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Implementing an effects-based approach under Article 82

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Abstract

In the context of the ongoing discussions regarding the use of an "effects-based" approach under Article 82, this paper discusses a framework for assessing exclusionary effects arising from unilateral conduct by dominant firms. The best approach to designing rules for Article 82 has abundantly been debated in recent months: while a per se approach has been deemed undesirable for its chilling effect on competition (by prohibiting potentially desirable conduct), a full rule of reason has been criticized for implying too much legal uncertainty. This paper focuses on outlining an approach to evaluate exclusionary conduct and establish whether a conduct leads to "anticompetitive foreclosure" (i.e. foreclosure of competitors to the detriment of consumers). The American Airlines predatory case is used as an example to illustrate how the approach would work in practice.

Dans le cadre des discussions sur l'utilisation d'une approche basée sur l'analyse des effets pour l'application de l'Article 82, cet article présente un cadre d'analyse pour évaluer les effets d'exclusion que peuvent entraîner les comportements unilatéraux des entreprises dominantes. Les débats continuent d'être intenses sur l'approche à adopter: entre l'approche per se (considérée indésirable car elle peut freiner la concurrence en raison du risque élevé d'empêcher des comportements pro concurrentiels) et la "règle de raison" (critiquée pour les incertitudes qu'elle implique). La méthodologie présentée dans cet article définit un ensemble de critères pour évaluer les effets d'exclusion qui sont anti-concurrentiels ("exclusion anti-concurrentielle", soit l'exclusion de concurrents au détriment des consommateurs). L'affaire de prédation American Airlines est utilisée comme exemple pour illustrer l'application de cette méthode en pratique.

* The views expressed in this paper are those of the individual author and do not necessarily reflect those of DG Comp or the European Commission.

Introduction

The debate on whether to and how to reform Article 82 has been raging for some time now. The Article 82 Discussion Paper[1] published in December 2005 (re)launched the debate on the objectives of Article 82 (i.e. the protection of the process of competition rather than competitors) and suggested a number of rules to disentangle pro-competitive conduct from anti-competitive conduct for a number of practices (such as predation, rebates, etc…). In the context of the ongoing thinking about the principles and rules that should underpin the application of Article 82, this paper discusses the implementation of an effects-based approach to assess the exclusionary effects of unilateral conduct by dominant firms. The approach focuses on identifying the relevant criteria to take into account when undertaking an integrated assessment of the behavior under investigation. In particular, it builds on the experience in merger control where the post-merger situation is compared to a relevant counterfactual (i.e. what would have happened without the merger?).

The paper is structured as follows: First, we review the alternative approaches for implementing Article 82 (per se illegality, unstructured rule of reason, structured rule of reason, qualified per se legality). Second, we present a framework of analysis that could underpin Article 82 investigations. Such framework would be common to all Article 82 investigations but could be associated with sets of criteria providing more specific guidance to particular types of conduct (predation, rebates, bundling, etc.) Finally, we provide an example of application of the approach based on the predation case involving American Airlines in the US.

Different policy approaches to designing rules

There are several ways to design rules for the evaluation of the anti-competitive effects arising from the unilateral behavior of firms with market power.[2] At one extreme, *per se* rules (or a form-based approach) determine, *ex-ante*, practices that are deemed abusive and hence prohibited for dominant firms (e.g. tying, loyalty rebates, below cost-pricing)[3] Per se rules rely on the presumption that certain practices by dominant firms lead to anti-competitive foreclosure (i.e. in legal language, they are abusive). This approach, which has so far largely prevailed in the application of Article 82, poses a

1 DG Competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses, December 2005.

2 For a recent discussion on the "rules versus discretion" issue, see Jorge Padilla, "*The Reform of Article 82: What we agree, what we are still discussing and what will have to be discussed*", 3 July 2007, Paris. For an interesting overview of the US / Europe differences in the application of competition rules to unilateral conduct by dominant firms and the origins of these differences, see also the recent speech by J. Thomas Rosch at the IBA conference in Florence on 8 September 2007, "*I say Monopoly, You say Dominance: the Continuing Divide on the Treatment of Dominant Firms, is it the Economics?*". In particular, Commissioner Rosch questions whether post-Chicago theories of exclusionary conduct should inform the design of policy rules in the area of Article 82.

