemporaneous tying concerns bundling components at a point in time and preventing consumers from acquiring one of those components separately. Consumers are therefore required to take component B at the initial sale in order to obtain component A. Contemporaneous tying may take the form of contractual tying, economic tying or technical tying.

Temporal tying concerns ties between products over time. These involve “aftermarkets”, where products are purchased after the purchase of the initial product. The classic example of temporal tying involves a primary product and consumables, for example a staple gun and staples. There is a tie if a manufacturer of staple guns makes the sale of its staple guns conditional upon an agreement by the customer that it will only buy its future staple requirements from the staple gun manufacturer.

---

<sup>3</sup> R. H. Bork, *The Antitrust Paradox: A Policy at War with Itself*, New York, the Free Press, 1978, pp.378-79.

<sup>4</sup> Most pricing abuses concern, to a greater or lesser extent, a cost-price analysis; see e.g. Case C-62/86 *AKZO v Commission* [1991] E.C.R. I-3359. However, cost concepts have not been deployed by the law on tying (which is largely derived from concerns about the leveraging of market power).

<sup>5</sup> We are not proposing to consider in detail the question of how the law of tying should apply to technological forms of tying.

Tying arrangements may have both a contemporaneous and a temporal aspect. An example is a replacement part, such as an engine spark plug. The spark plug is contemporaneously tied to the engine, in that it is integrated into the engine at the moment of initial purchase. In addition, there may be a temporal tie (i.e. where a supplier requires that customers who purchase the engine (with the spark plug already installed) also agree to purchase their replacement spark plugs from the original manufacturer only).

### C. Tying and other abuses

Tying is closely linked to two other practices which equally may be regarded as abusive under certain circumstances.

The first are bundled rebates/discounts. As mentioned above, tying may take the form of an economic tie where the bundle and the individual products are offered separately but where the bundle is so heavily discounted that the individual products are not purchased separately. Looking at it from a different angle, tying may be regarded as a specific form of bundled discounts where the price of the individual products is set at infinity.

The second practice is refusal to supply. A refusal to supply could frequently be reformulated as tying. When Mediaprint, for example, refused to make available its home delivery service to Bronner, a competing newspaper company, arguably, it made its use of its home delivery service conditional on the purchase of its newspaper. Conversely, the Commission's claim that Microsoft tied Windows Media Player to its operating system could equally (and possibly more appropriately) be re-characterised as a refusal to supply claim, namely that Microsoft refused to make its proprietary distribution system, Windows, available to its competitors.

It follows that the criteria used to assess the legality of tying arrangements and the evidence required to prove an infringement should be consistent with the substantive and evidential rules applicable to discounts and refusal to supply.

## **III. Economic Analysis**

### A. Overview

Economic analysis with respect to tying falls broadly into three phases: (i) the classical tying approach, based on leveraging theories, which was extremely hostile towards tying; (ii) the Chicago School approach which explained how tying could lead to efficiencies and which demonstrated why, as a matter of theory, in many circumstances businesses cannot use tying to leverage a monopoly position in one market in order to secure extra

profits elsewhere (the so-called single monopoly profit theorem); and (iii) the Post-Chicago approach, which questioned the universal applicability of the single monopoly profit theorem and showed that in certain circumstances tying may have anti-competitive motives.

## B. The classical tying approach

The classical approach operated on the basis that tying was primarily a means of restricting competition with few, if any, redeeming features. In *United States Steel v Fortner*, the Court held that tying arrangements “generally serve no legitimate business purpose that cannot be achieved in some less restrictive way”.

The classical approach to tying was based on a simple theory of extension of market power or leveraging. A firm with a dominant position in nail guns or salt processing machines was able, through tying, to obtain a further dominant position (and earn a second monopoly profit) in the market for nails or salt respectively. This rather simplistic leverage theory has since been replaced by the more rigorous theory of tying as a form of price discrimination whereby “a firm with monopoly power in the tying product using the tie-in as a method of transferring additional wealth from consumers, beyond the amount that could be received from simply setting a monopoly price for the tying product”.<sup>6</sup>

## C. The Chicago School

### 1. Introduction

The Chicago School challenged the classical approach towards tying on two important points:

- first, that tying, far from being primarily anti-competitive, was generally motivated by efficiencies;
- second, that while dominant firms may have the ability to leverage their market power, they rarely have the incentive to do so (the so-called single monopoly profit theorem).

### 2. Recognition of efficiencies

Proponents of the Chicago School recognised the conflict between classical theory and observable practice: if tying were ubiquitous even among non-dominant firms, then the underlying driver had to be efficiencies rather than the restriction of competition. Tying could not survive in competitive markets if it were otherwise. Economists of the Chicago

---

<sup>6</sup> K.N. Hylton and M. Salinger, *supra* in acknowledgments.

School<sup>7</sup> demonstrated how tying could provide increased convenience and lower transaction costs.<sup>8</sup>

Potential benefits arising from tying include:

(i) Reduction in production and distribution costs

Tying may give rise to economies of both scale and scope in production and distribution. “Peugeot and buyers of Peugeot bicycles both benefit from Peugeot’s tie of the ring bell, saddle, brakes and other equipment, even though this tie forecloses rival equipment manufacturers’ access to Peugeot bicycles. Similarly, a three-star restaurant chef and her customers both benefit from the customers’ inability to select among the pastries of all top pastry shops in the region”.<sup>9</sup> Also, the specialisation of labour allows manufacturers to combine the various products that are part of the tie or bundle more efficiently than end users would do. Not so long ago, for example, electrical appliances and plugs were sold separately in Europe. Such a commercial practice was everything but user-friendly or efficient.

Marketing and distribution costs may also be reduced when various products or services are combined. The software industry provides an example of these types of savings.<sup>10</sup>

(ii) Reduction in transaction costs

Tying reduces the costs of searching for the most appropriate combinations of products that satisfy a complex need. And it greatly simplifies use. For example, at one time, software technologies such as toolbars, modem support, power management and sound were all formally offered as stand-alone products. Today, they are universally offered as an integrated, “bundled” part of the operating system. The widespread use of bundled software is itself a function of better technology — faster speed and expanded memory. But it is also a response to consumers who value the ease of use of bundled software.<sup>11</sup>

---

<sup>7</sup> See, e.g., A. Director & E. H. Levi, “Law and the Future Trade Regulation”, (1956) 51 *Northwestern U. L. Rev.* 281; G. J. Stigler, *The Organization of Industry* (1968); R. A. Posner, *Antitrust Law: An Economic Perspective* (1976); and R. H. Bork, *supra* note 3, pp. 378-79.

<sup>8</sup> Chicago economists also noted that tie-ins can be used to accomplish price discrimination. Economic theory has shown that price discrimination can, in principle, be pro- or anti-competitive, depending upon a series of structural factors, but that it is most often welfare increasing. See D. W. Carlton and J. M. Perloff, *Modern Industrial Organization*, pp. 289-291 (3rd ed., Addison-Wesley 2000). Hence, tying practices aimed at facilitating price discrimination should be typically considered welfare increasing and thus pro-competitive. This is more or less the case under U.S. law; however, EU competition law treats price discrimination as nearly *per se* illegal. See R. Whish, *Competition Law*, pp. 657-62 (5th ed., Butterworths 2003) (1985).

<sup>9</sup> J. Tirole, “The Analysis of Tying Cases: A Primer”, 1 *Competition Policy International*, Spring 2005.

<sup>10</sup> See S. J. Davis, K. M. Murphy & J. MacCrisken, “Economic Perspectives on Software Design: PC Operating Systems and Platforms”, in *Microsoft, Antitrust and the New Economy* (David S. Evans ed., 2002), p. 361, for an explanation of the forces and factors that determine whether and when new features and functions are included in commercial operating systems products.

<sup>11</sup> See D. Evans, J. Padilla and M. Polo, “Tying in Platform Software: Reasons for a Rule of Reason Standard in European Competition Law”, (2002) 25 *World Competition* 509.

(iii) Product improvement

When products are tied or bundled, the whole may be worth more than the sum of its parts; the resulting combined product offers benefits to consumers above and beyond the individual components added together. To take a simple example, today consumers enjoy breakfast cereals featuring a dizzying array of combinations of ingredients (fruits, nuts, grains), shapes (flakes, squares, doughnuts), textures, and tastes. For example, Apple-Cinnamon Cheerios is simply a bundle of grains, shaped into crunchy doughnuts, and flavouring (apple and cinnamon). Arguably, this product is an improvement on the first cereal products mass-produced at the turn of the nineteenth century, and an improvement to the consumer in terms of convenience and health benefits from assembling all the ingredients for the cereal herself. According to an econometric study, the introduction of Apple-Cinnamon Cheerios in 1990 into the U.S. market increased consumer welfare by approximately \$66.8 million per year.<sup>12</sup> Likewise, other studies have shown that the introduction of the mini-van — a product based on assembling the components of existing products (trucks and cars) — in the mid-1980s resulted in consumer welfare gains of approximately \$560 million per year.<sup>13</sup>

(iv) Quality assurance

Because firms bring skill, knowledge, experience and other resources to tying or product integration, allowing consumers to assemble the individual components themselves may affect the quality of the final product to the detriment of both producers and consumers. For example, in earlier decades of the electronics industry, hobbyists and other interested consumers could find the component parts of radios and other simple electronic equipment and with some effort, assemble them by themselves. However, with the increasing sophistication — miniaturisation, digitisation and other complexities — of electronics equipment, it is nowadays more difficult to ensure that the final product will meet with consumer satisfaction. When the consumer assembles the product, it may not be clear if any malfunctions are the fault of the consumer or the component suppliers. Equipment manufacturers may suffer from an undeserved reputation for poor quality, and it may be more difficult for consumers to identify substandard manufacturers. Bundling components together gives both the consumer and the producer more certainty regarding product quality.

(v) Pricing

Augustin Cournot showed, in work published in 1838, that a firm monopolising the markets for two complementary products would charge lower prices than would two

---

<sup>12</sup> This figure is \$97 million in 2002 U.S. dollars. J. Hausman, “Valuation of New Goods Under Perfect and Imperfect Competition” in *The Economics of New Goods*, T. Bresnahan and R. Gordon (ed)., 1997, p. 234.

<sup>13</sup> This figure is \$1.01 billion in 2002 U.S. dollars. A. Petrin, “Quantifying the Benefits of New Products: The Case of the Minivan”, (2002) 110 *J. Pol. Econ.* 728.

separate monopolists each selling a different product.<sup>14</sup> That is, complements may be priced lower if offered by the same firm in a bundle. This is similar to the well-known “double marginalisation” problem in the analysis of vertical integration, where a monopoly provider of two goods at different levels of supply will maximise its profits across the two goods, while separate providers will price each good at the individual profit-maximising price.<sup>15</sup>

In media markets, for example, “in an unbundled system, a change in the price charged to subscribers for a given program service will affect not merely the demand for that service but also the demand for transmission, and possibly the demand for complementary program services,” making it more efficient to bundle content with delivery.<sup>16</sup>

### 3. The single monopoly profit theorem

The second major line of attack by the Chicago School against the classical approach was in relation to the claim that tying was motivated by an attempt to earn a second monopoly profit in the tied market.

According to the Chicago School proponents, a firm enjoying monopoly power in one market (the market for the tying good) could not generally increase its profits, and instead could face reduced profits, by monopolising the market for another good (the market for the tied good). This idea is commonly referred to as the “single monopoly profit theorem”.

According to the single monopoly profit theorem, where monopolists engage in tying or bundling, this is motivated by efficiency considerations rather than an attempt to secure a greater profit by leveraging their monopoly from one market to another.

In principle, the single monopoly profit theorem applies to cases where demands for the bundled goods are both independent and complementary. Where demands for the two goods are independent (in other words the quantity demanded by consumers of one good is independent of the price of the other good), tying a competitively supplied good to a monopolistically supplied good is like establishing a tax on the latter. This tax would reduce consumption of the monopoly good unless consumers like the competitively supplied (tied) good and the monopolist prices the tied good competitively.

If the demands for the two goods were, instead, complementary and the two products were consumed with fixed ratios,<sup>17</sup> a monopolist could only benefit from the tied good

---

<sup>14</sup> A. Cournot, *Recherches sur les Principes Mathématiques de la Théorie des Richesses*, (1838).

<sup>15</sup> J. Tirole, *The Theory of Industrial Organization*, 1988, p. 333-335.

<sup>16</sup> B. Owen and S. Waldman, *Video Economics*, 1992, p. 219.

<sup>17</sup> The single monopoly profit theorem fails to hold when the two goods are consumed in variable proportions. Trying to extract the rents generated in the tied market through the pricing of the monopoly product is not a valid strategy since consumers would substitute away from the monopoly product. However, that does not imply that tying is necessarily anti-competitive when goods are consumed in variable proportions. On the contrary, it is precisely under such kind of consumer preferences that the monopolist has an interest in tying to price discriminate efficiently.

being competitively supplied, since all of the monopoly rents available in the two markets could be captured by a monopoly in one of these.

#### D. Post-chicago

In the 1990s, the so-called post-Chicago economic literature showed that the single profit monopoly theorem is not as robust as the Chicagoans suggest. The theorem depends, at least in its most extreme form, on the assumptions that the tied product and tying products are used in fixed ratios and that the tied product market is “perfectly” competitive.<sup>18</sup> When those assumptions do not hold, the theorem may fail.

Economists developed a number of models to try to understand the competitive implications of tying and bundling when the structure of the tied market is oligopolistic, rather than perfectly competitive. They showed that a firm enjoying monopoly power in the tying good might have an anti-competitive incentive to tie when the tied good market is imperfectly competitive if, in addition, tying keeps potential rivals out of the market for the tied product or, alternatively, helps the monopolist to preserve its market power in the tying product market.

##### 1. Foreclosure

The basic mechanism that leads to the exclusion of actual and potential competitors from the tied good is foreclosure. It has been argued that by engaging in tying practices the monopolist deprives its competitors in the tied good market of adequate scale, thereby lowering their profits below the level that would justify remaining active in or entering that market.

