VOLUME 2 | NUMBER 1 | SPRING 2006

Competition Policy International

Article 82: A Commentary on DG Competition's Discussion Paper

Bill Allan

Copyright © 2006
eSapience, Ltd.

Published in *Competition Policy International* (print ISSN 1554-0189, online ISSN 1554-6853), Spring 2006, Vol. 2, No. 1.
Competition Policy International is a free publication. To order or download additional copies, visit eSapience.org.

Article 82: A Commentary on DG Competition's Discussion Paper

Bill Allan

DG Competition's discussion paper is a welcome commitment to a consumer welfare standard implemented through an effects-based control of exclusionary abuses. As such, it appears to signal a departure from the form-based approach articulated most strongly in *Michelin II*. However, its full significance is limited by the enunciation of a precautionary principle under which abuse is framed to capture any conduct likely to limit entry or expansion and justification is limited to the narrowest plausible extent. While that approach reflects a concern to prevent the erection of artificial entry barriers, it results in rules that undervalue existing competition. That risk is compounded by a narrow approach to market definition and dominance. These problems will only be avoided if the European Commission fully embraces a standard based on a determination that the disputed conduct substantially lessens effective competition in a way that can effectively be remedied by intervention under Article 82 of the EC Treaty.

The author is a lawyer with Linklaters (London) and an Affiliated Lecturer in the Faculty of Law, Cambridge University. He is indebted to his colleagues Christian Ahlborn and David Bailey for making numerous positive suggestions and for saving him from error. Any errors that remain are, of course, his own.

I. Introduction

Among the numerous opportunities for Christmas displacement activity thoughtfully provided by the competition courts and agencies, DG Competition's (DG COMP) discussion paper (Discussion Paper) was among the most widely anticipated.[1] Its appearance marks an important point in a debate that has intensified since the judgment of the European Court of First Instance (CFI) in *Michelin II*, where the Court said that:

> "The [anti-competitive] effect referred to in the case law . . . does not necessarily relate to the actual effect of the abusive conduct complained of. For the purposes of establishing an infringement of Article 82 EC, it is sufficient to show that the abusive conduct of the undertaking in a dominant position tends to restrict competition or, in other words, that the conduct is capable of having that effect.
>
> . . .
>
> It follows that, for the purpose of applying Article 82 EC, establishing the anti-competitive object and the anti-competitive effect are one and the same thing . . . If it is shown that the object pursued by the conduct of an undertaking in a dominant position is to limit competition, that conduct will also be liable to have such an effect."[2]

That approach evoked a strong reaction from those for whom it gave primacy to form over substance and, in so doing, produced results that lacked economic logic.[3]

The Discussion Paper indicates DG COMP's proposed approach to resolve that conflict. On any view, the scale of the task is daunting, dwarfing the (already accomplished) updating of Article 81 of the EC Treaty and the EC Merger Regulation and reflecting the profundity of the conflicts that the control of market power evokes. Moreover, the Discussion Paper is only a first step in the process. Its self-imposed limitation to exclusionary abuses means that it cannot

[1] European Commission, DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses (Dec. 2005), *available at* http://europa.eu.int/comm/competition/antitrust/others/discpaper2005.pdf [hereinafter Discussion Paper].

[2] Case T-203/01, Manufacture française des pneumatiques Michelin v. Commission, 2003 E.C.R. II-4071 (CFI) [hereinafter *Michelin II*], at paras. 239 and 241.

[3] That concern was well articulated in J. Vickers, *Abuse of market power*, European Association for Research in Industrial Economics, Berlin, Sep. 3, 2004, *available at* http://www.oft.gov.uk/NR/rdonlyres/948B9FAF-B83C-49F5-B0FA-B25214DE6199/0/spe0304.pdf.

even suggest a complete resolution of conflicts that derive, to a substantial extent, from the differing perspectives of exclusionary and exploitative abuses. The development of a coherent policy that embraces and reconciles both categories of abuse is effectively deferred to the next phase in DG COMP's program.[4] Ultimately, the effect of this and any subsequent work undertaken by DG COMP depends on the extent to which it is embraced by the EC Courts.[5]

This paper is organized in the following sections. Section II addresses issues of general principle and the general analytical framework. Sections III, IV, V, and VI consider the Discussion Paper's treatment of specific abuses (predation, rebates, tying, and refusal to supply).[6] Finally, Section VII contains some concluding remarks.