3 A quote from Joined Cases 6/83 and 7/73 Istituto Chemioterapico Italiano and Commercial Solvents v Commission [1974] ECR 223, paragraph 25 illustrates this point: "*… for example, a refusal by an undertaking in a dominant position to sell an essential component to its competitors in itself constitutes an abuse of that position*".

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number of issues, not least the wide scope for Type I errors (false positives) it entails. It is worth noting that the scope for Type I errors and the absence of robust presumptions have become apparent over the years with new developments in the economic theory of unilateral conduct by firms with market power. Indeed, unilateral practices can have pro-competitive or anti-competitive effects depending on specific circumstances prevailing in the market. While the simplicity of per se rules may provide a high degree of legal certainty (e.g. offering loyalty rebates or pricing below cost is not allowed if the firm is dominant[4]), the prohibition of certain types of conduct may in fact deter desirable conduct and negatively affect consumer welfare. This is obviously highly detrimental from a policy perspective and has in fact led to the "Article 82 reform" initiative aimed at incorporating the teachings of economic theory in the area of strategic behavior by dominant firms. Moreover, per se rules may prohibit certain practices while allowing others that may in fact have exactly the same market effect.

At the other extreme stands the rule of reason (also characterized as an unconstrained effects-based approach). Under a rule of reason approach, an ex-post assessment of unilateral practices is undertaken to establish, on a case-by-case basis, whether consumer harm has ensued. This approach also poses a number of problems: it leads to a significant degree of legal uncertainty and may in fact also lead to a chilling effect on competition as firms cannot predict whether the circumstances are such that a given practice will be deemed anti-competitive or not.[5]

The structured rule of reason is an intermediate policy approach. Under a structured rule of reason, the finding of particular circumstances triggers a full rule of reason. In fact, the dominance test could be expressed as a structured rule of reason if the finding of dominance warrants a more detailed analysis of the effects of a given practice. Finding that a practice has no efficiency justifications and only raises obstacles to competition could also trigger the presumption that it is anticompetitive. Structured rules of reason can be designed for specific conducts (and this may be particularly appropriate in the area Article 82 as economic models focus on a particular conduct and define circumstances likely to generate anticompetitive effects that are specific to the conduct). For example, a structured rule of reason has been suggested in the area of tying. Ahlborn et al. have designed a three-step approach to assess tying cases[6]: the first two steps screen out cases that are unlikely to generate anti-competitive effects (based on a market power test and a test of the theory's plausibility which would confront the theory of harm with observed facts). A number of cases would be eliminated at the first or second stage. For those cases that cannot be eliminated, the third and last stage of the investigation would involve balancing pro and anticompetitive effects of the tying practice. In the area of predation, Bolton et al. have also proposed a structured rule of reason to evaluate predatory practices which encompasses the recent developments in the economic theory of predatory strategies (not only pricing)[7] Their proposal includes a number of steps such as evaluating (a) the degree of market power; (b) evidence that a scheme of predation was in place; (c) likely recoupment; (d) pricing below cost and (e) the absence of efficiency justification.

Finally, qualified per se legality constitutes another policy approach: under such rules, practices are deemed legal unless exceptional circumstances hold, in which case they may be condemned. In the area of IP licensing, Ahlborn and Padilla suggest such a rule to deal with refusals to license[8]. In particular, they advocate that compulsory licensing should only be implemented if a set of conditions are satisfied on grounds that only in such circumstances are the costs of compulsory licensing (reduction in the incentive to innovate) outweighed by the benefits (competition is preserved).