Whinston’s 1990 American Economic Review article demonstrates that leveraging a monopoly position in the tying market onto an adjacent (tied) market may be privately profitable when the tied market is subject to economies of scale and, therefore, it is imperfectly competitive, and leveraging successfully induces the exit (or deters the entry) of competitors in the tied market.<sup>19</sup>

Suppose, for example, that a firm selling two goods, A and B, enjoys a monopoly position in the market for product A but faces competition (actual or potential) in the market for product B. Suppose also that the demands for products A and B are independent, so that the quantity sold of each of them is independent of the price of the other. If the monopolist in market A were to tie its two products, it would effectively be linking its sales of product A to the sale of product B. As a result, its incentive to price product B aggressively would be greatly increased. Tying, therefore, would lead to lower prices for product B. It would also lead to lower profits in the market for this product. Both the

---

<sup>18</sup> Even if both markets are monopolised, welfare could still be enhanced through elimination of the double marginalisation problem or through price discrimination. The critical observation here is that consumers can benefit even when tying and bundling are conducted by a firm with market power.

<sup>19</sup> M. D. Whinston, “Tying, Foreclosure and Exclusion”, (1990) 80 *American Economic Review* 837.



monopolist's and its competitors' profits from the sale of product B would fall, but the impact on the latter would be far greater. This is because tying would allow the monopolist to capture sales from its competitors, which in the presence of economies of scale in production would make them less effective competitors. The reduction in profits may induce the monopolist's competitors to exit the market for product B, or not to enter into it if they were potential competitors. In those cases, tying could both increase the monopolist's profits and harm consumers.

Whinston's leveraging result requires that (a) the monopolist of product A is able to commit to tying and (b) tying leads to market foreclosure. Otherwise, the monopolist's strategy would be self-defeating. Tying would just serve to increase the intensity of price competition in the market.<sup>20</sup>

The leveraging result also depends on the interrelationship between the demands for the two goods. Monopolising the tied market might lead to lower sales and lower prices in the monopoly market when the two goods are complements and tying causes the exit (or prevents the entry) of more efficient producers of good B.<sup>21</sup> In that case, the incentives to tie would be reduced. Alternatively, the incentives to tie would be greater if consumers' valuations for the tying and tied goods were positively correlated.

Since 1990, various authors have developed models that aim to relax the conditions under which tying may turn out to be anti-competitive. Nalebuff, for example, constructed a model where a firm producing goods A and B has a "credible" incentive to tie them together in order to deter entry.<sup>22</sup> In contrast to Whinston's model, tying makes entry more difficult, not because the monopolist is committed to a price war, but because it deprives the entrant of an adequate scale. Credibility is not an issue here because even when entry is not foreclosed, the price for good B and the monopolist's profits are higher with a tie than without.<sup>23</sup>

## 2. Protection of monopoly

Carlton and Waldman argue that the logic behind leveraging a monopoly position onto another market through tying may not be to increase profits in that (competitive) market, but to deter future entry into the monopoly (tying) market.<sup>24</sup>

In the Carlton-Waldman model, there are two goods: the primary good (the tying good or monopoly product) and a complementary good (the tied good). The primary good can be used by itself. The complementary good can be used only in conjunction with the primary

---

<sup>20</sup> C. Ahlborn, D. Evans and J. Padilla: "The Antitrust Economics of Tying: A Farewell to Per Se Illegality", (2004) 49 *Antitrust Bulletin* 287-341.

<sup>21</sup> Or, in the context of product differentiation, of higher quality versions of product B.

<sup>22</sup> B. Nalebuff, "Bundling", Yale ICF Working Paper #99-14, 1999.

<sup>23</sup> See also J. Carbajo, D. De Meza and D. Seidman, "A Strategic Motivation for Commodity Bundling, (1990) 38 *J. Indus. Econ.* 283.

<sup>24</sup> D. Carlton and M. Waldman, "The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries", (2002) 33 *Rand J. Econ.* 194.

good.<sup>25</sup> Their theory is built on the assumption that potential competitors may refrain from entering the monopoly market if they face the incumbent as its sole complementary good producer. The monopolist, therefore, has an incentive to monopolise the tied good in order to protect its rents. Entry into the tying market obviously would dissipate some of the rents made in that market. However, it would also make it impossible to extract rents from the market for the complementary good, as the incumbent would find it costly to raise its price in the tying market because of the competition from the newly established entrant.

The incentives of the incumbent to monopolise the complementary good market may exist even when entry is costless provided there were network externalities in that market (i.e. consumers' valuations for the complementary good were an increasing function of the number of other users). Carlton and Waldman showed that tying the complementary good to the monopoly product gives the monopolist a head start in the race to become the standard in the market for the complementary good market. This incentive exists because the incumbent sees its monopoly position in the primary good market subject to the threat of entry. Otherwise, it would prefer to have competition in the complementary good market, so as to ensure the adoption of the best standard and to appropriate the rents generated by that standard via a higher price in the primary product market.

Notwithstanding its conceptual simplicity, the validity of the theory developed by Carlton and Waldman relies on a number of strong assumptions that do not always fit well with the facts of the markets under scrutiny. First, Carlton and Waldman's theory requires that entry into the tied market is very costly. Otherwise, the strategy of foreclosure could be defeated by simultaneous entry into two complementary markets. Second, their theory does not fare well when the product sold in the monopoly market has a life of its own (i.e. when some consumers have a demand for the monopoly good only). In this case the profitability of entry in the monopoly market is much less affected by the monopolisation of its complementary market.

#### E. Implications

Although the post-Chicago theories challenge the general validity of the single monopoly profit theory of the Chicago School, they do not advocate a return to the classical approach to tying. Proponents of post-Chicago theories recognise the fact that tying is frequently efficiency enhancing in a wide range of circumstances and suggest "a very cautious approach in antitrust cases involving tie-in sales, even in cases where harm is theoretically possible"<sup>26</sup>.

---

<sup>25</sup> The authors cite as an example a computer (primary good) and a printer (complementary good).

<sup>26</sup> D. Carlton and M. Waldman, How can Economics Improve Antitrust Doctrine towards Tie-in Sales: Comment on Jean Tirole's "The Analysis of Tying: A Primer", 1 *Competition Policy International* (2005).

#### IV. Legal Analysis

This section is intended to provide a brief overview of the key developments in U.S. and EC law on tying to date.

##### A. Terminology

At the outset, it is important to clarify the meaning of certain expressions used throughout the remainder of this position paper, in particular: “*per se* prohibition”, “modified *per se*” approach and the “rule of reason” analysis.

##### 1. *Per se* and modified *per se* prohibition

Historically, certain categories of agreements, including tying arrangements, have been held to be *per se* unlawful in the U.S. and the EU, dispensing with the need for case-by-case evaluation.<sup>27</sup> *Per se* rules are normally reserved for conduct that is manifestly anti-competitive and amount to nearly absolute prohibitions (subject to very limited defences). Where *per se* prohibition has largely been based on criteria which are used as proxies for competitive harm and which require some (simple) assessment of market conditions, we talk about a “modified *per se*” approach.

##### 2. “Rule of reason”

A further mode of analysis centres around determining the legality of tying through case-by-case application of the so-called “rule of reason”, that is to say, where all of the circumstances of a case are considered in deciding whether the tie should be prohibited as imposing an unreasonable restraint on competition or should be permitted on account of its beneficial effects. A decision-maker is effectively asked to undertake a balancing exercise and determine whether the demonstrable, pro-competitive effects of a tie outweigh its likely anti-competitive effects.

##### 3. *Per se* (and modified *per se*) legality

Under this rule, tying would automatically be regarded as legal provided that certain criteria are satisfied. *Per se* rules of legality would be reserved for those situations where economic theory and experience indicate that the risk of harm to competition is so rare that it is unnecessary to carry out the balancing exercise between the pro-competitive benefits and anti-competitive effects of the conduct.

---

<sup>27</sup> For an account of the development of *per se* rules and the “rule of reason” in the US, see W. Kovacic and C. Shapiro “Antitrust Policy: A Century of Economic and Legal Thinking” (2000) 14 *Journal of Economic Perspectives* 43.

B. U.S. law

1. Overview

In the U.S., tying has generally been considered under Section 1 of the Sherman Act (which concerns restrictive agreements) as opposed to Section 2 (which seeks to control monopoly power). Although a certain degree of market power by the seller in the tying market has consistently been one of the conditions to make a finding of illegal tying, there is no evidence that such market power must amount to monopoly power as defined by Section 2 of the Sherman Act.

The three approaches described in Section 2 above can be identified in the U.S. case-law to date. Initially, the courts adopted a *per se* prohibition approach, demonstrating a prominent hostility towards tying practices. In *Jefferson Parish*, however, the *per se* approach was modified, and the Supreme Court attempted to use the criteria for tying as proxies for competitive harm and, arguably, efficiencies.<sup>28</sup> The third approach is the rule of reason approach evident in the judgment of the Court of Appeals in *Microsoft III*,<sup>29</sup> which recognises that, in certain circumstances at least, even the modified *per se* approach towards tying arrangements might be overly restrictive. The approach taken by U.S. courts in a number of other cases involving technological integration also suggests that there may be scope for concluding that a more permissive approach may be appropriate in certain circumstances.

2. Relevant case-law

(i) Early cases

The U.S. courts started from the presumption that tying – defined as “an agreement by a party to sell one product but only on the condition that the buyer also purchases a different (or tied) product, or at least agrees that he will not purchase that product from any other supplier”<sup>30</sup> – had no redeeming features. In *Times-Picayune Publishing v United States*, the Supreme Court held that:

“the essence of illegality in tying arrangements is the wielding of monopolistic leverage; a seller exploits his dominant position in one market to expand his empire into the next.”<sup>31</sup>

The judgment in *United States Steel v Fortner* confirmed the Court’s early view that tying arrangements “generally serve no legitimate business purpose that cannot be achieved in some less restrictive way”.<sup>32</sup> Another example of this stance may be found in *Northern*

---

<sup>28</sup> *Jefferson Parish Hospital Dist. No. 2 et al. v. Hyde*, 466 U.S. 2, 16 (1984).

<sup>29</sup> *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001).

<sup>30</sup> *Northern Pacific Railway Co. et al. v. United States*, 356 U.S. 1 (1958).

<sup>31</sup> 345 U.S. 594, 611 (1953).

<sup>32</sup> *United States Steel Corp. et al. v. Fortner Enterprises*, 394 U.S. 495, 503 (1969).

*Pacific Railway v United States*.<sup>33</sup> This case concerned the inclusion by Northern Pacific – in sale and lease agreements relating to its land – of clauses requiring purchasers or lessees to use Northern Pacific for the transportation of goods produced on the land, provided that Northern Pacific’s rates were equal to those of its competitors.

When considering whether Northern Pacific had sufficient market power to make a finding of illegal tying, the Supreme Court stated that the relevant test was whether “a party has sufficient economic power with respect to the tying product to appreciably restrain free competition in the market for the tied product”.<sup>34</sup> It concluded that in the case before it, the “very existence of this host of tying arrangements is itself compelling evidence of [Northern Pacific’s] great power, at least where, as here, no other explanation has been offered for the existence of these restraints”.<sup>35</sup>

The Supreme Court held in *Northern Pacific* that the clauses in question were illegal, without considering whether the tying practice in fact generated anti-competitive effects or efficiency gains. Nor did it appear to recognise that tying must have been considered to serve some purpose beyond the restriction of competition, bearing in mind the fact that firms without market power frequently engage in such arrangements.

(ii) Jefferson Parish<sup>36</sup>

The hostile approach towards tying displayed in *Northern Pacific* and other cases was revised in *Jefferson Parish*, in which the Supreme Court accepted that there might be circumstances in which tying might be beneficial to consumers.

The case concerned the tying of hospital and anaesthesiological services. Specifically, East Jefferson Hospital had entered into an agreement with a professional medical corporation, Roux & Associates, to provide the hospital with all of its anaesthesiological services. It therefore rejected an application for admission to the medical staff from another anaesthesiologist, who proceeded to seek an injunction to compel his admission. In its judgment, the Supreme Court recognised that:

“[N]ot every refusal to sell two products separately can be said to restrain competition. If each of the products may be purchased separately in a competitive market, one seller’s decision to sell the two in a single package imposes no unreasonable restraint on either market, particularly if competing suppliers are free to sell either the entire package or its several parts. ... Buyers often find package sales attractive; a seller’s decision to offer such packages can merely be an attempt to compete effectively - a conduct that is entirely consistent.”<sup>37</sup>

---

<sup>33</sup> *Northern Pacific Railway Co. et al. v. United States*, 356 U.S. 1 (1958).

<sup>34</sup> *Id.*

<sup>35</sup> at 8-9

<sup>36</sup> *Jefferson Parish Hospital Dist. No. 2 et al. v. Hyde*, 466 U.S. 2 (1984).

<sup>37</sup> *Id.* at 19.

The Supreme Court's approach to the test for "tying" two products in *Jefferson Parish* has been reaffirmed by the Court in *Eastman Kodak*.<sup>38</sup>

Four of the justices advocated a rule of reason approach.<sup>39</sup> However, the majority opinion of the Supreme Court favoured a less drastic approach that built on the *per se* prohibition described above, on the basis that, "It is far too late in the history of our antitrust jurisprudence to question the proposition that certain tying arrangements pose an unacceptable risk of stifling competition and therefore are unreasonable *per se*."

The Supreme Court therefore focused on adapting the definitional criteria of tying (namely the question of whether the products involved were "separate", and the concept of sufficient economic power) in an effort to exclude cases that were not likely to result in anti-competitive effects. Ultimately the court held that a market share of 30% was not sufficient to constitute the requisite market power. It was not therefore necessary to conduct an assessment of the individual tying arrangements in the actual circumstances of the case.

