



Competition Competence Report 15/ 2006

MORE ECONOMICS BASED APPROACH IN ARTICLE 82 EC TREATY: NEW TEST PROCEDURES

The “more-economics-based-approach” in European competition policy is now about to be implemented in Article 82 EC Treaty. On December 19th 2005, Competition Commissioner Neelie Kroes issued a comprehensive discussion paper on this matter.¹ In this paper, the former legalistic straight-jacked approach is rejected in favour of a more-economics-based-approach.

Some of the issues dealt with in the discussion paper are not new. However, they are discussed at length and in the context of the reform. What is new is the consequent focus on an “effects-based” approach. In other words: What really count are the measurable effects on the market. This approach requires sound economic analysis. The discussion paper not only provides instructions on how competition authorities should assess an abuse of a dominant position: the paper also gives guidance on defences companies can bring forward against allegations of an abuse or in which way competitors can plead their case in front of the competition authorities. In particular, the latter group is favoured by the effects-based approach. Hypothetical test procedures can be carried out even when first hand information about the cost structures of the dominant company is missing.

With this discussion paper, Commissioner Kroes continues the modernisation process within European competition law initiated by her predecessors. The CCR at hand is the first one in a series of contributions to the current more-economics-based-approach discussion in Article 82. Future CCRs will deal with the effects-based approach in assessing a dominant position as well as the issue of market definition in dominant position cases. Further topics that are to be dealt with are predatory pricing, tying and refuses to supply.

¹ „DG competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses“; Comments are welcomed till March, 31 2006. http://europa.eu.int/comm/competition/antitrust/others/article_82_review.html.

Objective of Article 82 EC Treaty

Two forms of an abuse of a dominant position can be distinguished: exclusionary abuses (behaviours by a dominant firm likely to have a foreclosure effect on the market) and exploitative abuses (behaviours where companies take advantage of their market power, e.g. by charging excessive prices). The current discussion paper covers the analytical approach how to assess exclusionary abuses. The focus of the analysis is on the potential threat to consumers: The clear orientation on the consumer welfare standard confirms that it is competition and not competitors that is protected by Article 82. However, competition and consumers benefit if competitors are able to expand, to enter markets and to compete on the merits without facing competition conditions which are distorted or impaired by a dominant firm. On the other hand, the issue of an efficient allocation of resources is also part of the new approach. The discussion paper illustrates the extent to which efficiency gains should be considered. In this respect the dominant company has to prove that its conduct produces efficiencies which may outweigh any negative effects on competition. This approach complies with the systematic of Article 81 (balancing).

An economics-based-approach focusing on consumer welfare requires a careful examination of how competition functions in each particular market. The centre of the economic appraisal is the analysis of the economic effects of certain behaviours. Restrictions to competition need to be proven on a case-by-case basis. In addition, as already stated, an evaluation has to take place in which way negative effects can be outweighed by efficiency gains. The identification of the competitive harm is based on sound economic theories and supported by empirical evidence. Similarly, efficiencies should be properly justified on the basis of economic analysis and grounded on the facts of each case.

In order to assess the competitive harm arising from specific business practices, the European Commission proposes in its discussion paper different test procedures like for example the "as-efficient-competitor-test". This test is a price-cost test which is less effects-based than other possible tests.² Furthermore, the European Commission presents the criteria that need to be met in order to apply for example an efficiency defence. In the following, the "as-efficient-competitor-test" and the efficiency defence are illustrated.

² A fully effects-based approach would derive the assessment whether a given practice is detrimental to competition or not solely from the effects of the practice on the consumer. A multi-stage approach could e.g. include a Sacrifice-Profit-Test, an Exclusion-Test and a Recoupment -Test.

“As-efficient-competitor-test”

Article 82 prohibits exclusionary conduct which produces actual or likely anticompetitive effects in the market and which can harm consumers in a direct or indirect way. Harm to intermediate buyers is generally presumed to create harm to final consumers as well. Therefore, the central concern of Article 82 is to inhibit business practices that foreclose competitors and create harm to final consumers in terms of rising prices or declining quality. Thereby not only short term harm, but also medium and long term harm arising from foreclosure, is taken into account. Foreclosure means that actual or potential competitors are completely or partially denied profitable access to a market. Possible effects of foreclosure can be 1) that rivals are disadvantaged; 2) rivals compete less aggressively or 3) may even encourage rivals to leave the market or 4) inhibit market entry of newcomers. The checkable assumption is that disadvantages that occur to rivals may potentially harm in the long end consumers as well.

The disadvantages for rivals are manifold: the dominant company can reduce demand for the rivals` products or directly raise rivals` costs. In the first case, foreclosure occurs because the dominant company is able to improve its market position by using exclusionary practices such as predatory pricing or unfair rebate systems. In the latter case, the dominant company is vertically integrated or disposes of a strong position on the relevant market as well as on the upstream-market. The dominant company is then able to raise prices of input factors and thereby deteriorate the market position of the rivals on the relevant market.

The issue is to differentiate between business conducts that are part of a normal functioning of markets and those that are part of an abusive strategy of the dominant company. The discussion paper suggests to draw the line between competition on the merits and abusive practices by using the “as-efficient-competitor-test”: The question that has to be answered is whether a competitor which is as efficient as the dominant company can compete against business practices used by the dominant company. The “as efficient competitor” is a hypothetical competitor having the same costs as the dominant company. Foreclosure of an “as efficient competitor” can only result if the dominant company prices below its own costs.