In the area of exclusionary conduct, the difficulties associated with designing the appropriate rules to reduce the likelihood of Type I and Type II errors stems from the fact that the theories of harm are not very general or robust. Unlike the analysis of coordination between competitors or horizontal mergers, there is no unified theory of foreclosure.[9] The same practice (e.g. retroactive rebate or bundling) can be either pro-competitive or anti-competitive. In such context, simple rules can be particularly prone to mistakes in the decision-making process. Moreover, there can also be errors in measurement. In the area of predatory pricing for example, the calculation of the relevant cost measure is inherently imprecise and subject to controversy.[10] Therefore, the use of cost-based tests should not constitute the sole or major criteria for decision but be part of an overall assessment of the effects of the practice.

The debate on the most effective way to design rules for Article 82 is still well under way. Finding the right balance between legal certainty and sound principles is not necessarily an easy exercise. Yet, the pursuit of legal certainty should not be favored to the expense of sound economic principles. This paper argues that it may be preferable to establish a number of relevant criteria (e.g. in guidelines) and evaluate whether these criteria lead to a consistent set of insights when investigating a

4 Note however that even so-called simple per se rules may not warrant an easy ex-ante self-assessment: it may not always be clear that the firm is dominant and assessing whether price is below cost is far from straightforward.

5 According to Jorge Padilla, "*…for an unstructured rule of reason to perform satisfactorily, our courts and competition authorities should be populated by enlightened economists born and bread in the arcane business of balancing pro and anticompetitive effects – a kind of King philosophers, like those envisioned by Plato to rule his Republic.*" *Op. cit.*

6 C. Ahlborn, D. Evans and J. Padilla, *The Antitrust Economics of Tying: A Farewell to Per Se Illegality*, Antitrust Bulletin, March 2004.

7 Bolton, Brodley and Riordan, Predatory Pricing: Strategic Theory and Legal Policy, Georgetown Law Review, August 2000.

8 Christian Ahlborn, David Evans and Jorge Padilla, *"The Logic and Limits of the 'Exceptional Circumstances' Test in Magill and IMS Health*", 28 Fordham International Law Journal 1109 (2005)

9 As discussed also in Papandropoulos P., "*What can be expected from the Non-Horizontal Merger Guidelines?*", Concurrences No 1-2007, pp. 31-37.

10 See the discussion on the disagreements between the Commission and the parties on cost calculations in the Wanadoo Judgment, Court of First Instance, Case T-340/03, 30 January 2007.

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particular conduct. The weight given to any single criteria may vary according to the circumstances of the case, as discussed below. Such criteria could also be adapted over time as the economic theory evolves and provides further insights into the circumstances that lead to anti-competitive foreclosure.

Investigating anti-competitive effects under Article 82

Following from the discussion above, this paper proposes an approach to implement an effects-based analysis of unilateral conduct. In fact, the approach expresses an "effects-based" analysis of exclusionary foreclosure but also borrows from the experience and practice in the area of merger control. Merger control analysis evaluates the potential impact of the merger (based on a set of observable circumstances and facts on the market) by comparing the expected outcome with the merger with an unobserved counterfactual (the world if the merger did not proceed). The question is then: will competition be significantly impeded relative to the counterfactual? Will consumers be worse off as a result of the merger relative to the counterfactual? In the area of Article 82, a similar thought process could be applied when investigating a particular conduct. In this case, the counterfactual is the world without the practice being implemented (e.g. what if higher prices were charged instead of the allegedly predatory prices, what if a set of products were not bundled but sold separately). If anything, under Article 82, the world with the practice is in fact observed while in merger control, the analysis compares two unobserved states of the world (the future world with the merger and the future world without the merger). In the case of Article 82, the question becomes: is competition impeded as a result of the practice relative to the counterfactual? Are consumers worse off as a result of the practice relative to the counterfactual? In other words, an approach to Article 82 grounded on the analysis of *effects* has common elements with other areas of competition policy.

