

Quantification of Damages in Exclusionary Practice Cases

by

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1. Introduction

The antitrust treatment of potentially exclusionary conducts is particularly challenging. In recent years many competition agencies have tried to provide guidance on how unilateral strategies adopted by firms with substantial market power should be evaluated. The most noteworthy of these endeavors are those of the European Commission² and that of the US Department of Justice.³ The troubled (and very short) life of the document issued by the US DOJ is a clear proof of the existence of many questions that are yet awaiting a satisfactory answer. This state of affairs characterizes, even to a greater extent, the theory and practice of the quantification of damages in exclusionary cases. Indeed, while there exists a large literature on the quantification of damages in cartel cases,⁴ the academic contributions on how to assess damages stemming from exclusionary conducts is extremely limited⁵. In this short contribution I argue that this is mostly due to an insufficient consideration of the “theory of harm” that should support a finding of an exclusionary abuse. In many abuse cases the antitrust violation is still ascertained using formal categories without fully identifying the channels through which the illicit conduct is supposed to harm the dominant firm’s competitors and, eventually, the end-consumers. As an illustration of this argument I will refer to

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² See the *Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings*, OJ No. C 45/7, February 24, 2009, available at <http://ec.europa.eu/competition/antitrust/art82/index.html>.

³ Both antitrust US agencies (the Federal Trade Commission and the Department of Justice-Antitrust Divisions) in 2006 started a project to issue a report on monopolization offenses under antitrust law. The report was finally issued in September 2008 only by the DOJ. The FTC did not join the report and the commissioners and its chairman published their opinions on which their decision was based. On 11 May 2009 Christine A. Varney, Assistant Attorney General in charge of the Department’s Antitrust Division, announced that the Department withdrawn the report published only a 8 months earlier clarifying that the Section 2 report would not reflect any longer the DOJ policy on exclusionary practices.

⁴ See. CONNOR J.M., *Forensic Economics: An Introduction with Special Emphasis on Price Fixing*, *Journal of Competition Law and Economics*, 2007, 4(1), 31–59; VAN DICK T. and F. VERBOVEN, *Quantification of damages*, in *ABA Section of Competition Law, Issues in Competition Law and Policy*, 2008 and references therein.

⁵ MARTINEZ GRANADO M. and G. SIOTIS, *Computing Abuse Related Damages in the Case of New Entry: An Illustration for the Directory Enquiry Services Market*, *CEPR Discussion Paper*, NO. 5813, 2006, is one of the few contributions I am aware of; accounting techniques to compute damages in abuse cases are briefly described in CLARK, E., M. HUGHES and D. WIRTH, *Study on the Conditions of Claims for Damages in Case of Infringement of EC Competition Law: Analysis of Economic Models for the Calculation of Damages*, (Ashurst Study for the European Commission, 2004), available at http://ec.europa.eu/competition/antitrust/actionsdamages/economic_clean_en.pdf.

the analysis of “margin squeeze” cases. I will point out that these cases are based on an incomplete theory of harm that prevents the solution of some relevant economic and legal questions. Then I will argue that once the theory of harm is fully spelled out, standard Industrial Organization (IO) models and quantitative techniques can be applied to compute the direct and indirect damages caused by the abuse. I will then suggest a practical way to define a theory of harm in follow-on cases when the theory of harm is missing or incomplete.

2. Theory of harm in exclusionary cases

The theory of (antitrust) harm is the nexus of causal links that goes from the potentially illegal conduct to the ultimate effects on consumers. While in exploitative infringements, such as cartels or exploitative abuses, there is a direct link between the illegal behavior and the (likely) harm suffered by consumers, in exclusionary cases, by definition, the illicit conduct, in order to produce its negative consequences on consumers, needs to affect rivals and reduce their ability to compete. As a consequence, an indispensable ingredient of a complete theory of harm in exclusionary cases is the description of how the behavior of the dominant firm impacts on the profitability of rivals.

A firm’s profits depend on three essential variables: 1) the price it can charge to sell its products; 2) the cost it bears to produce and sell these products, 3) the quantity it is able to sell. It follows that the theory of harm applicable to an alleged exclusionary practice must describe how, given the circumstances of the case, this practice causes one, or a combination, of the following effects: 1) it lowers the rivals’ price; 2) it increases the rivals’ costs; 3) it lowers the rivals’ demand.⁶ None of these effects is sufficient to prove an antitrust violation, because they may result from genuine competition. Yet, at least one of them is necessary to have an anticompetitive foreclosure.

In many actual cases, courts and competition authorities apply the prohibition of exclusionary abuses without any reference to the mechanisms that are likely to reduce the rivals’ ability to compete, that is without spelling out the relevant theory of harm. The same *Guidance Paper* issued by the European Commission⁷ describes in some details which practices may infringe EC competition law (i.e. exclusive purchasing, conditional rebates, tying, bundling, predatory pricing, refusal to supply and margin squeeze), and identifies the circumstances in which these practices may be anticompetitive, but it never clarifies how they can impair the rivals’ profitability. This

⁶ Lear, *The cost of inappropriate interventions/non interventions under Article 82*, OFT Discussion Paper, September 2006 (available at http://www.learlab.com/pdf/oft864_1158144540.pdf) provides a classification of potentially exclusionary conducts based on their effects on rivals’ profits.