The “as-efficient-competitor-test” is thus a cost-benchmark-test. To apply the test it is crucial to choose the appropriate cost benchmarks since the results of the assessment may vary depending on the costs under scrutiny: marginal costs, average variable costs, average avoidable costs, long-run incremental costs or average total costs. Other effects need to be considered as well including the existence of economies of scale and scope, learning curve effects or first mover advantages which may favour

declining costs. The exact application of the “as-efficient-competitor-test” as well as the chosen cost benchmarks vary on a case-by-case basis. In the following, the analysis of a rebate system is illustrated as an example.

Example: “As-efficient-competitor-test” for rebate systems

Issue: What is the economic effect of a fidelity rebate system? Do customers buy additional output from the dominant company by diverting purchases from other suppliers to the dominant company?

The analysis has to assess the likelihood and the extent of the economic incentive: What is the threshold level the customer applies? What is the economic effect once the threshold level is reached or passed? Is it possible that a hypothetical efficient undertaking is able to keep up with the price level of the dominant company and to set its own prices at the same threshold? Which other factors have an impact on the threshold? Within the analysis, the following concerns have to be addressed:

“Suction” effect: A suction effect emerges from the fact that exceeding the threshold will not only reduce the price for all purchases above the threshold, but also for all previous purchases: prices for the last units which were bought before the threshold was exceeded are significantly lower and possibly even negative because the transaction triggers the rebate for all the purchases below the threshold as well. The extent of the suction effect depends on the relative size of the threshold and the applied rebates. This suction effect has to be assessed empirically.

Supply of commercially viable amounts: As the majority of the competitors normally is not able to compete for the entire demand, the question is, whether the rebate system hinders them from supplying commercially viable amounts to individual customers. To answer this issue a market simulation has to be performed.

Price analysis: What is the effective price level for the purchase of a commercially viable share with respect to the rebates offered by the dominant company?

Cost analysis: What are the average total costs of the dominant company or of a hypothetical efficient competitor?

Price/cost analyses: Is the effective price for a commercially viable share of a competitor below the average total costs of an efficient competitor?

Price/cost comparison: Is the effective price below the average total costs of an efficient competitor, so that it is impossible to compete with the dominant undertaking for this part of the demand?

Efficiency Defence

If the results of the “as-efficient-competitor-test” show that the business conduct holds foreclosure effects and that the foreclosure effects in turn increase the dominant position, the dominant company can defend the allegations by means of objective justifications like the efficiency defence. The burden of proof for such an objective justification is on the dominant company. The dominant company must thus in the first place show that the otherwise abusive conduct is actually a necessary conduct on the basis of objective factors external to parties involved and in particular external to the dominant company (“objective necessity defence”). The other type of objective justification is where the dominant company is able to show that the otherwise abusive conduct is actually a loss minimising reaction to competition from others (“meeting competition defence”). In relation to the efficiency defence, the dominant company must be able to show that the efficiencies brought about by the conduct concerned outweigh the likely negative effects on competition resulting from the conduct and therewith the likely harm to consumers that the conduct might otherwise have.

For the efficiency defence to be accepted, the dominant company must demonstrate that the following conditions are fulfilled:

- Efficiencies are realised or likely to be realised as a result of the conduct concerned.
- The conduct concerned is indispensable to realise these efficiencies.
- The efficiencies benefit consumers.
- The competition in respect of a substantial part of the products concerned is not eliminated.

Considering as an example again a rebate system, the following questions have to be addressed when applying the efficiency defence.

Example: Efficiency defence in case of a rebate system

When assessing the indispensability of the rebate system, the following questions have to be addressed.

- Can cost advantages be obtained and passed on to the customers?
- Can downstream customers be motivated to purchase welfare optimizing amounts and can double marginalisation be avoided?
- Can incentives be introduced for the dominant company to make certain relationship-specific investments in order to supply the downstream market in a better way?

Conclusion

In the discussion paper, the European Commission provides a detailed description how to assess cases under Article 82. These guidelines offer direction if

- companies have to defend themselves against the allegations of an abuse of a dominant position, either by a national competition authority or the European Commission or
- companies which are strongly disadvantaged by exclusionary abuses from a dominant company.

In either case, the application of the "more-economics-based-approach" means that market facts need to be presented based on sound economics and grounded on empirical evidence. The empirically collected market evidence need to be linked to established economic theory and serves competition authorities as foundation in their decision making process. With this approach, the European Commission is in line with the critical remarks of the European Courts which complained in many cases that the economic analysis carried out by the European Commission was inadequate.

In particular with the "as-efficient-competitor test", the European Commission developed a detailed framework for the assessment of specific cases of exclusionary abuses. In addition, the implementation of the efficiency defence reflects the basic insight from economic theory that many business practices can both harm and promote competition respectively consumer welfare. However, the realisation and practical implementation of this approach requires broad experiences and substantiated empirical analyses.

EE&MC provides these broad experiences with economic analyses as well as a solid know-how how to collect the respective empirical evidence. The services of EE&MC comprehend the economic quantification of those practices in accordance with the "more-economic-based-approach" as developed by the European Commission in Article 82.