(iii) Microsoft III<sup>40</sup>

During the 1990s, the U.S. Department of Justice and 21 states brought a number of antitrust charges against Microsoft, ranging from monopoly leveraging to monopoly maintenance and exclusive distribution. The complainants also alleged that Microsoft had violated U.S. antitrust law by contractually and technologically bundling the Internet Explorer with its Windows operating system. The District Court considered that the combination of Internet Explorer and Windows satisfied the modified *per se* approach in *Jefferson Parish* and was therefore illegal.

However, this finding was overturned by the Court of Appeals, which concluded that software platforms such as Windows should be subject to a rule of reason balancing anti-competitive effects and efficiencies on the basis that "integration of new functionality into platform software is a common practice and [a] wooden application of the *per se* rules in this litigation may cast a cloud over platform innovation for PCs, network computers and information appliances".<sup>41</sup>

The D.C. Circuit therefore remanded the government's tying claim to the district court to be considered under the rule of reason. Ultimately no decision was reached on this point, as the government decided to drop the claim.

---

<sup>38</sup> *Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451 (1992).

<sup>39</sup> Justice O'Connor, with whom Chief Justice Burger, Justice Powell and Justice Rehnquist joined, argued for the contract to be analysed under the rule of reason.

<sup>40</sup> *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001).

<sup>41</sup> *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001).

3. General approach to tying

As evidenced by the above summary of cases, the approach of the U.S. courts has evolved from a *per se* illegality approach as demonstrated in *Northern Pacific* towards the rule of reason approach (at least in some cases) advocated in *Microsoft III*. Historically, the central purpose of tying law has been to protect competition in the tied product market by preventing the forced taking of the defendant's product so as to foreclose the opportunities of independent suppliers of the tied product.<sup>42</sup>

(i) *Per se* prohibition approach

The initial approach of the courts was motivated by extreme hostility towards tying practices: any firm with “sufficient economic power” who engaged in tying was in breach of the law, provided that “a not insubstantial amount of interstate commerce” in the tied product was affected. It has been said that “the consistent judicial instinct [at least in early tying cases] has been that these arrangements have but a single purpose and effect, to extend the seller’s power in the market for the tying product into that for the tied product.”<sup>43</sup> The explanation for this entrenched judicial instinct was the view that tying contracts are inherently anti-competitive. If a consumer intended to purchase a tied product, the law saw no reason for it to be tied to another product; equally the law would not permit a supplier to “force” a tied product upon an unwilling consumer.<sup>44</sup>

As regards the first element, the need for “sufficient economic power”, it is evident from the judgment in *Northern Pacific* and other cases<sup>45</sup> that in this context “sufficient economic power” did not necessarily mean the same thing as traditional “market power”. For example, the fact that a product is particularly desirable, or has unique characteristics, was sufficient to confer “sufficient economic power” on an undertaking, as was the fact that an undertaking had some kind of competitive advantage over others. In *Northern Pacific* itself, the Supreme Court’s reasoning on the topic of economic power was rather circular, in that it considered that the existence of the tying arrangement in itself was evidence of sufficient market power.

For the purposes of the *per se* approach, an unlawful tying arrangement comprised three components: first, it involved “separate products”. In *Northern Pacific* and other cases of this era, the question whether products were separate was straightforward and intuitive – the products at issue were intuitively separate. However, as discussed elsewhere in this paper, the way in which products are analysed to determine whether they are separate may be critical to other types of cases, notably those involving integrated products. The second element was (and continues to be) all-important: an element of coercion must be established – the customer must be “forced” into purchasing something that he does not want, or that he might have preferred to buy from someone else. A third requirement that

---

<sup>42</sup> *Jefferson Parish Hospital Dist. No. 2 et al. v. Hyde*, 466 U.S. 2, 21 (1984).

<sup>43</sup> L. Sullivan, *Antitrust*, 1977, p. 431.

<sup>44</sup> *United Shoe Machinery Corp. v. United States*, 258 U.S. 451, 457 (1922).

<sup>45</sup> *International Salt Co., Inc. v. United States*, 332 U.S. 392, 395-96 (1947); *International Business Machines Corp. v. United States*, 298 U.S. 131 (1936).

a “not insubstantial amount of interstate commerce” in the tied product had to be affected was relatively easily satisfied: in *United States v Loew’s*,<sup>46</sup> for example, just \$60,000 was considered “not insubstantial”.

In some circumstances, it should be noted that the courts considered that tying arrangements were exceptionally justified. For example, the idea that a tying arrangement can be a valuable way of effectuating beneficial price discrimination was accepted by Chief Justice White as early as 1912.<sup>47</sup> However, such opinions and cases are rare and are generally limited in scope and in time.<sup>48</sup>

(ii) Modified *per se* approach

Currently, the general position in the U.S. remains the modified *per se* approach favoured in *Jefferson Parish*, which recognised that not every tying practice should be assumed to restrain competition. The Supreme Court therefore attempted to adjust the definitional criteria of tying to exclude cases that were not likely to result in competitive harm. Indeed, the Court has insisted that “the legality of petitioners’ conduct depends on its competitive consequences, not on whether it can be labelled ‘tying’.”<sup>49</sup>

The first adjustment in approach regarded the question of “separate products”. Rather than limiting themselves to an analysis of the functional relationship between products, the justices in *Jefferson Parish* focused on the nature of demand for the two products in question, and whether separate demand existed for each product. As regards the case at hand, therefore, the court took the view that:

“No tying arrangement can exist unless there is a sufficient demand for the purchase of anaesthesiological services separate from hospital services to identify a distinct product in which it is efficient to offer anaesthesiological services separately from hospital services.”<sup>50</sup>

In practice, it found that in hospitals where anaesthesiological services were not offered as part of a package, patients frequently requested separate services, and the arrangement in place with Roux & Associates was therefore a tying arrangement.

The use of the criteria as proxies for competitive harm also led the Supreme Court to adopt a definition of economic power that was more focused on the economic concept of market power, as opposed to the vague concept of “sufficient economic power” previously used.

---

<sup>46</sup> *United States v Loew’s Inc et al*, 371 U.S. 38 (1962)

<sup>47</sup> *Henry v. A.B. Dick Co.*, 224 U.S. 1, 65 (1912) (accepting the idea of metered pricing).

<sup>48</sup> For example, in *Jerrold Electronics Corp et al. v. United States*, 365 U.S. 567 (1961) a tying arrangement in a new industry was justified for a limited period on the basis that selling an integrated system would help ensure that the equipment functioned properly.

<sup>49</sup> *Jefferson Parish Hospital Dist. No. 2 et al. v. Hyde*, 466 U.S. 2, 21 n.34 (1984).

<sup>50</sup> *Id.*



(iii) Towards a rule of reason?

Although *Jefferson Parish* still represents the general position in the U.S. with respect to tying, the Court of Appeals' judgment in *Microsoft III* indicates a preference – in some circumstances at least – for a rule of reason approach, noting the Supreme Court's warning in *Broadcast Music v. CBS*<sup>51</sup> that “[i]t is only after considerable experience with certain business relationships that courts classify them as *per se* violations”.<sup>52</sup>

In *Microsoft III*, the Court of Appeals concluded that a *per se* rule was inappropriate, due to the fact that the circumstances in *Microsoft III* differed from previous cases, and that the separate products approach used in *Jefferson Parish* was not a suitable approach given that it was backward looking. The case was therefore referred back to the District Court with a direction to conduct a rule of reason analysis which balanced the anti-competitive effects and efficiencies.

However, the Court of Appeals' judgment in *Microsoft III* was limited to products in “platform software markets” and, as a matter of law, to the DC Circuit. As set out below, it may be argued on the basis of this and other cases that the courts in the U.S. in fact apply a different legal standard to cases involving technological integration and cases involving other forms of tying. Ultimately, though, the Court of Appeals' criticism of the modified *per se* approach was clear, and it is therefore quite possible that the general law in this area will continue to evolve.

4. Technological integration vs. other forms of tying

There are indications in the U.S. that the courts treat cases involving technological integration differently from cases involving other forms of tying. The Supreme Court has not yet to consider the question of a tie between two software products: *Jefferson Parish* concerned a tie between two services and *Eastman Kodak* involved a tie between a physical product and a related service.

Prior to the adoption of the modified *per se* approach by the Supreme Court in *Jefferson Parish*, for example, the application of the *per se* approach in practice appears to have been limited to cases involving contractual tying. On two occasions IBM escaped censure in the face of complaints from third parties that the integration of technology was illegal.<sup>53</sup>

A difference in approach from that taken in classical tying cases is also perceptible in a number of cases involving Microsoft. *Microsoft II* involved an appeal from a preliminary

---

<sup>51</sup> *Broadcast Music, Inc. et al. v. Columbia Broadcasting System, Inc. et al.*, 441 U.S. 1 (1979).

<sup>52</sup> *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001) at 124 quoting *United States v. Topco Assocs., Inc.*, 405 U.S. 596, 607-08 (1972).

<sup>53</sup> See *ILC Peripherals Leasing Corp. v. International Business Machines Corp.*, 448 F. Supp. 228, 233 (N.D. Cal. 1978). See also *Telex Corp. v. International Business Machines Corp.*, 367 F. Supp. 258 (N.D. Okla. 1973).

injunction in a contempt case that involved interpretation of a consent decree.<sup>54</sup> One question before the Court was whether Windows and Internet Explorer were one product under the consent decree's integration test. The Court proposed that a technological tie could be considered lawful if "there is plausible claim that the tie-in brings some advantage". However, the *Microsoft II* majority was careful to recognise that the question of whether Windows and IE are also one product for the purposes of a Section 1 tying infringement would remain to be determined in an antitrust action.

A similar approach was followed in *Caldera*, although the Court in that case imposed a more stringent test, holding that a tying claim was not in breach of the law "if the evidence shows that a valid, not insignificant, technological improvement has been achieved by the integration of two products".<sup>55</sup>

When deciding in favour of a rule of reason approach in *Microsoft III*, the Court of Appeals noted that the case in front of it differed from the tying cases previously addressed by the Supreme Court in at least two respects.

First, none of the previous cases concerned a situation in which the tied good was "physically and technologically integrated with the tying good". Rather, the majority of preceding cases had involved contractual ties.

Secondly, it was argued that in Microsoft's case the tie "improved the value of the tying product to users and to makers of the complementary goods"<sup>56</sup> in that the bundling of the Internet Explorer Application Program Interfaces (APIs) with Windows made Windows a better applications platform for third party software. As a result of these specific characteristics, Microsoft argued, certain of the general policy conclusions from preceding cases, such as the suggestion that the efficiencies of tying could be achieved by other less restrictive means, were questionable.

The *Microsoft III* test thus departs from *Jefferson Parish* only insofar as it focuses the "separate product" inquiry on whether there is some "technological value to integration" that improves it in certain ways than leaving the customer to combine the separate products on his own. Ultimately, the Court of Appeals did not take any view on the validity of the efficiency claims. However, it took the view that "judicial 'experience' provides little basis for believing that, 'because of their pernicious effect on competition and lack of any redeeming virtue' a software firm's decisions to sell multiple functionalities as a package should be 'conclusively' presumed to be unreasonable and

---

<sup>54</sup> The dispute centred around the interpretation of Section IV(E)(i) of the 1994 consent decree, which provided that: "Microsoft shall not enter into any License Agreement in which the terms of that agreement are expressly or impliedly conditioned upon: the licensing of any other Covered Product, Operating System Software product, or other product (provided, however, that this provision in and of itself shall not be construed to prohibit Microsoft from developing integrated products)". The panel's task was to "discern the bargain that the parties struck." *United States v. Microsoft Corp.*, 147 F.3d 935, at 946 (D.C. Cir. 1998).

<sup>55</sup> *Caldera Inc v Microsoft Corp.*, 72 F. Supp.2d 1295 (D. Utah 1999), at 1325.

<sup>56</sup> *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001).

therefore illegal without elaborate inquiry as to the precise harm that they have caused or the business excuse for their use.”<sup>57</sup>

The Court of Appeals also recognised that the *per se* rule’s “direct consumer demand and direct industry custom inquiries are, as a general matter, backward looking and therefore systematically poor proxies for overall efficiencies in the presence of new and innovative integration”. It therefore concluded that there was merit to Microsoft’s broader argument that *Jefferson Parish*’s consumer demand test would “chill innovation to the detriment of consumers by preventing firms from integrating into their products new functionality previously provided by standalone products — and hence, by definition, subject to separate consumer demand”.

It can therefore be concluded that, while there is no universal standard for the treatment of technological integration cases, a number of courts have clearly been willing to approach these types of cases from a *per se* legality standpoint as opposed to applying the *per se* illegality approach taken towards classical ties.

## C. EC law

### 1. Overview

In the EU, tying is given as an example of an abuse of dominance. Article 82(d) of the EC Treaty states that an abuse of a dominant position may, in particular, consist in “making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts”.<sup>58</sup>

To date, there have been very few Commission decisions or judgments of the European Court dealing with the topic of tying in detail. The most recent is the Commission’s decision of March 2004 in *Microsoft*,<sup>59</sup> which is currently on appeal before the Court of First Instance.<sup>60</sup>

Prior to the *Microsoft* decision, the Commission and the European Courts have consistently applied a *per se* prohibition approach, without considering whether a particular tying practice is in fact harmful (or beneficial) to consumers. The European

---

<sup>57</sup> Id.

<sup>58</sup> In the absence of any dominant position, the block exemption Regulation 2790/99 and the Commission’s Guidelines on Vertical Restraints tend to adopt a more economics-oriented (and thus more permissive) approach to tying arrangements. Where the market share of the supplier on the markets both for the tying and for the tied products is below 30%, the tying agreements benefit from the block exemption from the prohibition in Article 81(1). Above that market share threshold, paragraphs 219 to 221 of the Guidelines discuss the respective merits and drawbacks of tying agreements under Article 81(1) and Article 81(3). Of particular importance is the recognition by the Commission that tying agreements may result in economic benefits for the purposes of Article 81(3).

<sup>59</sup> Commission decision of 24 March 2004, *Microsoft*, not yet published.