⁷ See footnote 2.

approach may be justified because, with the probable exception of predation, for which there exists a clear and unequivocal theory of foreclosure, all the other practices may foreclose rivals in many different ways, depending on the specific circumstances of the case. For instance, they may raise rivals' costs or they may prevent rivals from offering a higher quality product, thereby reducing their demand. Distinguishing between the two cases may be irrelevant for a competition authority, because either way the conduct breaches the applicable prohibition, but it is central in the determination of the damages suffered by the victims of the infringement, as this contributes to solve some important economic and legal issues. The analysis of margin squeeze abuses can provide a clear illustration of this argument.

3. Margin squeeze: an incomplete theory of harm

A margin squeeze occurs when a vertically integrated firm charges, for an essential input and for the relevant retail product, a pair of prices such that the margin between the two is insufficient for an equal efficient competitor to trade profitably in the downstream market. *Deutsche Telekom*,⁸ and *Telefonica*⁹, are two recent cases in which the European Commission has found evidence of margin squeeze abuses. Similar cases have been investigated by several national competition authorities.¹⁰

In a margin squeeze case a competition authority does not feel compelled to establish whether the margin compression is the consequence of an excessive input price (in the upstream market) or a below-cost retail price (in the downstream market). This attitude is justified by the idea that in both cases an equally efficient competitor cannot operate profitably in the downstream market and, therefore, that in the medium/long run it will be forced out of the market, reducing the degree of competition. This simplification may be acceptable for a competition authority. However, it engenders an incomplete theory of harm that creates difficulties for the quantification of damages. Indeed, it is immediate to see that the two possible illegal conducts that lead to the margin squeeze are different both in economic and in legal terms.

⁸ See Commission decision of 21 May 2003, Cases COMP/C-1/37.451, 37.578, 37.579, Deutsche Telekom AG, O.J. L 263/09 (2003), and the CFI Judgment, Case T-271/03 Deutsche Telekom AG v Commission [2008] ECR II-477.

⁹ Commission decision of 4 July 2007, Case COMP/38.784, Wanadoo España/Telefónica, available at http://ec.europa.eu/comm/competition/antitrust/cases/decisions/38784/dec_en.pdf;

¹⁰ For a review of national margin squeeze cases, see GERADIN D. and R. O'DONOGHUE, "The Current Application of Competition Law and Regulation; the Case of Margin Squeeze Abuses in the Telecommunication Sector", *Journal of Competition Law and Economics*, No. 1, 2005, pp. 355-425.

3.1. A complete theory of harm is necessary to build the relevant “but for” scenario

The quantification of the damages requires the identification of the so called “but for” scenario, that is the state of the world that would have occurred had the abuse not be committed. In this hypothetical situation the dominant firm would not have abused its dominant position. In a margin squeeze case what this means is not clear, as the integrated firm may increase the margin both by lowering the upstream price or by increasing the downstream price, or through a combination of the two strategies. The various possible “but for” scenarios are completely different and they may lead to very different market equilibria, both in the short run and in the long run. Since the quantification of the damages is not possible without building a credible “but for scenario”, the incomplete theory of harm makes this calculation difficult, if not impossible.

3.2. A complete theory of harm is necessary to decide the applicable categories of harm

The damages that can be recovered in an action are: 1) the actual monetary loss incurred (*damnum emergens*) and 2) the monetary profit not earned (*lucrum cessans*). A firm that is the victim of an exclusionary margin squeeze may suffer both types of damages: a monetary loss, due to the overcharge paid to purchase the required input, and a loss of profits, due to its reduced ability to compete *vis à vis* the dominant firm. Normally, for companies the direct monetary loss is a component of the more general category of lost profits and one may consider immaterial to single out this specific category of harm. However, from a practical point of view this is not the case, because courts tend to treat *damnum emergens* and *lucrum cessans* differently, whether or not these two categories of damages are strictly different from a legal viewpoint. If the margin squeeze strategy occurs because the dominant firm charges an excessive input price, then a direct extra-cost is imposed on the plaintiff, which gives rise to an actual monetary loss. On the contrary, if the margin compression is determined by a predatory retail price, the only type of harm that it can cause on the rival firm is a loss of profits.

3.3. A complete theory of harm is necessary to decide if a “passing on defense” is admissible

A direct and clear legal consequence of the impossibility to build a univocal “but for scenario” is that one cannot establish whether a passing on defense is admissible. Indeed, if a margin squeeze results from the application of an overcharge in the upstream monopolized market, in principle, the defendant can argue that the downstream competitors are not entitled to recover the entire

overcharge as they could have passed it, at least partially, on to the indirect purchasers of the input. This defense is not admissible in case of predatory pricing.

