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On the Art 82 enforcement priorities Effects on consumer welfare

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*The views expressed are those of the authors and do not necessarily reflect those of DG COMP or the European Commission

Introduction

- Guidance on enforcement priorities
- Not meant to be a statement of the law
- Focus on single dominance and exclusionary conduct
- General approach
  - Safeguarding the competitive process and not the protection of competitors
  - Effects on consumers
  - Objective necessities and efficiencies
- To ensure that dominant firms do not impair effective competition by foreclosing rivals in an anti-competitive way thereby having an adverse impact on consumer welfare

Dominance and market power

- The extent to which a firm can behave independently of its competitor relates to degree of competitive constraints exerted on this firm
- A dominant firm enjoys substantial market power over a period of time (two years)
- Competitive constraints :
  - Imposed by actual competitors
  - By the threat of expansion and entry of potential competitors
  - By the bargaining strength of customers
- High market share are only a first indication
- Low market share (below 40 %) are a good proxy for the absence of substantial market power

(past) Non-hypothetical example

- defendant had high market shares in a homogenous good market (above 60%)
- Important barriers to entry could be identified: large overcapacity, declining demand, high fixed costs to establish new facilities, strong learning effects
- Extensive use of long term contracts and thus limited customer switching
- Defendant had the broadest product and technological range and the largest financial resources.

- EU Commission concluded the defendant was <u>not dominant</u> because:
  - Buyer concentration (top 3 customers take 70%)
  - Product homogeneity allows to switch supplier without incurring significant switching costs
  - Buyers have dual sourcing strategy and shift volumes between suppliers
  - Rival suppliers have overcapacity
  - Competition mechanism: bidding for large occasional contracts

Anticompetitive foreclosure

- No particular test applied across all practices
- Anticompetitive foreclosure
  - Foreclosure : access to market is hampered or eliminated
  - Anticompetitive : in such way that consumers are harmed
- Assess the actual or likely future situation in the relevant market relative to an appropriate counterfactual
- The conditions of entry, the existence of scale/scope economies, network effects, the counterstrategies of competitors, …
- As efficient competitor test as a useful benchmark (when assessing price conduct) – taking a dynamic view of the constraint exercised by seemingly less efficient competitor

Objective necessity and efficiencies

- A dominant firm may justify conduct leading to anticompetitive foreclosure on the ground that efficiencies are sufficient to guarantee that consumers are not harmed
- Efficiencies likely to be realised as a result of the conduct
- Conduct is indispensable (i.e. it is a more effective, less anticompetitive way of achieving efficiencies)
- Exclusionary conduct which maintains a position approaching that of a monopoly can normally not be justified
- Burden of proof to show efficiencies on the dominant firm
- The Commission makes the ultimate assessment of whether, considering the efficiencies, the behavior is likely to lead to consumer harm

How economic reasoning informs the 82 Guidance Paper: e.g. Predation

- Predation is costly*:* and increases with the market share of the predator, while the victim's losses are smaller, the smaller its market share.
- Since predation can only be temporary, the prey will not exit.
  - Not even a dominant firm can successfully predate on equally or more efficient rivals.
  - A predator would ultimately raise prices or behave less aggressively to recoup initial loses.
  - If the industry is profitable in the long term, lenders should be prepared to back the prey through any period of temporary losses.
- Predation cannot lead to permanent exclusion: Even if the prey ceased operations during the predatory phase, either it or a successor would reenter during the recoupment phase, making use of the prey's original assets.

Definition

- Ordover & Willig (1981) define predatory conduct as a strategy "*that sacrifices part of the profit that could be earned under competitive circumstances were the rival to remain viable, in order to induce exit and gain consequent additional monopoly profit*".
- Much broader than just pricing
- Strategy in two stages, which is (partly) how to distinguish it from normal competition
- Tricky part: why/how does the predator's behavior today influence whether the prey wants to be in the market tomorrow?