It is also important to note that a high level of consistency between the non-horizontal merger guidelines and the policy towards Article 82 is warranted.[11] Both sets of policies tend to evaluate similar conducts (in the context of non-horizontal mergers, the assessment relates to the likelihood of emergence of a certain conduct and its potential for anti-competitive foreclosure while under Article 82 the focus is on the evaluation of the anticompetitive foreclosure of observed conduct) The non-horizontal merger guidelines advocate an approach that first spells out a consistent theory of harm and second evaluates the facts to check whether they fit the "story" while at the same time considering the role of efficiencies on the final outcome on competition and consumers.

Similar principles should apply to the analysis under Article 82.[12] These principles can be described as follows: first, a logically consistent theory of consumer harm should be elaborated. Second, the theory should be validated empirically. Empirical validation covers two aspects: (a) the assumptions underlying the theory of harm should be consistent with factual observations (this can be characterized as ex-ante validation – e.g. do the products have characteristics that fit the theory? Is the market structure such that the expected harm is likely?); and (b) market outcomes should also be consistent with the predictions of the theory (this can be characterized as ex-post validation – e.g. is the reaction of rivals as expected? Are the expected shifts in demand observed in any significant way?). And third, pro-competitive motivations for the practice and efficiencies brought about by the practice should always be explored.

Based on the elements gathered above, the test for assessing the anticompetitive effects would aim at comparing the exercise of market power with the practice (taking into account the likely efficiencies and expected harm predicted by the theory– if backed up by the facts) with the exercise of market power without the practice. In this context, a practice would only be condemned if foreclosure of rivals is likely to result *and* if rival foreclosure is expected to lead to consumer harm (relative to the counterfactual). In other words, a practice would only be condemned if the exercise of market power it entails leads to anticompetitive foreclosure (as opposed to foreclosure alone).

The proposed framework may suggest that the implementation of an unstructured rule of reason is being advocated. This is not necessarily the case. While recognizing the pros and cons of the various approaches, an effects-based analysis needs to be grounded on sound economic theory. While an overarching framework should encompass all analyses, the investigation of a particular conduct should also be consistent with a set of criteria adapted to "fit" the specificities of the conduct under investigation and incorporate teachings from the economic literature. In order to illustrate how this approach could be implemented in practice, the next section discusses the American Airlines predation case in the US.

Example of the application of the approach: Predation and the American Airlines case

In the case of predation, evaluating anticompetitive foreclosure would involve a number of criteria relevant to build a theory of harm in accordance with modern economic theories of predation.[13] In view of the recent developments of the so-called

11 This point was recently made by John Vickers at a recent conference. See "*A Reformed Approach to Article 82 EC and the US practice: An Overall Appreciation*", 12th EUI Competition Law and Policy Workshop, Robert Schuman Centre, 8-9 June 2007. The new non-horizontal merger guidelines are available on the Commission website: http://ec.europa.eu/comm/competition/mergers/legislation/nonhorizontalguidelines.pdf.

12 See also a recent speech by Chief Economist Damien Neven, "*A Reformed Approach to Exclusionary Conduct*", 12th EUI Competition Law and Policy Workshop, Robert Schuman Centre, 8-9 June 2007.

13 For a more detailed discussion of these criteria and the American Airline case, see De la Mano M. and Durand B., *A Three-Step Structured Rule of Reason to Assess Predation under Article 82*, Office of the Chief Economist Discussion Paper, 12 December 2005. As indicated by the authors, the review of the American Airlines case relies on public information and does not aim to rejudge the case.

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"post-Chicago" school of thought, a move away from systematic price-cost tests is warranted as predatory strategies can take many forms that do not necessarily involve below cost pricing.[14] In such context, the criteria should be clear but flexible enough to accommodate the range of possible predatory theories of harm. Predation occurs when firms engage in strategies that entail a profit sacrifice *but for* the subsequent foreclosure of rivals and ability to exercise market power once rivals have been significantly weakened or excluded. According to economic theory, a credible predatory "story" should include three elements: (a) a profit sacrifice (relative to another action that would have been more profitable); (b) the foreclosure of rivals; (c) the possibility of recoupment. Absent a theory of harm that covers all these criteria, a case of predation would be difficult to make. For example, a predatory strategy that entails profit sacrifice and rival foreclosure but does not lead to recoupment would not harm consumers and need not be pursued. Also note that the elements of the test can be assessed in any given order (e.g. if recoupment is shown to be unlikely because for example, barriers to entry are extremely low, there may be no need to establish profit sacrifice or likely exclusion).