3.4. A complete theory of harm is necessary to decide on standing

A strictly related issue is whether indirect purchasers, and in particular end-consumers, are entitled to some form of compensation. As a matter of law, both direct and indirect victims of an anticompetitive behavior can seek compensation. However, while excessive pricing may harm indirect purchasers from the very moment in which the abuse starts, predatory pricing benefits indirect purchasers in the short run and may harm them only in the medium and long run. Hence, a complete theory of harm may be indispensable, given the time in which the abusive conduct is detected and stopped, to decide whether indirect purchaser can bring an action to seek compensation.

4. A complete theory of harm allow to employ technique used in cartels

IO theoretical models allow to identify the market equilibrium in terms of prices, quantities – or market shares – and profits on the basis of a simplified description of the consumers' behavior and of the firms' cost functions and available market strategies. If we have a complete theory of harm we can use an IO model to build a scenario in which the detrimental effects on rivals of the illicit conduct do not occur. For instance, if conduct is exclusionary because it raises the rivals' costs, one can use an IO model to predict the price that the rivals would have charged and the quantity they would have sold if they had borne a lower level of costs. Of course to quantify the damage one needs to translate the theoretical model into an empirical one. In many case it may not be feasible a full fledged structural model because of lack of data or of time constraints. However, “reduced-form” models, based on approaches typically used in cartel cases (before-and-after or yardstick approaches) can be easily adapted to examine exclusionary conducts.

5. A practical suggestion to complete the theory of harm in follow-on cases

So far I have highlighted the problems that may arise from an incomplete theory of harm. What are the solutions? In general, both the parties and the courts should try to complete the theory of harm that is applicable in the specific case by focusing on the institutional characteristics of the markets involved. The various theories of harm suggested by the economic theory, may allow one to formulate alternative hypotheses that can be empirically tested. For instance, excessive input prices

induce rivals to increase their prices and this, in turn, should have a negative effects on the quantities sold. On the contrary, if the dominant firm charges below-cost retail prices , the rivals reduce their own prices, thus leading to an overall expansion of the output. If one is able to determine whether, over the relevant period of time, output expanded or contracted, this allows to identify the correct elements that are missing to complete the theory of harm.

This solution is not always feasible, either because is difficult to build alternative hypotheses to be tested empirically or because the necessary data is not available. However, I want to suggest a different solution that is applicable in follow-on cases. When a competition authority finds an abuse, its decision normally contains some remedies. In some cases these remedies are clearly spelled out, so that the conduct that the dominant firm has to undertake to comply with the decision can be easily identified. In many cases the decision does not impose any specific remedy but requires the dominant firm to refrain from continuing the abusive behavior, i.e. it imposes a “cease and desist order”. This order is generally accompanied by the request to report, within a specified deadline, all the initiatives that have been adopted to restore effective competitive conditions in the relevant market. The dominant firm has to comply with these orders. Therefore, it will modify its market behavior and will inform the competent competition authority about it. Consequently, the competition authority will assess the dominant firm conduct. If it decides that the dominant firm has complied with the decision, this means that the remedies adopted by the dominant firm were sufficient to eliminate the risk of an anticompetitive foreclosure.

In both cases – when the remedies are set in the decision, and when they are determined by the dominant firm and “approved” by the competition authority – we can say that the dominant firm would not have committed an abuse in the first place, if it had behaved according to the conducts prescribed by the “remedies”. In other words, the remedies identify the dominant firm’s behavior that would have occurred in the hypothetical “but for” state of the world. The contraposition of the unlawful abuse and the legitimate conduct provides the essential elements to complete the theory of harm. For instance, if the margin squeeze was remedied by an increase in the dominant firm’s downstream price, the correct theory of the competitive harm should maintain that the rivals were foreclosed because they were forced, either to reduce their price below the level that would have occurred under normal competitive conditions or to sell a lower quantity than the quantity they would have sold otherwise. As argued before, other legal and economic consequences derive from a complete description of the theory of harm: the foreclosed rivals can only claim *lucrum cessans*; a passing-on defense is not admissible; indirect purchasers are not entitled to recover damages if the

abusive behavior stopped before rivals exited the market, and, thus the dominant firm was not able to raise its downstream price.

6. Conclusions

The economic literature on the methods applicable to the quantification of the damages stemming from exclusionary unilateral conducts is still underdeveloped. Back of the envelope calculation or more sophisticated accounting techniques are frequently employed when the need arises. Economic theoretical and empirical models are less often mentioned as valid approaches, while they are regarded as the best tool to quantify damages in exploitative cases. The first aim of this short contribution was to clarify that the main reason for this attitude towards economic models and quantitative techniques is the consequence of the lack of a complete theory of harm in most exclusionary cases. The second aim was to emphasize that several economic and legal problems cannot be solved without a complete theory of harm. Finally this note suggests, as a practical approach, in follow on cases, to use the remedies imposed on the dominant firm or chosen by the same firm to comply with the decision, as a means to identify the missing elements of a complete theory of harm.