<sup>60</sup> Case T-201/04 *Microsoft v Commission* (judgment pending).

institutions tended to be doctrinaire in their approach, appearing to assess tying arrangements by reference to their form rather than their effects: the tendency is to say a tying has this form, therefore it is exclusionary – even if there is manifest evidence that that is not the case.<sup>61</sup> Although in *Microsoft* the Commission acknowledged that the circumstances at hand required it to engage in a more detailed examination of the likely effects of the practice at issue,<sup>62</sup> it is at this stage still unclear whether it is the Commission's intention to limit this approach to specific circumstances, and what the legal basis for such a test actually is. In any event, the starting assumption in the EU still appears to be firmly contra-tying.

## 2. Relevant case-law

Tying may occur in numerous contexts and take numerous forms. The text that follows attempts a categorisation of the relatively limited case-law in relation to tying under Article 82. It groups cases according to the nature of the tying arrangement in question: contractual tying, discounts which have a tying effect and technological tying. Although the European Courts themselves have not explained the law in these terms, it would seem to offer a helpful exegesis of how the law and policy of Article 82 is currently applied to various tying arrangements.

### (i) Contractual ties

#### a. *Eurofix-Bauco/Hilti*<sup>63</sup>

*Eurofix-Bauco/Hilti* involved the temporal tying of consumables. The case concerned the supply of nail guns and associated nails and cartridge strips which are specifically adapted to a particular brand of nail gun. Hilti, which at the time of the investigation was the largest manufacturer of nail guns in the EU, had patent protection for its guns, cartridge strips and nails. Notwithstanding this, a number of other companies had entered the market with a range of nails for use in Hilti guns.

Two of Hilti's competitors complained to the Commission that Hilti was engaging in abusive practices which limited their ability to compete in the market for Hilti-compatible nails. The practices included making the sale of nails conditional upon the sale of cartridge strips, the refusal to honour guarantees if customers used nails manufactured by another supplier, the refusal to supply cartridge strips to customers who might resell them, and frustrating the grant of legitimate licenses of right available under its patents.

---

<sup>61</sup> See e.g. E. Rousseva, "Modernizing by Eradicating: How the Commission's new Approach to Article 81 EC Dispenses with the Need to Apply Article 82 EC to Vertical Restraints", (2005) 42 *C.M.L.R.* 587.

<sup>62</sup> Supra note 59, recital 841.

<sup>63</sup> Commission decision of 22 December 1987, *Eurofix-Bauco v Hilti*, (1988) OJ L 65/19. See also *Novo Nordisk* (Commission's XXVIth Report on Competition Policy, pp. 142-143) in which objections were raised against Novo Nordisk's practices of disclaiming liability or refusing to guarantee its pen products (used for the delivery of insulin) when such products were used in conjunction with the compatible components of other manufacturers. The case was closed on receipt of undertakings from Novo Nordisk that it would discontinue such practices.

The Commission found that Hilti was dominant in three relevant product markets: nail guns, Hilti-compatible cartridge strips and Hilti-compatible nails, and went on to conclude that tying the sale of cartridge strips to the sale of nails and the general policy of refusing to honour a guarantee if a customer had used third party nails was abusive on the basis that:

“These policies leave the consumer with no choice over the source of his nails and as such abusively exploit him. In addition, these policies all have the object or effect of excluding independent nail makers who may threaten the dominant position Hilti holds.”<sup>64</sup>

Hilti’s arguments that its policies were motivated by concerns over quality and safety were rejected. The Commission’s decision was upheld by the Court of First Instance and the Court of Justice.<sup>65</sup>

b. Napier Brown/British Sugar<sup>66</sup>

The Commission initiated proceedings against British Sugar in the mid 1980s in response to a complaint from Napier Brown which alleged that a number of British Sugar’s sales policies were abusive, including the policy of offering sugar at “delivered prices” only, which in effect tied the supply of sugar to the service of delivering the sugar.

The Commission took the view that, by “reserving for itself the separate activity of delivering the sugar which could, under normal circumstances be undertaken by an individual contractor acting alone”,<sup>67</sup> British Sugar’s practice amounted to an abuse, in that it deprived customers of the choice between purchasing on an ex-factory and delivered price basis, thus eliminating all competition in relation to the delivery of the products.

c. Alsatel<sup>68</sup>

The Court of Justice considered an “after sales” tying scenario in a reference to it from the tribunal *de grande instance* in Strasbourg which related to proceedings between Alsatel (a telecommunications provider in the Alsace region) and Novasam, a temporary employment agency. The dispute between the parties concerned payments that were outstanding under contracts for rental and maintenance of telephone installations, which arose from a contractual obligation requiring Alsatel’s customers to deal exclusively with

<sup>64</sup> Commission decision of 22 December 1987, *Eurofix-Bauco v Hilti*, (1988) O.J. L 65/19 at 75.

<sup>65</sup> Case T-30/89 *Hilti AG v Commission*, [1991] E.C.R. II-1439 and Case 53/92 P *Hilti AG v Commission* [1994] E.C.R. I-667.

<sup>66</sup> Commission decision of 18 July 1988, *Napier Brown - British Sugar*, (1988) O.J. L284/41.

<sup>67</sup> Case 311/84 *Centre Belge d’Etudes de Marché Télémarketing v CLT* [1985] E.C.R. 3261 the refusal by CLT to supply the necessary services to telemarketing undertakings to enable them to carry on their activity via RTL television was held to be an abuse of a dominant position for the same reason, namely it reserved to CLT the ancillary market for telemarketing.

<sup>68</sup> Case 247/86 *Société Alsacienne et Lorraine de Télécommunications et d’Electronique (Alsatel) v SA Novasam* [1988] E.C.R. 5987.

Alsatel for any changes, moves, extensions, putting lines into service and, in general, any modifications of the installation.

The national court asked the ECJ whether Alsatel's contracts were evidence of an abuse of a dominant position, given Alsatel's share of the regional market.

The Court noted that:

“[a]lthough the obligation imposed on customers to deal exclusively with the installer as regards any modification of the installation may be justified by the fact that equipment remains the property of the installer, the fact that the price of the supplements to the contract ... is unilaterally fixed by the installer and the automatic renewal of the contract for a 15 year term [if certain conditions are met] may constitute unfair trading conditions prohibited as abusive practices by Article [82] of the Treaty if all the conditions for the application of that provision are met.”<sup>69</sup>

It went on to describe the necessary conditions, which were those of the *per se* approach adopted in other cases, namely that trade between Member States must be affected, and that Alsatel must be found to be dominant in a relevant market (though ultimately it was for the national court to determine whether as a matter of fact those conditions were satisfied). No mention was made of any requirement to assess the effects of the practice.

d. Tetra Pak II<sup>70</sup>

The reasoning of the Commission in *Tetra Pak II* was similar to the approach taken in *Hilti*. The Commission found that Tetra Pak was in a dominant position on the markets in aseptic machines and cartons intended for the packaging of liquid foods in the EU and that it had abused that position contrary to Article 82 from at least 1976 until 1991 both on those markets and on the markets in non-aseptic machines and cartons. The Commission imposed a fine of €75 million on Tetra Pak for, *inter alia*, tying the purchase of its carton packaging machines to the purchase of cartons, reserving to itself an exclusive right to maintain and repair equipment and to supply spare parts, and withholding guarantees on equipment unless purchasers complied with all of the preceding contractual obligations (or, in one country, used only Tetra Pak cartons).<sup>71</sup>

---

<sup>69</sup> Id. at para. 10.

<sup>70</sup> Commission decision of 24 July 1991, *Tetra Pak II*, (1992) O.J. L72/1.

<sup>71</sup> A number of similar cases were settled without a formal decision. See eg. *Oliofiat* (Commission's XVIIth Report on Competition Policy, p. 77): Fiat had been imposing an obligation on its dealers and authorised repairers to use in car servicing and to sell over-the-counter only lubricants and complementary products sold and manufactured by Fiat. Following the intervention of the Commission, Fiat sent a circular letter to all its dealers and workshops which confirmed that when servicing vehicles either Fiat lubricants or third party lubricants could be used, provided that such products met minimum quality standards and specifications. The Commission also initiated proceedings against *Digital Equipment Corporation* (Commission's XXVIIth Report on Competition Policy, pp. 34) on the basis of its commercial policy which, it was alleged, was “typified by discriminatory practices and tied sales” which, it was said, “revealed a clear desire to obstruct the ability of independent service suppliers to compete with Digital on the markets for maintenance services and other hardware services for Digital computers. Again, the Commission's file was closed after Digital entered into formal commitments. See also *Industrial Gas*, Commission's XIX

The decision was upheld by the Court of First Instance (“CFI”),<sup>72</sup> who considered that the various tying provisions were abusive because they strengthened Tetra Pak's dominant position by reinforcing its customers' economic dependence on it, and ultimately the European Court of Justice (“ECJ”).<sup>73</sup>

(ii) Discounts which are equivalent to tie-ins

The bundled discounts primarily under discussion here differ fundamentally because they do not provoke the central objection to tying, namely that the customer is unable to purchase the tied products separately. However, where a bundled price reflects any of the cost of the tied product, customers are purchasing the tied product, it may be deemed to be the functional equivalent of an explicit tie and thus may attract the same odium as an outright tie.

a. Hoffman-La Roche<sup>74</sup>

Bundled discounting was condemned by the Court of Justice in *Hoffman-La Roche*. That case was primarily concerned with “loyalty” rebates offered by Roche to customers who agreed to take all or substantially all of their vitamin requirements from Roche. It was common ground between the Commission and Roche that the different vitamin groups comprised separate markets. The Court held, on that basis, that the system of rebates on overall purchases was an abuse contrary to Article 86(d).<sup>75</sup>

b. Michelin<sup>76</sup>

The Commission decided that Michelin was guilty of an abuse of its dominant position by setting its dealers a volume target for the sale of car tyres in order to obtain a discount on the purchase of heavy vehicle tyres. The Court of Justice disagreed. In its view, the evidence showed that Michelin operated similar discount systems for car tyres and heavy vehicle tyres and that, in this instance, the discount was actually granted on sales of car tyres. This being so, the Commission was not entitled to regard the discount as relating to the quantity of heavy vehicle tyres sold.

---

Competition Report, point 62.

<sup>72</sup> Case T-83/91 *Tetra Pak v Commission* [1994] E.C.R. II-755.

<sup>73</sup> Case C-333/94 P *Tetra Pak International SA v Commission*, [1996] E.C.R. I-5951. The Advocate General was even more trenchant in his analysis: “Thus, a system of tied sales of products which are by nature inseparable or one which is normal commercial practice in the sector will in principle constitute an abuse, unless it is objectively justified. This Court has held that an undertaking which is in a dominant position and ties purchasers directly or indirectly by an exclusive purchasing obligation abuses its position inasmuch as it deprives the purchaser of choice as to his possible sources of supply and limits access to the market by other producers. In the final analysis, it is only in exceptional cases that tied sales by a dominant undertaking may be justified by the nature of the products or commercial usage.”

<sup>74</sup> Case 85/76 *Hoffman-La Roche v Commission* [1979] E.C.R. 461.

<sup>75</sup> *Id.* at 111.

<sup>76</sup> Case 322/81 *NV Nederlandsche Banden Industrie Michelin v Commission* [1983] E.C.R. 3461.

c. De Post/La Poste<sup>77</sup>

Making the grant of a preferential tariff in connection with one product or service dependent on an agreement to purchase a second product or service may also constitute an unlawful tying practice. In *De Post-La Poste*, for example, the Belgian post operator (which enjoyed a monopoly over the delivery of business-to-private mail) made the grant of preferential tariffs for the delivery of such mail conditional upon the acceptance of a business-to-business service.

The Commission was of the view that this prevented the establishment of other systems, and also stated categorically that “tying between services covered by a monopoly and services open to competition always has repercussions on competition”.<sup>78</sup>

(iii) Technological tie-ins

a. IBM<sup>79</sup>

In the EU, technological tying became a cause for concern in December 1980, when the Commission initiated proceedings against IBM in relation to its business practices with regard to its System/370 mainframe computer. It was alleged that IBM held a dominant position in the common market for the supply of the central processing unit (CPU) and the operating system for the System/370 as a result of which IBM was able to control the market for the supply of all products compatible with the System/370. In this context, the Commission objected to IBM’s integration of memory devices with the CPU and the bundling with the basic software applications.

Ultimately the case was settled informally: IBM undertook to offer its System/370 CPUs in the EU either without memory devices or with the minimum capacity required for testing.

This proposal was accepted by the Commission, which took the view that the settlement would “bring new opportunities for competition” in the sector. Interestingly, not long

---

<sup>77</sup>, Commission decision of 5 December 2001, *De Post-La Poste* (2002) O.J. L61/32.

<sup>78</sup> See also *IRI/Nielsen* (Commission’s XXVIth Report on Competition Policy, pp. 144-146). The Commission initiated an investigation into AC Nielsen’s activities in the European national markets for retail tracking services. It found that Nielsen had concluded contracts with substantial discounts in exchange for commitments from customers to call upon Nielsen’s services in a wide range of countries. This involved the bundling of countries where Nielsen was held to be dominant together with other countries in which one of Nielsen’s competitors was attempting to establish a presence. The Commission concluded that this could be abusive taking into account the “specific circumstances” of the case. It closed its file after Nielsen gave a formal undertaking that its multinational customers could switch to a competitor in any country without losing the benefit of conditions granted in other countries.

<sup>79</sup> *The Community v International Business Machines Corporation*, EC Commission Notice of 1 August 1984, [1984] 3 C.M.L.R. 147.



after the undertakings were accepted, the integration of the CPU and main memory devices as part of a single product became standard practice in the computer industry.<sup>80</sup>

b. Microsoft<sup>81</sup>

Two decades after the *IBM* proceedings, the issue of technological tying came to the fore once again in proceedings against Microsoft. Following a complaint by Sun Microsystems to the Commission alleging that Microsoft had infringed Article 82 by failing to disclose and make available for use sufficient interface information, the Commission began a further investigation in 2000 into the effects of the alleged tying of Microsoft's Windows Media Player (WMP) with the company's Windows PC operating system (PC OS).