The evaluation of *profit sacrifice* can rely on cost-tests (e.g. whether price is below some relevant measure of cost such as the average avoidable cost) but it can also refer to other relevant variable such as capacity (as discussed in the American Airlines case below). Indeed, if capacity expansion is undertaken in a context where such an action was not profitable (because demand conditions did not warrant it), the possibility that profits have been sacrificed should be explored as part of the investigation.

The elements to establish the *exclusionary effect* of the predatory strategy (low price or else) will depend on the underlying theory (financial predation, signal jamming, reputation building…) and the reasons why rivals would rather exit the market than continue to compete. Depending on the theory of harm, relevant factors for the assessment of likely foreclosure will include the duration and continuity of the predatory practice, the reliance of the "prey" on external financing (and the extent to which external financing depends on performance), the degree of demand uncertainty, the extent to which key customers are targeted by the predatory strategy,..

The likelihood of *recoupment* hinges on the predator's ability to acquire (or protect) market power on the market where predation occurred or on other markets (in case of reputation building). This assessment requires a careful analysis of barriers to (re)entry, the extent of sunk costs which can be create asymmetries between the incumbent(s) and potential entrant(s) There have been suggestions that the finding of dominance may act as a proxy for the likelihood of recoupment given that the evaluation of dominance also relies on market characteristics such as barriers to entry. However, relying on dominance to assess recoupment may lead to over-enforcement (i.e. concluding that recoupment is likely when it is not necessarily the case) Indeed, there are many instances in which recoupment is not likely despite the pre-predation dominant position of the alleged predator. What matters is the increased scope for exercising market power once the predatory strategy has successfully led to exit. For example, rivals may be led to exit but their assets may remain in the market or if a rival offering a distant substitute has been excluded, the scope for exercising market power would be limited.

Moreover, successful recoupment can occur despite the absence of substantial market power ex-ante. Indeed, predation aimed at building a reputation may be implemented in small markets where the predator does not have significant market power (but holds some advantage relative to existing competitors such as excess capacity to implement a predatory strategy) Market power can then be exercised on other markets where the tough reputation becomes a barrier to entry.

The set of criteria developed above can be illustrated in practice. In the late 90s, American Airlines was sued by the DOJ for alleged predatory practices against low-cost new entrants on certain routes from its main hub of Dallas-Fort Worth (DFW). The predatory strategy in this case did not relate to below-cost pricing but rather to capacity expansions on certain routes which could be unprofitable but for the expected exit of low-cost carriers or reputation building to deter entry on other routes from the DFW hub. As indicated above, a strong predatory claim theory should rely on evidence of profit sacrifice, rival foreclosure and recoupment. If these three elements are present, a conclusion of anti-competitive foreclosure is warranted as the predatory practice is likely to enable the predator to exercise *more* market power relative to the counterfactual without predation, and hence harm consumers. The facts of American Airlines case can be interpreted as providing evidence of sacrifice, exclusion and recoupment.

With respect to sacrifice, the DOJ undertook a number of price-cost tests which it considered conclusive. Yet, there was other type of evidence to suggest that American Airlines may have unprofitably added capacity on the routes where it faced low-cost competition. Such evidence included the fact that American Airlines seem to add capacity more thoroughly on routes where it faced new low-cost entrants compared with routes where it faced more established airlines (even low-cost established players). American Airlines was adding capacity exceeding demand and operated with low load factors suggesting it did not fully implement yield management. It also re-entered routes that it had previously exited (deemed unprofitable). Another example of unexpected change of strategy in face of new entry included the switch between aircraft types. On a given route, American Airlines had switched from jet planes to propellers but switched back (thus increasing capacity) when a low-cost carrier entered the route. Such modifications in strategy could not be explained by a sudden demand surge on the routes concerned. Taken together, these elements suggested that American Airlines was adding capacity at levels exceeding profitable expansion.