II. General Principles

A. POLICY OBJECTIVES IN THE ENFORCEMENT OF ARTICLE 82 OF THE EC TREATY

1. Consumer Welfare as the Primary Goal

The Discussion Paper proclaims its central orientation in the introduction: "With regard to exclusionary abuses the objective of Article 82 is the protection of competition on the market as a means of enhancing consumer welfare and of ensuring an efficient allocation of resources."[7] The clarity of that statement is qualified by the introductory reference to exclusionary abuses.[8] While that may be no more than a precautionary qualification to avoid pre-empting the next

[4] *See Commission discussion paper on abuse of dominance - frequently asked questions*, *at* http://www.europa.eu.int/rapid/pressReleasesAction.do?reference=MEMO/05/486 (last visited Feb. 7, 2006), *cited in* Discussion Paper, *supra* note 1, at 1 n.1. In defining the scope of the Discussion Paper, it should also be noted that, while it discusses issues presented by collective dominance, the attention that they receive is slight by comparison with the attention devoted to the central topic of single firm dominance and largely consists in a restatement of the principles enunciated by the EC Courts. Accordingly, that topic is not discussed in this paper.

[5] *See* Case C-95/04 P, British Airways v. Commission, AG Opinion (Feb. 23, 2006) [hereinafter *Virgin/British Airways (ECJ)*], at para. 28.

[6] The Discussion Paper also includes a section on aftermarkets (*see* Discussion Paper, *supra* note 1, at paras. 243-265). The discussion focuses almost entirely on the question of whether the supplier of the primary product holds a dominant position in relation to its secondary products. Where dominance is established, DG COMP says that it will presume that the supplier abuses that dominant position if it reserves the secondary market to itself. For more detailed analysis, it simply cross-refers to the sections on tying and refusal to supply.

[7] Discussion Paper, *supra* note 1, at para. 5.

[8] *See also id.* at paras. 54 and 56 (which include the same qualification).

phase in DG COMP's program, equally it may signal the existence of a different objective where exploitative practices are concerned.

From its inception, EC competition law has pursued a diversity of objectives that cannot always be reconciled. Those tensions crystallize when notions of fairness embodied in the protection against discrimination collide with notions of maximizing consumer welfare such as those articulated in the Discussion Paper.[9] The law cannot equivocate on this issue. When an authority or a court decides whether to apply Article 82, either it makes its decision by reference to rules designed to maximize consumer welfare or it does not. If it does not, because it applies rules designed to achieve another objective, consumer welfare is necessarily diminished.[10]

2. DG COMP's Application of the Consumer Welfare Standard to Exclusionary Abuses

As importantly, DG COMP commits itself to a methodology based on the disputed conduct's likely effect on the market where:

> "... The conduct in question must in the first place have the capability, by its nature, to foreclose competitors from the market. To establish such capability it is in general sufficient to investigate the form and nature of the conduct in question. *It secondly implies that, in the specific market context, a likely market-distorting foreclosure effect must be established.*" (emphasis added)[11]

Although not said in so many words, this should mark the welcome repudiation of the form-based philosophy articulated by the CFI in *Michelin II*.[12] The

[9] The (cautiously contemplated) meeting competition defense provides an instance of that tension. It requires that the dominant firm's response be the minimum required to protect its commercial interests yet that may necessitate otherwise unjustified discrimination between its customers. DG COMP does not articulate in this paper how it proposes to resolve that tension. More broadly, EC competition law has yet to reach the conclusion, enunciated by the U.S. Supreme Court in Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993), that prohibitions on discriminatory conduct only offend the antitrust laws where they interfere with competition.