In line with earlier case-law, the Commission decided that PC OS and WMP were separate products, focusing on the existence of separate demand for and supply of streaming media players.<sup>82</sup> That being so, the Commission considered that Microsoft's tying of WMP – by refusing to give customers the choice as to whether to acquire WMP<sup>83</sup> – had the effect of foreclosing the market to competitors by putting competing products at a disadvantage which is unrelated to their price or quality.<sup>84</sup> The Commission effectively considered that independent streaming media players were foreclosed unless they were able to achieve levels of distribution comparable to those achieved by WMP through Windows.<sup>85</sup> The Commission concluded that Microsoft had not shown that tying WMP was “indispensable” to the realisation of various efficiencies and that, therefore, there was no objective justification for such behaviour.

In addition to a substantial fine, Microsoft was ordered to offer PC manufacturers a version of Windows PC OS without WMP. According to the Commission press release:

“The un-tying remedy does not mean that consumers will obtain PCs and operating systems without media players. Most consumers purchase a PC from a PC manufacturer which has already put together on their behalf a bundle of an operating system and a media player. As a result of the Commission's remedy, the configuration of such bundles will reflect what consumers want, and not what Microsoft imposes.”<sup>86</sup>

Microsoft is currently appealing against the Commission's decision.<sup>87</sup>

---

<sup>80</sup> C. Ahlborn, D. Evans, J. Padilla, “The Antitrust Economics of Tying: A Farewell to Per Se Illegality”, (2002) 49 *Antitrust Bulletin* 287-34.

<sup>81</sup> Supra note 59.

<sup>82</sup> Supra note 59 recitals 803-813 (the Commission also identifies a range of other differences between PC OS and WMP).

<sup>83</sup> Supra note 59 recital 829.

<sup>84</sup> Commission Press Release IP/04/382, 24 March 2004.

<sup>85</sup> Supra note 59 recital 863.

<sup>86</sup> Commission Press Release IP/04/382, 24 March 2004.

<sup>87</sup> Case T-201/04, *Microsoft v Commission* (judgment pending).

3. General approach to tying

(i) Per se approach prior to Microsoft

Prior to its decision in *Microsoft*, the Commission and the European Courts were largely perceived to have applied a *per se* prohibition, which could be satisfied by a finding of (a) market power, (b) separate products and (c) coercion. For example, in *Napier Brown/British Sugar*, the Commission did not expressly consider whether the delivered pricing policy would result in material foreclosure of the tied market.

The exceptional possibility of objective justifications for tying cases was acknowledged but did not seem to have any relevance in practice.

a. Market definition

Market dominance is a pre-requisite for the application of Article 82. Not surprisingly, dominance in the market for the tying product had been established in all tying cases. In certain cases, however, the Commission defined the market so narrowly (e.g. Hilti-compatible cartridge strips) that a finding of dominance was inevitable. Furthermore, the Commission clearly stated that a finding of dominance in the market for primary products was not necessary for establishing a tying abuse:

“Even if it were correct as Hilti argues that nail guns form part of a wider market and compete with other fixing methods in general, this would not alter the analysis given above as far as the relevant markets for Hilti-compatible nails and cartridge strips in particular are concerned and Hilti’s dominance thereof. For the independent producers of those consumables the relevant markets on which they compete are those for Hilti-compatible consumables.”<sup>88</sup>

b. Separate products

As regards the issue of “separate products”, as noted above, Article 82(d) makes reference to “supplementary obligations which by their nature or according to commercial usage have no connection with the subject of such contracts”. Prior to *Microsoft*, therefore, the question of separate products is generally considered in terms of “commercial usage”. As in U.S. law, many cases in the EU have concerned products that are intuitively separate. However, in *Tetra Pak II*, Tetra Pak argued that its practices fell outside the ambit of Article 82 on the basis that they represented “normal commercial usage”. In support of its claim, it pointed to the fact that its competitor, Elopak, had acknowledged that combining the sales of machines and cartons was a more effective way of competing. However, this contention was neither accepted by the Commission nor the Court of First Instance, which stated that:

“Consideration of commercial usage does not support the conclusion that the machinery for packaging a product is indivisible from the cartons. For a considerable time there have been independent manufacturers who specialise in the manufacture of non-aseptic cartons

---

<sup>88</sup> Commission decision of 22 December 1987, *Eurofix-Bauco v Hilti*, (1988) O.J. L 65/19, para.72.

designed for use in machines manufactured by other concerns and who do not manufacture machinery themselves.”<sup>89</sup>

The fact that only a limited number of sales were untied was considered to be irrelevant. On appeal, the Court of Justice went even further:

“The list of abusive practices set out in the second paragraph of Article [82] of the Treaty is not exhaustive. Consequently even where tied sales of two products are in accordance with commercial usage or there is a natural link between the two products in question, such sales may still constitute abuse within the meaning of Article [82] unless they are objectively justified.”<sup>90</sup>

This implies that the absence of commercial usage is not necessarily a prerequisite for tying, but that the issue of commercial usage is a more a factor to be considered as a possible objective justification. The precise scope of this statement is unclear; however, it could be interpreted as permitting an approach which would be even more restrictive than the *per se* approach previously applied in the U.S.

c. Coercion

The restriction of actual customer choice has always been an essential element of a finding of abusive tying. According to the language of Article 82, customers must be forced to accept “supplementary obligations”. In *Tetra Pak II* the CFI stated that:

“The Court of Justice has in particular ruled that, where an undertaking in a dominant position directly or indirectly ties its customers by an exclusive supply obligation, that constitutes an abuse since it deprives the customer of the ability to choose his sources of supply and denies other producers access to the market.”<sup>91</sup>

Hence coercion is widely regarded as: “a crucial element of the abuse. Any company, even a dominant one, is free to sell two or more products together. The abuse will only occur when the customers of a dominant company are coerced to purchase two products together against their will.”<sup>92</sup>

The element of coercion can take various forms – ranging from the imposition of an outright tie to offering price incentives which are so powerful that customers would not choose to buy products individually. In *Hilti* the Commission decided that Hilti’s policies left the consumer “with no choice over the source of his nails”. Similarly, in *Tetra Pak*, the Commission concluded that the imposition by Tetra of various contractual obligations had the object of “unduly binding” its customers to it. In both cases the tying precluded customers from their choice of an alternative product.

---

<sup>89</sup> Case T-83/91 *Tetra Pak International SA v Commission* [1994] E.C.R. II-755, para.137.

<sup>90</sup> Case C-333/94 P *Tetra Pak International SA v Commission* [1996] E.C.R. I-5951, para.37.

<sup>91</sup> *Tetra Pak II*, para.137.

<sup>92</sup> J. Faull and A. Nikpay, *The EC Law of Competition*, Oxford University Press, 1999, 3.202.

d. Anti-competitive effects

Prior to *Microsoft*, there was no particular need to establish any anti-competitive effects in the market for tied products.

In the *British Sugar* case, for example, where British Sugar had tied the supply of sugar to the service of delivering the sugar, the Commission did not regard it as necessary to assess whether the delivery of sugar was part of a wider transport market and whether the tying foreclosed any significant part of that market. The fact that British Sugar had “reserved for itself the separate activity of delivering sugar” was sufficient as an anti-competitive effect.

Similarly, in *Hilti*, the Commission took the view that depriving the consumer of choice of buying the tied product from separate suppliers was in itself abusive exploitation:

“These policies leave the consumer with no choice over the source of his nails and as such abusively exploit him.”

This strongly suggested that prior to *Microsoft*, tying was subject to a *per se* prohibition, with the possible exception of an objective justification. This is consistent with the view put forward by the Commission in its *Guidelines on Vertical Restraints*.<sup>93</sup>

e. Objective justification

The existence of an objective justification defence in tying cases was generally acknowledged but where it had been raised in the past, for example in *Hilti* on the basis of safety and reliability, it had failed due to lack of evidence.<sup>94</sup>

(ii) Rule of reason approach in the *Microsoft* case

In its *Microsoft* decision, however, the Commission appeared to recast the analytical framework somewhat in comparison with previous cases and did so in the following terms:

“Tying prohibited under Article 82 of the Treaty requires the presence of the following elements: (i) the tying and tied goods are two separate products; (ii) the undertaking concerned is dominant in the tying product market; (iii) the undertaking concerned does not give customers a choice to obtain the tying product without the tied product and (iv) tying forecloses competition.”<sup>95</sup>

---

<sup>93</sup> O.J. [2000] C 291/1, para.215; see similarly para.141.

<sup>94</sup> The possibility of objective justification has been considered in a number of UK cases by the Competition Appeal Tribunal; see e.g. *Genzyme v Office of Fair Trading* [2004] CAT 4; *Floe Telecom Limited (in administration) v Office of Communications* [2004] CAT 18; *ME Burgess JJBurgess and SJ Burgess (trading as JJ Burgess & Sons) v Office of Fair Trading* [2005] CAT 25; all of which are available on the CAT’s website: <http://www.catribunal.org.uk/default.asp>.

<sup>95</sup> Supra note 59 at recital 794.

According to the “Questions and Answers on the Commission Decision”,<sup>96</sup> the Commission purported to follow:

“A ‘rule of reason’ approach in order to establish whether the anti-competitive effects of tying WMP outweigh any possible pro-competitive benefits. This is precisely the framework for tying cases that U.S. Court of Appeals laid down in 2001.”

Thus, while the Commission’s stated position appears to accord with its preceding practice and case-law in some respects, it significantly departs from previous jurisprudence in other respects. It is therefore worthwhile considering each of the elements of the Commission’s proposed test in further detail.

a. Separate products test

In *Microsoft* the Commission decided that there was a separate consumer demand for media players, distinguishable from the demand for client operating systems, evidenced by the fact that “there are vendors who develop and supply media players on a stand-alone basis, separate from PC operating systems.” According to Microsoft the relevant question is not only whether there is demand for tied products separate from the demand for the tying product, but also whether there is demand for the tying product without the tied product.

b. Coercion

In *Microsoft* the Commission subtly reformulated the coercion requirement. In its decision, the Commission took the view that Microsoft has “forced” customers to buy WMP with Windows as “customers are not given the choice of acquiring the tying product without the tied product”. The Commission rejected Microsoft’s view that the integration of WMP into Windows does not restrict customer choice. Microsoft had argued that the absence of any coercion was demonstrated by the fact that WMP as well as other media players are free and can be easily downloaded and that consumers typically use multiple media players. Thus a key question for the Court to decide will be whether it is sufficient for a particular action to restrict a hypothetical customer choice, in which case every pure bundling satisfies *per se* the condition of coercion, or whether it is necessary to prove the restriction of actual customer choice.

c. Foreclosure

In the *Microsoft* decision, the Commission saw the need for a move towards an effects-based analysis. Referring to the particular circumstances of tying WMP, the Commission signalled a departure of sorts from the entrenched formalism that underpins much of the law on Article 82. In recital 841 of its decision the Commission recognised that:

“There are indeed circumstances relating to the tying of WMP which warrant a closer examination of the effects that tying has on competition in this case. While in classical

---

<sup>96</sup> Commission MEMO/04/70, 24 March 2004.

tying cases, the Commission and the Courts considered the foreclosure effect for competing vendors to be demonstrated by the bundling of a separate product with the dominant product, in the case at issue, users can and do to a certain extent obtain third party media players through the Internet, sometimes for free. There are therefore indeed good reasons not to assume without further analysis that tying WMP constitutes conduct which by its very nature is liable to foreclose competition.”

Thus the Commission accepted that it was incumbent on it to establish market foreclosure in respect of tying WMP and found that there was a “risk” of foreclosure occurring in the future. The alleged risk was expressed in a number of ways in the Decision.<sup>97</sup> Ultimately, the Commission concluded that there is “a reasonable likelihood that tying WMP with Windows will lead to a lessening of competition so that the maintenance of an effective competition structure will not be ensured in the foreseeable future”.<sup>98</sup> Whether this is the correct legal standard for measuring market foreclosure in a case like *Microsoft* has yet to be established by the Courts.

d. Objective justification

It is well-established that the Commission and the Court of Justice will examine whether there is an objective necessity for tied-sale provisions or for a supplier to reserve to itself a particular service.<sup>99</sup> Of particular importance is the existence of alternative business methods by which an undertaking may achieve its objectives without the need to engage in the impugned tie. The availability of less restrictive alternatives was of crucial significance for the Commission’s assessment of objective justification in *Microsoft*. Efforts to escape censure on this ground have thus far been unsuccessful in previous tying cases. For example, Hilti’s arguments that its tying practices were necessary on the grounds of safety and quality assurance were rejected by the Commission, with whom the CFI agreed.

In *Microsoft* the Commission appeared to raise the bar significantly in order to show that tying is capable of objective justification. While the Commission acknowledged the efficiencies of using WMP as a platform for software content and applications, it concluded that Microsoft had not demonstrated that tying WMP was “indispensable” for procuring the benefits in question. Thus, it would seem that a dominant undertaking must show that the tying arrangement is “indispensable” to compete on the merits and that, as a result, its allegedly restrictive conduct is in fact pro-competitive. This would appear to ‘read-across’ and apply one of the ingredients of Article 81(3) in the context of Article 82.

---

<sup>97</sup> The “potential to foreclose competition” (recital 842); a claim that effective competition is “put at risk” (recital 842); a “serious risk” of foreclosing competition” (recital 842); a claim that content and applications are “liable” to be developed primarily for WMP (recital 863); a claim that Microsoft’s competitive advantage is “liable to have a harmful effect on the structure of competition” (recital 878).

<sup>98</sup> Supra note 59 at recital 984.

<sup>99</sup> See e.g. Commission decision of 2 June 1971, *GEMA* (1971) O.J. L 134/15; Commission decision of 18 July 1988, *Napier Brown-British Sugar* (1988) O.J. L 284/41; Case 311/84 *Centre Belge d’Etudes de Marché Télé-marketing v CTL* [1985] E.C.R. 3261 and Commission’s Guidelines on Vertical Restraints (2000) O.J. C 291/1, (stating that a dominant company may not impose non-compete obligations on their buyers unless it can objectively justify such commercial practices within the context of Article 82).