14 See Bolton et al. *op. cit.*

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On the issue of likely exclusion, the circumstances of the case could have been candidates for a financial predation theory of harm or a reputation-building predation story. Indeed, in the airline industry, there is evidence that new airlines rely heavily on external financing in particular in the launching phase. By adding capacity as soon as entry occurred, the initial performance of the low-cost carriers was immediately and negatively affected. In fact, American Airlines were carefully and closely monitoring the performance of the new entrants. Once again, the evidence on the different strategies on routes where it faced established players (more accommodating) may have suggested that financial predation would not have been possible with players having established their ability to compete successfully. A case can also be made that American Airline's aggressive reaction to new entry was aimed at building a reputation for toughness to deter entry on other routes from its DFW hub. A sustained predatory strategy (spanning from 1995 to 1997) was likely to deter entry on any significant scale (a prediction that seems to have been validated). Exit by the three main new entrants eventually ensued (two of which filed for bankruptcy and one of which relocated its operations to another hub).

Based on the possible theory of harm (financial predation coupled with reputation building), barriers to entry would have been raised on the markets where predation occurred but also other markets (routes) where American Airlines operated from DFW. Such barriers to entry would make recoupment more likely. In fact the DOJ presented evidence of American Airline's prices on routes where it faced low-cost competition relative to routes where it did not face such competition. There was also past evidence of American Airline's ability to raise prices on a route where a rival exited (a price increase of 13% was calculated after Braniff Airline exited routes on which it competed with American Airlines from DFW).

Taken together, the various elements of the American Airlines suggest that a coherent story, of predatory practices backed with evidence could have been built. In the context of predation, a coherent story involves looking at profit sacrifice, exclusion and recoupment. Based on the discussion of the case above, it might be argued that consumers were harmed by American Airline's predatory capacity expansion on the routes where it faced low cost entry. Not only were the new entrants unsuccessful (and eventually exited the routes) but American Airlines is likely to have been able to deter entry on other routes where it is able to maintain higher prices. On the face of it, the American Airlines may therefore be interpreted as having the necessary ingredients of a credible story of anti-competitive foreclosure.[15] ■

15 Note that DOJ was dismissed in this case largely on the basis of the price-cost tests which failed to convince the Judge that predatory *pricing*

Conclusion

This paper discusses an approach to evaluate the competitive effects of exclusionary conduct by dominant firms. The approach has common elements with the methodology and experience developed in the area of merger control where the impact of a merger is assessed against a counterfactual (i.e. the world without the merger). The paper argues for a similar methodology to be applied in the area of Article 82. The economic theory on the competitive effects of unilateral conduct by firms with significant market power is not a unified theory but a collection of possible theories. Given that the predictions are generally less robust, it is important to apply a unified and structured approach relying on sound economic principles. While implementing a selection of simple rules may be attractive from the point of view of legal certainty, the scope for errors in decision-making is significant. It is preferable to define a sound overarching framework in line with economic theory. Such framework would be associated with sets of criteria relevant to assess the anti-competitive effects of particular conducts. This approach advocated in the area of Article 82 is in line (as it should be) with the spirit of the guidelines on non-horizontal mergers (an area where economic is equally less robust) which propose a general framework (evaluation of ability, incentives and effects on consumer) to assess efficiencies and anticompetitive effects in an integrated manner.

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Avec l'entrée en vigueur du Règlement n° 1/2003, les décisions nationales d'application du droit communautaire de la concurrence sont devenues une nouvelle source d'information. Ces décisions sont encore peu nombreuses et difficiles à recenser, les juridictions nationales n'alimentant pas encore régulièrement le site de la Commission. Grâce à son réseau de correspondants, *e-Competitions* offre à ses abonnés un accès en avant-première à ces décisions.

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