Insight 1: Predation may work if prey is financially constrained

- The prey is dependent upon some source of external financing (i.e. it is financially constrained)
- The predator seeks to manipulate that relationship between the prey and its investors.
- For example, the predator may reduce prices in order to reduce the profitability of its rivals.
- Lenders may be unable to determine whether the default stems from (a) predatory pricing, (b) or the debtor’s poor performance or (c) see low profitability as as a signal that prospects in this market are limited.
- Lenders may decide to pull the plug

Insight 2: Asymmetric information reinforces exclusionary effects of predation

- Rivals will enter the market if they believe the dominant firm is a high-cost provider, but will not enter the market or will choose to exit the market if they believe the dominant firm is a low-cost provider.
- A predator may drastically reduces prices to mislead the prey to believe that the predator has lower costs and to exit the market.
- Observing the predator's low price, the prey rationally believes that there is a least some probability that the predator has reduced costs. This lowers the prey's expected returns and causes the prey to exit.
- Similar models: test-market predation (secret price cuts) signal jamming (public price cuts)
- In all cases: Predation to mislead rivals in believing the market is unprofitable

Insight 3: Reputational effects can make predation a cheap and effective strategy

- The predator seeks to convey a reputation for "toughness" and a willingness to defend its market at virtually any cost.
- The predator reduces prices in one market to induce the prey and potential entrants to believe that it will cut price at a later time or in other markets.
- The predator seeks to establish a reputation as a cut-throat competitor, based on some perceived special advantage or characteristic.

Predation Test

- “In line with its enforcement priorities, the Commission will generally intervene where there is evidence showing that:
  - a dominant undertaking engages in predatory conduct by deliberately incurring losses or foregoing profits in the short term (referred to hereafter as "sacrifice"),
  - so as to foreclose or be likely to foreclose one or more of its actual or potential competitors
  - with a view to strengthening or maintaining its market power, thereby causing consumer harm”.

Sacrifice

- “Pricing below AAC will thus in most cases be viewed by the Commission as a clear indication of sacrifice”.
- “However, the concept of sacrifice includes not just pricing below AAC…
- (important)… whether the allegedly predatory conduct led in the short term to net revenues lower than could have been expected from a reasonable alternative conduct …only economically rational and practicable alternatives will be considered.”
- “In some cases it will be possible to rely upon direct evidence (e.g internal documents)”

Anticompetitive Foreclosure

- As efficient competitor test:
  - "If sufficient reliable data are available, the Commission will apply the as efficient competitor analysis, described in paragraphs 24-26, to determine whether the conduct is capable of harming consumers"
- Foreclosure
- Consumer Harm

Foreclosure

- …whether and how the suspected conduct reduces the likelihood that rivals will compete:
  - "For instance, if the dominant firm is better informed about cost or other market conditions, or can distort market signals about profitability, it may predate so as to influence the expectations of potential entrants and thereby deter entry" (*signaling)*
  - "If the conduct and its likely effects are felt on multiple markets and/or in successive periods of possible entry, the dominant firm may be shown to be seeking a reputation for predatory conduct" (*reputation*)
  - "If the targeted competitor is dependent on external financing, substantial price decreases or other predatory conduct by the dominant firm could adversely affect the competitor's performance so that its access to further financing may be seriously undermined" (*financial constraints*)

Consumer Harm

- "…consumers are likely to be harmed if the dominant undertaking can reasonably expect its market power after the predatory conduct comes to an end to be greater than it would have been had the undertaking not engaged in that conduct in the first place…
  - …if the undertaking **is likely to be in a position to benefit from the sacrifice**".
- "Likely consumer harm may be demonstrated by assessing the likely foreclosure effect of the conduct, combined with consideration of other factors, such as entry barriers. In this context, the Commission will also consider possibilities of re-entry".
- Counterfactual: concerns also if…"the conduct would be likely to prevent or delay a decline in prices that would otherwise have occurred".
- "Identifying consumer harm is not a mechanical calculation of profits and losses, and proof of overall profits is not required".
- "It is less likely that the dominant undertaking engages in predatory conduct if the conduct concerns a low price applied generally for a long period of time"

Conclusion

- Enforcement aimed at prohibiting conduct that undermines the competitive process vs conduct that is harmful to consumers
- Over-enforcement, administrability and form
- Effects based analysis should not be caricatured
- Allocation of the burden of proof
- Disproportionality test (anti-competitive effects substantially disproportionate to any associated pro-competitive effects, emphasis on type I errors) vs anti-competitive foreclosure and efficiencies.
- Dominance presumption (never below 50 %, vs soft safe harbour at 40 %)

Conclusion

- Recoupment vs consumer harm
- Loyalty discounts – predation vs exclusive dealing
- Refusal to deal – minimum role vs stricter conditions
- Exclusive dealing – safe harbor in market coverage