The Commission effectively states that Article 82 will prohibit tying unless it can be shown that the distortion of competition which the tying arrangement entails is no greater than is necessary to carry on the dominant firm's business.<sup>100</sup>

(iii) Summary

Overall, the precise status of tying under EU law remains unclear. A *per se* approach that appeared to be based on Article 82(d) is apparent in the Commission's decisions in *Hilti* and *Tetra Pak II*. A different test is purportedly being applied by the Commission in *Microsoft*, but the basis for, and the application of, such a test is not altogether clear. And the implication of the ECJ's judgment in *Tetra Pak II* is that it is not necessary to rely on Article 82(d), but that the general provisions of Article 82 could be relied upon.

4. Technological Integration vs. other forms of tying

It is difficult to draw any conclusions regarding the approach of EU law to technological tying cases due to their relative scarcity. The only formal decision at our disposal is that in *Microsoft*. As noted above, the test that was applied in *Microsoft* does differ from that applied in previous cases, in part as a result of the introduction of the "foreclosure" requirement. The Commission appeared to recognise that a more extensive analysis was called for, not least because EU law on tying has not developed with products such as computer software in mind. However, it is not clear from the decision whether the Commission's new four-pronged test is intended to be a general test applicable to all tying cases, or whether it is limited in scope to technological integration cases or some other sub-category of cases.<sup>101</sup>

The Court of First Instance, which is currently considering Microsoft's appeal, therefore finds itself in uncharted waters. It remains to be seen whether it will revert to a *per se* prohibition approach, favour a distinction between cases involving technological integration and classical cases, or pursue an alternative approach of more specific or general application. In refusing Microsoft's application to suspend the application of the Commission's decision, the President of the Court of First Instance acknowledged that the appeal against the prohibition of tying WMP raised complex, important and intricate questions of both principle and fact, which the Court would need to consider more fully in the main action.<sup>102</sup>

---

<sup>100</sup> See similarly L. Gyselen "Rebates: Competition on the Merits or Exclusionary Practices" 8th EU Competition Law and Policy Workshop, What is an Abuse of a Dominant Position?, European University Institute, Florence, June 2003.

<sup>101</sup> See supra note 59 at recital 794 (which is expressed in general terms but has only been applied in the specific context of the *Microsoft* case).

<sup>102</sup> Case T-201/04 R *Microsoft v Commission*, Order of the President of the CFI, 22 December 2004, paras 400-402.

D. U.S. and EU law compared

As mentioned earlier, U.S. tying policy has been considered under Section 1 of the Sherman Act while in the EU tying has predominantly fallen under the abuse of dominance provisions. Paradoxically, this had led to a more similar approach, as the concept of market power for tying under Section 1 of the Sherman Act is more in tune with the concept of dominance under Article 82 than monopoly power under Section 2 of the Sherman Act.

Despite this similarity and indeed the overall similarity of the analytical framework, significant differences remain.

First, the framework of analysis in the U.S. has been re-interpreted to accommodate a shift in policies moving from *per se* illegality towards a modified *per se* rule and, in certain circumstances, a rule of reason approach. This shift in policy frequently reflected new views in economic theory. EC law by contrast has until recently been largely static and immune to influence from economic thought. Courts have tended to infer an exclusionary effect from a company's actions by reason of the action's nature rather than its effect. In its *Microsoft* decision, the Commission has moved away from excessive formalism but its insistence on a high evidential requirement for efficiencies, in particular the newly established need to show "indispensability", still shows considerable hostility towards tying.

Second, U.S. Courts have engaged in a debate about the purpose of certain criteria within the context of a cost-benefit or error cost analysis. An example is the re-evaluation of the separate product test in *Jefferson Parish* as a proxy for foreclosure, or more recently an even more detailed discussion of the policy rationale of this test in the *Microsoft III* judgment of the DC Circuit Court of Appeals, cited by the Commission in its decision.<sup>103</sup> In the EU such a debate has been entirely absent and the approach has been, again, overly formalistic. Where the interpretation of the separate product test in the EU has been similar to that in the U.S., as in the case of *Hilti*, one cannot help feeling that this was coincidental rather than the result of an informed advice by the European authorities. More generally, contrary to other areas of competition law, European Courts have been largely silent on policy issues in abuse of dominance cases and have tended to confirm Commission decisions even where these decisions were highly controversial.

Finally, it is striking that despite the very hostile approach towards tying and the wide scope of illegal tying under Article 82, there have in fact been very few tying cases, either at the Commission or the Court level. This is curious, given the extent to which bundling is practised throughout the modern world by non-dominant and dominant firms alike. Whilst tying arrangements between non-dominant firms (those with a market share of less than 30%) are presumed to be lawful pursuant to Commission Regulation 2790/99, this is of little comfort to dominant firms.

---

<sup>103</sup> See supra note 59 at recital 808.



## **V. Error Costs and Decision Theory Framework<sup>104</sup>**

### **A. General aspects**

#### **1. Errors and Error Costs**

It is increasingly recognised that some form of economic welfare (either consumer surplus or alternatively, total welfare, i.e. consumer surplus plus profits) should be the benchmark for antitrust policy. In the context of tying this means that any legal rule should outlaw tying if, and indeed only if, it lowers consumer surplus (or alternatively, total welfare).

As we have seen in Section III, economic analysis does not provide simple guidelines which distinguish clearly between harmful and benign tying. Tying may be harmful in narrowly defined circumstances but even potentially harmful tying may also result in efficiencies. In an imperfect world, competition authorities and courts have to rely on inherently imperfect tests based on imperfect information.

Decision theory provides an analytical framework to assess the choices among various different legal rules and the trade-offs they involve.

As Hylton and Salinger explain:

“According to the decision-theory framework, a legal rule divides cases (of tying and product integration) into two categories: those that are legal under the rule and those that are illegal. Because the rule is inherently imperfect, this categorisation is not identical to the distinction between the cases that are harmful and benign. Thus, one can further categorise cases according to whether the practices found legal or illegal are harmful or not.”

This leads Hylton and Salinger to the following cross-classification:

	Harmful	Not harmful
Illegal	cases that both are harmful and illegal	cases that are not harmful even though they violate the legal standard
Legal	cases that are harmful even though they do not violate the legal standard	cases that are neither harmful nor illegal

<sup>104</sup> This section borrows heavily from K.N. Hylton and M. Salinger, *Tying Law and Policy: A Decision Theoretic Approach*, Boston University School of Law, Working Paper No. 01-04.

The classification shows two possible types of errors, namely “false positives” (tying which violates the legal rule even though it is benign) and “false negatives” (tying which does not violate the legal rule even though it is harmful).

Both types of errors are costly. In the case of false positives, the costs are efficiencies foregone, for example efficiencies in distribution, which in turn will lead to higher prices for consumers. In the case of false negatives, the cost is consumer harm due to restrictions of competition.

## 2. Basic trade-offs

In designing a policy with respect to tying, policy makers face two fundamental trade-offs:

- Trade-off between false positives and false negatives: By making it harder (easier) to establish that tying is illegal, authorities can reduce (increase) the risk of false positives in return for an increased (reduced) risk of false negatives.
- Trade-off between error costs on the one hand and investigatory costs on the other hand: Authorities are able, to some extent, to reduce both types of error by conducting a more detailed investigation (i.e. by considering more factors and reviewing more data). This means the authorities face a trade-off between error costs on the one hand and investigatory costs on the other.

## 3. Two levels of enforcement

Enforcement of antitrust works at two levels: first, at a direct level in the case under investigation (in the U.S. primarily through a judicial system, in the EU primarily through an administrative system). Antitrust, however, is also designed to have a deterrent effect through administrative fines or treble damages (i.e. it is aimed at having an indirect effect on firms which are not currently subject to an investigation). Errors occur at both levels of enforcement.

Enforcement operates in different ways at both levels. At the direct level of enforcement, the decision is taken by the authorities, which generally will have reviewed detailed information from a wide range of sources (in particular the party under investigation, complainants and market participants). At the indirect level, decisions are made by the firms themselves on the basis of information available to them (e.g. whether or not to engage in a particular tie). In making these decisions firms will take into account (a) the likelihood of an investigation, (b) the severity of the sanctions for non-compliance and (c) the costs of compliant behaviour. Firms and the authorities will base their decisions on different sets of information.

As a result, different errors occur at the two levels of enforcement and the optimal trade-off between different enforcement costs is likely to be different. At the level of indirect enforcement, one would expect optimal rules to be fairly simple and in particular to

provide safe havens within which a particular type of behaviour is clearly legal. At the level of direct enforcement, the optimal rules are likely to be more complex.

## B. Policy parameters

There are two policy parameters in particular which determine the trade-offs between the various costs, in particular (a) the legal standard and (b) the standard and burden of proof.

### 1. Legal standards

Different legal standards will lead to different errors and error costs. They will also lead to different administrative costs.

We noted above that, broadly speaking, there are three different legal rules which can be distinguished:

- the *per se* illegality rule: according to this rule, tying would be illegal if certain criteria were satisfied (such as the existence of significant market power and pure bundling) independently of any actual impact in the market;
- the rule of reason: this rule assesses the impact on competition and efficiency gains in the context of the case and holds tying as unlawful if the harm outweighs any efficiencies;
- the *per se* legality rule: according to this rule, tying would be regarded as legal provided that certain criteria were satisfied.

Lawyers sometimes refer to this classification as if it were comprehensive, but it is important to bear in mind that various standards that have been deployed by U.S. and EC anti-trust law over the years. In practice, many legal rules may not fit neatly into one of these three categories: for example, it may be hard to draw a line between *per se* illegality and presumptions of illegality with very high evidential burdens for rebuttal; furthermore, rules may combine elements of different standards, for example aspects of *per se* legality with a 'quick look' rule of reason test. "The essential point is that the rule of reason can sometimes be applied in the twinkling of an eye."<sup>105</sup>

With respect to the trade-off between false positives and false negatives, the *per se* illegality rule and the *per se* legality rule are at extreme ends: with a *per se* illegality there will be no risk<sup>106</sup> of false negatives but a relatively high risk of false positives. For the *per se* legality, the reverse is true; there is a relatively high risk of false negatives but no risk of false positives. The rule of reason takes a position between these two extremes.

---

<sup>105</sup> P. Areeda, The "Rule of Reason" in "Antitrust Analysis: General Issues", Federal Judicial Center, June 1981, pp. 37-38.

<sup>106</sup> Ignoring possible errors in relation to the assessment of market dominance.

As to the second trade-off (error costs versus investigatory costs), both *per se* rules accept relatively high error costs in return for relatively low investigatory costs, while the rule of reason approach will lead to higher investigatory costs in return for lower error costs.

## 2. Standards and burden of proof

In addition to the legal standard, the standard and burden of proof (including special evidential requirements, such as indispensability) are a further key parameter in determining the trade-off between enforcement costs: who has to demonstrate competitive harm (if any) and to what evidential requirements, who has to establish efficiencies and to what standard and who is in charge of the balancing exercise between competitive harm. To some extent, the choice for the relevant legal standard will pre-determine some of these issues (e.g. no requirement to establish competitive harm under a *per se* illegality rule). In particular for the rule of reason, there is considerable scope for fine tuning via the relevant standard and burden of proof.

A high standard of proof for competitive harm (e.g. beyond reasonable doubt) moves the rule of reason approach towards a *per se* legality approach, a low standard of proof (e.g. establishing the mere possibility) moves it towards *per se* illegality. The reverse is true for the standard of proof with respect to efficiencies.

Evidential requirements, such as indispensability of tying for efficiencies, also affects the trade-off between false positives and false negatives. Certain efficiencies achieved by tying could also be achieved by other means, for example certain compatibility and safety efficiencies could be obtained by making interface information available and setting certain safety standards.

Without an indispensability requirement, the question is whether tying is welfare enhancing (assuming that those efficiencies will not be achieved in a different way). The indispensability requirement uses a different counterfactual, namely whether tying is welfare enhancing when compared to a hypothetical alternative.

Given that it is difficult to determine (for the authorities or the party under investigation) whether efficiencies could and indeed would be achieved in an alternative way in the absence of tying, the indispensability requirement increases the risk of false positives and decreases the risk of false negatives.

Finally, the burden of proof also affects the trade-off between false positives and false negatives. Imposing the burden on the authorities to show that any competitive harm outweighs efficiencies will lead to a greater risk of false negatives and smaller risk of false positives compared to a system where the burden is on the party subject to investigation to show that any efficiencies outweigh possible competitive harm.

### C. Optimal policy for tying

#### 1. Key factors

The optimal rule for tying is one which minimises the overall enforcement costs. Focusing on the trade-off between false positives and false negatives, the optimal trade-off is determined by three factors:

- the relative frequency of harmful and benign cases under review;
- the rate of false negatives (and positives): i.e. the conditional probability of acquittal (conviction) given that a case is harmful (not harmful);
- the cost of false positives and negatives.

##### (i) Relative frequency of harmful and benign cases

The relative frequency of harmful/benign cases is one of the key drivers for the overall trade-off between the two types of errors. The following example may illustrate the point. Assume that the error costs and the rate of errors are the same (the cost of errors in both cases and the rate of false negatives and positives being 5% – in other words in 5 out of 100 benign cases the legal rule is violated, and equally in 5 out of 100 harmful cases the legal rule is not violated).

If most of the cases subject to investigation are benign (e.g. 99%) then the overall number of false positives outweigh the number of false negatives and the optimal enforcement policy would be restrictive (i.e. the higher the threshold for illegal tying).

	Harmful	Not harmful
Illegal	0.95	4.95
Legal	0.05	94.05
Total	1%	99%

Despite the fact that the rate of error of false positives and false negatives are the same (i.e. 5%), due to the fact most cases (99%) are benign, (a) the number of false positives (4.95%) far outweigh the number of false negatives (0.05%) and (b) most of the cases declared illegal (more than 80%) are wrongly declared illegal.

##### (ii) Rate of false negatives/positives

The second important factor in determining the optimal trade-off between the two types of errors is the rate of false negatives to false positives. For any given frequency of harmful to benign cases (in our example below 50%), the greater the relative rate of error for false negatives (in our example 20% versus 10% for false positives), the more

aggressive the optimal enforcement policy (i.e. the lower the threshold for illegal tying).

	Harmful	Not harmful
Illegal	40	5
Legal	10	45
Total	50%	50%

(iii) Relative costs of error

Finally, the relative costs of error also determines the optimal enforcement policy. For example, the more costly false negatives relative to false positives, the more aggressive should be the optimal enforcement. In other words, if the costs of erroneously not prohibiting an abuse (i.e. allowing a restriction of competition) are expected to be greater than the costs of erroneously prohibiting benign behaviour (i.e. efficiencies foregone), all things being equal, the optimal policy would over-enforce.

2. Implications of factual evidence and economic theory

There does not exist any clear data which would allow us to quantify the three key factors (relative frequency of harmful tying, relative error rates and relative error costs) in order to determine the optimal policy with respect to tying.

However, in light of the factual evidence and economic theory discussed in the previous sections, the decision theoretic approach may nevertheless provide some guidance: first, and most importantly, bundling is ubiquitous by dominant and non-dominant firms alike, which strongly suggests that it is mainly the result of efficiency considerations; while bundling by dominant firms may result in a restriction of competition in certain limited circumstances, there are no simple and clearly defined criteria which would identify when tying is overall harmful.

Second, in most cases, even where a firm is dominant, the most likely explanation for bundling is still likely to be benign; this is particularly the case where non-dominant firms in the same market also bundle. At the same time, there is no evidence which suggests that the error costs for false negatives are significantly higher than for false positives. This strongly suggests that the optimal policy towards it is cautious rather than aggressive. This suggests some form of rule of reason (or alternatively a *per se* legality approach).

Third, for enforcement at the indirect level, some clearly defined safe haven where tying is legal is important.

## VI. Review of Different Policy Options

### A. Introduction

In the final section of this paper, we assess the three major rules towards tying under U.S. and EC law – namely (i) the modified *per se* analysis of *Jefferson Parish*, (ii) the *per se* prohibition of *Hilti* and *Tetra Pak II* under EC law and (iii) the Commission’s rule of reason in the recent *Microsoft* case and determine whether they can be reconciled with the decision theoretic approach in light of the economic theory and factual evidence.

In particular, we ask whether each of these legal rules (a) provides an appropriate safe haven at the level of indirect enforcement (that is, when firms are planning their market strategy and take into account the risk of infringing the competition rules) and (b) strikes the right balance between the different types of enforcement errors.

### B. The modified *Per se* approach to tying: *Jefferson Parish*

The test under *Jefferson Parish* is a modified *per se* approach. The key element of this approach is the separate products test which determines (together with the requirement of market power) the borderline between legal and illegal tying; in other words, the separate products test is both a criteria for the safe haven and a prohibition criteria.

The most detailed discussion of the policy rationale of the “separate products test” under *Jefferson Parish* can be found in the *Microsoft III* judgment of the DC Circuit Court of Appeals which is cited by the Commission in its decision.<sup>107</sup> Given that tying may have potentially positive as well as negative effects, the Court of Appeals recognised that the separate product test is a “rough proxy for whether a tying arrangement may, on balance, be welfare enhancing”. It stated:

“In the abstract, of course, there is always direct separate demand for products: assuming choice is available at zero cost, consumers will prefer it to no choice. Only when the efficiencies from bundling are dominated by the benefits to choice for enough consumers, however, will we actually observe consumers making independent purchases. In other words, perceptible separate demand is inversely proportional to set efficiencies.”

This proxy is intuitively convincing. If, due to efficiencies, two components can be offered together at a lower price (for example as a result of savings in distribution costs) or better quality, and for most consumers these efficiencies outweigh any restriction of choice, then one would expect most consumers to buy the components as a bundle rather than separately.<sup>108</sup> The rationale of the separate products test indicates that the critical question is whether consumers only demand the alleged tying product and tied product as a bundle, or whether there is separate demand for the components.

---

<sup>107</sup> *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C.Cir.2001).

<sup>108</sup> See above.

If the separate products test is not satisfied (i.e. there is no significant separate demand for the components and customers prefer to buy the bundle), then this leads to the conclusion that tying is welfare enhancing (otherwise customers would request the components separately). Conversely, if the separate products test is not satisfied, it leads to the conclusion that there could be some competitive harm and that tying is unlikely to be welfare enhancing.

It is important to note, however, the asymmetric strengths of the conclusion for a negative and positive result of the separate product test. A negative result of the separate product test leads to strong conclusions regarding competitive harm and efficiencies, neither of which is dependent on particular assumptions (namely that there can be no competitive harm, and that tying must be motivated by significant efficiencies). A positive result does not lead to any particular conclusion about competitive harm (other than that the possibility exists).

Indeed, the fact that there is separate demand for the “tied” product (i.e. that customers are willing to purchase the “tied” product separately, and that some firms are offering the “tied” product separately) allows only the conclusion that tying is not efficient if both of two conditions hold.

First, that the market for the tied product is static and not, for example, characterised by innovation. This condition is due to the fact that the separate product test (both as consumer demand test and as industry custom test) is backward looking, or as the Court of Appeals put it in *Microsoft III*:

“The direct consumer demand test focuses on historic consumer behaviour, likely before [technological tying], and the industry custom test looks at firms that, unlike the [tying firm] may not have integrated the tying and the tied goods. Both tests compare incomparables — the [tying firm’s] decision to bundle in the presence of integration, on the one hand, and the consumer and competitor calculations in its absence, on the other.”<sup>109</sup>

The more dynamic the industry, the greater the expected error of the separate product test under *Jefferson Parish*.

The second condition is that all firms in the market for the tied products have similar characteristics (for example similar cost structures) and operate in similar circumstances (for example have similar client bases). Without this condition it would not be possible to draw any conclusions from the fact that the majority of firms in a particular market did or did not bundle certain products, as any difference in strategy could be attributable to differences in characteristics or circumstances.

In practice, most industries do not satisfy the above conditions. This was acknowledged by the Commission in the *Microsoft* decision, in which it stated:

---

<sup>109</sup> *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C.Cir.2001).



“It may be true that the direct consumer demand test under a *per se* rule (as normally applied in the U.S. tying cases) ‘focuses on historic consumer behaviour likely before integration’ and therefore risks ignoring efficiency benefits deriving from new product integration [...]”<sup>110</sup>

It is therefore clear that the modified *per se* rule under *Jefferson Parish* does not strike the right balance between false positives and false negatives and that it is more prohibitive of tying than is optimal from a welfare perspective.

C. The *per se* approach under EC law prior to *Microsoft*

EC law has broadly developed a similar analytical framework for the assessment of tying as U.S. antitrust law. Similar concerns about a dominant undertaking “leveraging” its market power in the tying product into a second distinct market for the tied product have led the courts on both sides of the Atlantic to greater scrutiny of tying arrangements.<sup>111</sup> Both EC and U.S. competition law do not permit a monopolist to “exploit his dominant position in one market to expand his empire into the next.”<sup>112</sup>

The legal framework under which the alleged tie is examined are broadly similar in the U.S. under *Jefferson Parish* and the EC jurisprudence prior to *Microsoft*. Ties have effectively been subject to ‘*per se*’ prohibition in the EC and a modified *per se* rule in the U.S. For example, the assessment of the quantitative and qualitative aspects of market dominance in the EC is reminiscent of the assessment carried out under the modified *per se* approach in the U.S.

A further point of convergence can be identified in respect of the outcomes of the EC law prior to *Microsoft*: It is also likely that the U.S. courts would have reached the same outcome as their EC counterparts in *Hilti* and *Tetra Pak II* - both, with respect to the “separate products” analysis in the context of a tie of consumables (nails and cartons) and the finding that the ties in question should be prohibited because of the exclusivity which they created, removing the customer’s choice to use an alternative supplier (although, perhaps U.S. antitrust law would have required the courts to explain in greater detail how the tying practices would exclude rivals or deter their entry).

However, it is clear that there were some important differences between EC law prior to *Microsoft* and U.S. antitrust law on tying. In the U.S., *Jefferson Parish* signalled a move towards a less formalistic, more economically realistic approach to the analysis of tying arrangements. It is apparent that U.S. law has moved towards a more sensitive economic meaning of what is meant by an illegal tie, and that a consequence of this will be that fewer ties have been, are likely to be, condemned. This trend is exemplified by the “separate products” test laid down by the Court in *Jefferson Parish* and which recognised

---

<sup>110</sup> Supra note 87

<sup>111</sup> See T. Eilmansberger, supra note 56, p. 129–177.

<sup>112</sup> *Times Picayune Publishing Co. v. United States*, 345 U.S. 594, 611 (1953).

that the:

“definitional question [whether there are two separate products] depends on whether the arrangement may have the type of competitive consequences addressed by the rule [against tying].”

Although a majority of the Supreme Court considered it “far too late in the history of our antitrust jurisprudence” to question *per se* condemnation of certain tying arrangements, it is clear that U.S. law has modified the *per se* rule of illegality in order to recognise the economic rationale for, and the competitive consequences of, tying. In a different context the Court has recognised that “departure from the rule-of-reason standard must be based on demonstrable economic effect rather than ... upon formalistic line drawing.”<sup>113</sup> The same is not true of EC law prior to *Microsoft* however. In stark contrast to the developments in U.S. law, the law and policy of Article 82 on tying appears to be somewhat legalistic and unresponsive to the dynamics of the market-place. EC law has yet to benefit from the same economic insight that has underpinned U.S. jurisprudence following *Jefferson Parish*. EC law prior to *Microsoft* considered tying arrangements as abusive simply because they strengthened a firm’s dominant position by reinforcing its customers’ economic dependence on it. Article 82 has yet to fully embrace the possible pro-competitive effects and efficiencies associated with dominant firm behaviour. For example, EC law has yet to recognise that tying arrangements often serve the pro-competitive functions of facilitating new entry into certain markets.

One of the difficulties with EC law of *Hilti* and *Tetra Pak II* is that it meant that some of the rules that can be derived from the leading judgments of the Community Courts appear to be too formalistic and indifferent to the ability of dominant firms to compete in the market. Indeed, some of the rules do not offer much legal security and seem to leave little scope for a ‘safe haven’ from the prohibition in Article 82. In *Hilti*, for example, the Court held that Hilti’s dominant position in the market for nails for the nail guns which it manufactures was sufficient to invoke the *per se* rule against tying nail cartridges for example. The existence of even lively inter-brand competition would be no defence (even though inter-brand competition would have precluded Hilti from obtaining the monopoly rents against which the tying prohibition is directed).<sup>114</sup> A further example of the economically anaemic state of Article 82 can be drawn from *Tetra Pak II* which rejected that firm’s argument that Article 86(d) must be construed to mean that a dominant undertaking on a market does not commit an abuse if it ties products in accordance with normal commercial usage in the sector.<sup>115</sup> Such reasoning does not take sufficient account of the potential efficiencies associated with normal commercial practice; rather, it focuses on the risk that competitors will be eliminated. Evidence that firms without market power integrate two component products often suggests that the practice is efficiency-enhancing. In certain respects, we have failed in the EU to accord sufficient weight to those benign implications of standard commercial practice.<sup>116</sup>

<sup>113</sup> *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717, 726 (1988).

<sup>114</sup> See P. Areeda and H. Hovenkamp, *Antitrust Law*, p. 563 (Supplement, 1991).

<sup>115</sup> Case C-333/94 P *Tetra Pak International SA v Commission* [1996] E.C.R. I-5951, at para.37.

<sup>116</sup> Case T-65/89 *BPB Industries plc and British Gypsum Ltd v Commission* [1993] E.C.R. II-389, at para.66: “It is not unusual for commercial cooperation of that kind to involve, in return, an exclusive

Thus, it seems that the underlying principles of U.S. and EC law in respect of tying are broadly similar and that the leading EC cases prior to *Microsoft* would have reached the same result in the U.S. However, some of the principles set out by the Commission and the Court, albeit *obiter dicta*, are breath-taking in their scope and implications for the practice of bundling and tying.

D. A structured rule of reason: the Commission's *Microsoft* decision

1. Key issues

Of the three legal rules which are reviewed in this paper, at a general level the approach of the Commission in the *Microsoft* decision seems to be most in line with what the decision theoretical approach suggests in light of the economic theory and factual evidence in relation to tying: it provides some safe haven (in the form of market dominance and the separate product test) and applies a rule of reason to the cases which fall outside that safe haven.

At a more detailed level, however, three issues deserve a closer look in the context of an error cost analysis:

- Does the separate products test as applied by the Commission give the greatest possible comfort for firms at the indirect level of enforcement?;
- Does the Commission apply the correct (i.e. optimal) standard of proof for harm to competition?;
- Should there be an indispensability requirement for efficiencies and should the burden of proof of indispensability be on the party subject to investigation?

2. The separate products test as safe haven

In Section VI.-B above, we discussed the policy rationales for the separate products test of *Jefferson Parish*, namely as a proxy for foreclosure (defined by the Supreme Court in *Jefferson Parish* itself) as well as a proxy for net efficiencies (as set out by the DC Court of Appeals in *Microsoft III*). These rationales indicated that the critical question for the separate products test is whether consumers only demand the products in question as a bundle or whether there is significant separate demand for the components. In other

---

purchasing commitment given by the recipient of such payments or facilities to his supplier. Such exclusive purchasing commitments cannot, as a matter of principle, be prohibited"; and para.67 "But those considerations, which apply in a normal competitive market situation, cannot be unreservedly accepted in the case of a market where, precisely because of the dominant position of one of the economic operators, competition is already restricted. An undertaking in a dominant position has a special responsibility not to allow its conduct to impair genuine undistorted competition in the common market.".

words, the separate products test is satisfied if there is significant demand for the allegedly tied product and significant demand for the alleged tying product.

In *Microsoft*, the Commission applied the separate products test less stringently and only focused on the question of whether there is separate demand for the tied product. The Commission has not given any policy rationale for this particular interpretation.

While both interpretations may lead to the same results, namely where the absence of demand for the tied product also implies the absence of demand for the tying product (as is the case with ties between primary products and consumables), in other instances, the Commission's interpretation of the separate products test is over-inclusive and subjects tying practices which clearly cannot have any anti-competitive effects and which are likely to result in net efficiencies for consumers to a rule of reason test.

An example is the technical integration of products for which there also exists an aftermarket for one of the components. The mere fact that there is separate demand for spark plugs in itself does not answer the question of whether it is efficient to offer cars with bundled spark plugs.

The second flaw in the Commission's interpretation is that it covers cases for which the remedy of unbundling has no impact on competition in the market. In a scenario where there is demand for the tied product but no demand for the tying product without the tied product, there can be no causality between the alleged abusive behaviour and the alleged competitive harm. If the dominant firm were to offer the tying product without the tied product, by definition customers would not buy it and hence offering components would not affect competition.

In addition to the problems raised by the Commission's specific interpretation, there is the more general problem with the separate product test, namely that it focuses on historic customer and supplier behaviour. It is therefore systematically a poor proxy for overall efficiencies arising from new and innovative integration. Where a firm integrates new features into its products, the separate product test may lead to the erroneous conclusion that the innovation is an illegal tying arrangement merely because there are still firms in the market which offer two separate products (having failed to innovate). This risk underlines the caution required before concluding that the two components are separate products in an industry which is characterised by technological innovation. This means that the Commission's approach to tying in the *Microsoft* decision could be improved by adopting a more stringent separate products test in line with *Jefferson Parish*.

### 3. Standard and burden of proof of harm to competition

The second key issue concerns the standard of proof (and the evidential requirements to satisfy the standard of proof). Here two factors in particular are relevant:

- first, the likelihood that tying (by dominant firms) is harmful:

Where a particular practice is overwhelmingly harmful and only exceptionally or never benign, it may be appropriate to impose on the authorities a low evidential requirement for harm to competition. This is the position which the CFI has taken and has applied, highly controversially, to the law of fidelity rebates, for example.

Economic theory and factual evidence make clear that tying does not fall into that category. Indeed, they demonstrate that it is at the other end of the spectrum: it is generally motivated by efficiencies, even where practised by dominant firms, and may exceptionally lead to competitive harm.

The decision theoretical approach suggests that the lower the likelihood of harm, the higher should be the evidential requirement to satisfy the standard of proof. Or, in the words of Lord Hoffman:

“[I]t would need more convincing evidence to satisfy one that the creature seen walking in Regent’s Park was more likely than not to have been a lioness than to be satisfied to the same standard of probability that it was an Alsatian.”<sup>117</sup>

- second, the extent to which a case is concerned with predicted future loss of competition (rather than observed past loss of competition):

The more speculative the prediction of the loss of future competition, the greater the evidential requirements to support it.

This point was made clearly by the CFI in *Tetra Laval* where it stated that in light of the fact that “[...] the anticipated dominant position would emerge only after a certain lapse of time [...]”, the Commission’s analysis had to be “particularly plausible”.<sup>118</sup> This view was confirmed by the ECJ.<sup>119</sup>

Where a particular behaviour does not give rise to any presumption of competitive harm, but is generally benign, arguably the position under Article 82 is similar to that of merger cases where there is equally no presumption of competitive harm. The similarity is even greater with the analysis in abuse of dominance cases which is forward-looking rather than backward-looking in nature.

A starting point should therefore be the test in recent merger control cases which has been recently set out by President Vesterdorf as follows:

“The Commission, under judicial control of the Courts, would have to decide that it was satisfied at a high degree whether the concentration would be likely to result in significant anti-competitive effects and would have to prove that its conclusion was based on a body of solid, cogent and convincing evidence and not vitiated by any errors of fact, law or manifest errors of appreciation... [The standard required] would appear to be something more than a pure balance of

<sup>117</sup> *Secretary of State for Home Department v Rehman* [2002] 3 WLR 877.

<sup>118</sup> Case T-5/02 *Tetra Laval BV v Commission* [2002] E.C.R. II-4381, at para.162.

<sup>119</sup> Case C-12/03P *Commission v Tetra Laval BV*, judgment of 15 February 2005 (not yet reported).

probabilities standard, but most certainly something less than a criminal standard.”<sup>120</sup>

It is not entirely clear what standard of proof the Commission has applied in the *Microsoft* decision but it appears to have been significantly lower than the standard in merger cases and at times also seems to have been lower than the balance of probabilities standard.

For example, the Commission sees a “potential to foreclose competition”, refers to a “serious risk” of foreclosing competition and takes the view that Microsoft’s competitive advantage is “liable to have a harmful effect on the structure of competition”.

This suggests that the standard of proof applied by the Commission leads to a greater number of false positives than is optimal under decision theory framework.

4. The indispensibility requirement and the standard and burden of proof for efficiencies

It is clear that a dominant undertaking’s obligations under Article 82 EC are not unlimited. In classical tying cases, the Commission and the Court have at least recognised, in principle, that the ‘special responsibility’ of dominant undertakings is limited by reference to the possibility of a dominant firm adducing an objective justification. However the case-law has not yet addressed how evidence or the standard of proof should be dealt with.

It is generally accepted that neither the Commission nor the dominant firm should be subject to a “*probatio diabolica*”. In other words, neither party should be required to prove something which cannot be proved or could only be proved with great difficulty. It is axiomatic that proof of a negative is both complicated (if not impossible) and problematic. Thus EC law should generally set itself against unreasonable rules as to the burden and standard of proof. In determining the appropriate evidential requirements, it is important to bear in mind:

- the potential economic benefits from tying;
- any evidence of widespread/limited bundling by firms without market power; and
- the quantity and quality of evidence available to either party.

Taking these factors into account, it would seem preferable that the standard of proof for establishing efficiencies of the alleged tie should at least be commensurate with the countervailing harm to competition. A balanced approach is required. Both efficiency

---

<sup>120</sup> See B. Vesterdorf “Standard of proof in merger cases: reflections in the light of recent case-law of the Community Courts” European Competition Journal, March 2005, page 27.

gains and harm to competition are of great importance and any conflict between them should be resolved by balancing their likely effects. That said, many tying arrangements are economically beneficial, although the nature and magnitude of the relevant efficiencies are often difficult to verify. That being so, it is even arguable that the standard of proof should be less demanding in respect of substantiating efficiency gains derived from the alleged tie.<sup>121</sup>

A further question of importance concerns the desirability and indeed practicality of imposing additional evidential requirements related to proof of efficiencies under Article 82. In *Microsoft* the Commission analysed the efficiency claims put forward by Microsoft for tying WMP and concluded that that the alleged pro-competitive effects that arose from tying WMP to Windows were outweighed by the possible anti-competitive effects of so doing. In reaching that conclusion, the Commission imposed a very demanding standard of proof on dominant undertakings seeking to invoke an objective justification. The Commission decided that Microsoft had failed to establish that tying WMP was 'indispensable' for procuring economic benefits to third party application developers.<sup>122</sup>

The difficulty with an 'indispensability' criterion for assessing efficiencies is that it shifts the focus of the inquiry from the question as to whether, on balance, the tying is welfare-enhancing to whether the tying is more efficient than various hypothetical alternatives. At the same time, it increases the likelihood that certain efficiencies achieved by tying will be subject to condemnation and the risks of 'false positives'. This is particularly true in the case of technological tying where there often are very few realistic alternatives and yet it could nonetheless be very difficult to disprove that the relevant efficiencies could not be achieved in a different, less restrictive manner. Attempts to prohibit certain forms of technological tying present serious risks about whether efforts to remedy the anticompetitive effects may have the unintended consequence of chilling technological innovation. Indeed it is for that reason that the Areeda, Elhauge & Hovenkamp have gone so far as to suggest a *per se* rule of legality for bundling software:

"A single product conclusion seems to be the correct one in all cases in which the code for the two programs is interspersed such that the purchaser cannot readily separate them. The disadvantage of such a rule is that any software producer can comply with it by interspersing code. But the disadvantage of an alternative rule forcing separation is that most of the advantages of integration will have been lost."<sup>123</sup>

In other words, technological tying should be deemed a single product, and thus *per se* lawful, even though there might be certain circumstances where the economic benefit might be outweighed by the expected or actual anti-competitive effects.

One does not have to go this far however. In most cases, it would seem fair and

---

<sup>121</sup> Similar arguments have been raised in respect of the economic benefits of various forms of rebates and whether the law should be more accommodating to proof of those benefits; see, to that effect, B. Sher and J. Kallaugher, "Rebates Revisited: Anti-Competitive Effects and Exclusionary Abuse Under Article 82", (2004) 25 *E.C.L.R.* 263.

<sup>122</sup> *Supra* note 59 at 967.

<sup>123</sup> P. Areeda, E. Elhauge and H. Hovenkamp, *Antitrust Law* (Supplement, 1999) ¶1746.1b, at 494.

reasonable to expect a dominant undertaking to put forward compelling evidence of the efficiencies that it believes will be gained by its tying. Having done that, the authorities are better placed (with the assistance of information from third parties) and well-equipped to ascertain whether those efficiencies outweigh the likely harm to competition and could be achieved by less restrictive alternatives. This would be more sensitive to the risks of ‘false positives’ and well-meaning regulatory intervention having a chilling effect on beneficial tying arrangements. In this context “mistaken inferences and the resulting false condemnations are especially costly, because they chill the very conduct the antitrust laws are designed to protect.”<sup>124</sup>

Thus, it is for the dominant undertaking to put forward the efficiencies that it relies on by way of economic justification, for the Commission to put forward its views on whether the conduct is objectively justified, and for the Court to decide whether the Commission has manifestly erred in its assessment.<sup>125</sup>

## VII. Policy Recommendations

A number of conclusions follow from our analysis.

First, the bias of the three major legal rules, i.e. the modified *per se* approach of *Jefferson Parish*, the EC (quasi) *per se* approach of *Hilti* and *Tetra Pak II* and the structured rule of reason of the Commission in *Microsoft*, is at odds with economic theory: while economic theory suggests a rule of reason or *per se* legality, the evidential requirement to establish competitive harm imposed by the three rules is significantly lower. The evolution of, and the differences between, these standards are depicted diagrammatically in Annex I.

Second, of the three legal rules, the Commission’s overall approach in the *Microsoft* case, as a structured rule of reason, is, in theory, the most compatible with the error cost analysis. However, in practice, it is relatively close to a *per se* illegality approach and suffers from a number of major deficiencies:

- (i) The screens which provide firms with a degree of legal security and a safe haven are drawn far too narrowly. A wider interpretation of the separate products test (as suggested by *Jefferson Parish*) would clearly improve the analysis by reducing the risk of false convictions without increasing the risk of false acquittals;
- (ii) Furthermore, additional screens to increase the scope of the legal safe haven, focusing on further criteria of whether anti-competitive effects are possible (e.g. the status of competition in the tied market or the ability to commit to a tie) would also help to minimise the likelihood of error costs;<sup>126</sup>

---

<sup>124</sup> *Matsushita Elec. Industrial Co. v. Zenith Radio Corp.*, 475 U. S. 574, 594 (1986).

<sup>125</sup> See, to that effect, the CAT judgment in Case No 1016/1/1/03 *Genzyme Ltd v Office of Fair Trading* [2004] CAT 4, at para.578.

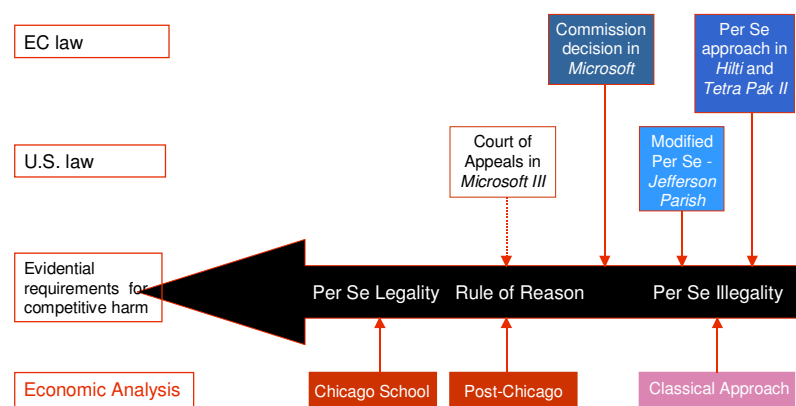
<sup>126</sup> See C. Ahlborn, D.S. Evans and A. J. Padilla, *supra* note 20, pages 57 et seq.



- (iii) In addition, the requisite standard of proof should be the same as under merger cases, being more than a pure balance of probabilities standard. The Commission has to be satisfied at a high degree that the behaviour would be likely to result in significant anti-competitive effects and has to base its conclusion on a body of solid, cogent and convincing evidence;
- (iv) Finally, as regards evidence of significant anti-competitive harm and efficiencies, generally the onus should be on the competition authority or plaintiff to demonstrate (a) that any efficiencies shown by the parties are not indispensable and (b) that any harm to competition clearly outweighs any demonstrable efficiencies resulting from the tying arrangement.

It seems that the Commission is going to turn the assessment of Article 82 into a two stage process similar to the assessment of Article 81 (step one: harm to competition, step two: efficiency justifications). This move should be resisted. The wording of Article 82, contrary to that of Article 81, clearly does not force such an approach. More importantly, such an approach would risk repeating the policy aberrations of the last 30 years under Article 81 in terms of over-inclusiveness and artificial separation of analysis. At a time when Article 81 finally moves towards an integrated Article 81(1)/81(3) analysis, a move into the opposite direction under Article 82 would be hard to justify and no doubt would mark the start of a new odyssey of EC competition law.

**Annex I – Diagramme demonstrating the Evolution of the Three Major Legal Rules in relation to Tying**



Linklaters