[10] That does not exclude other objectives (such as liberalization or single market integration) where they are wholly consistent with the consumer welfare goal.

[11] Discussion Paper, *supra* note 1, at para. 58.

[12] Note, however, that DG COMP enters a caveat in respect of conduct that is "clearly not competition on the merits" (*id.* at para. 60). Such conduct is presumed to be abusive subject to rebuttal evidence that the conduct has no exclusionary effect or meets the objective justification standard. The low threshold for exclusionary effect and the high threshold for justification combine to make the prospect of successful rebuttal remote. In any event, the necessity for any such qualification is questionable. If the conduct is generically as devoid of redeeming features as DG COMP suggests, the second

opinion of Advocate General Kokott in *Virgin/British Airways (ECJ)* is consistent with that position.[13]

That said, even if an effects-based approach does become firmly entrenched, its significance depends critically on the way in which it is applied. It is notable, for example, that the CFI's judgment in *Virgin/British Airways (CFI)*, endorsed by the Advocate General on appeal, reached a finding of abuse without having to rely on the full force of the *Michelin II* formula. It was sufficient for that Court to find an anticompetitive effect on the basis of a factual assumption that, absent the incentive schemes employed by British Airways (BA), rival airlines would have expanded more vigorously than they did.[14] As stated, that factual assumption had the legal effect of a presumption that is not substantially different from the *Michelin II* formula.

That leads directly to the central question of whether the scope and application of the exclusionary abuses will be determined by reference to the disputed conduct's effect on entry and expansion by rivals alone or on a broader basis in which those factors are treated as part of an assessment of the disputed conduct's effect on the intensity of competition. Although the Discussion Paper includes elements of both approaches, its dominant philosophy may be described as a precautionary principle under which any threat to the long-term competitive structure of the market is sufficient to justify intervention.[15] That underpins an analytical framework comprising a broadly defined concept of foreclosure and a nar-

footnote 12 cont'd
(market-specific) limb of the inquiry should not be unduly burdensome. Moreover, if these cases are as infrequent as DG COMP implies, then the need to adopt a per se standard to avoid substantial administrative burdens seems slight. At a minimum, it is important that this exception be confined to the margins that its location in the Discussion Paper indicates. To ensure that that happens, it would be useful if the final version of the Discussion Paper were to state expressly that this caveat does not apply to the principal abuses covered by the paper. Given the recognition that each of these abuses is capable of having beneficial effects, they would seem inappropriate candidates for this treatment.

[13] *See Virgin/British Airways (ECJ)*, AG Opinion, *supra* note 5, at para. 45.

[14] Case T-219/99, British Airways v. Commission, 2003 E.C.R. II-5917 (CFI) [hereinafter *Virgin/British Airways (CFI)*], at para. 298. In *Virgin/British Airways (CFI)*, para. 239 of *Michelin II* was repeated, but para. 241 was not. *See also Virgin/British Airways (ECJ)*, AG Opinion, *supra* note 5, at para. 83.

[15] The Advocate General's opinion in *Virgin/British Airways (ECJ)* expressly endorses that approach. See, e.g., *Virgin/British Airways (ECJ)*, AG Opinion, *supra* note 5, at para. 68 (". . . Article 82, like the other competition rues of the Treaty, is not designed only or primarily to protect the immediate interests of individual competitors or consumers, but to protect the *structure of the market* and thus *competition as such* (*as an institution*) . . . In this way, consumers are also indirectly protected. Because where competition is damaged, disadvantages for consumers are also to be feared" (emphasis in original, footnotes omitted)).

rowly circumscribed set of justifications in which primacy is given to ensuring that entry and expansion is possible.[16]

The Discussion Paper's dominant philosophy may be described as a precautionary principle under which any threat to the long-term competitive structure of the market is sufficient to justify intervention. That underpins an analytical framework comprising a broadly defined concept of foreclosure and a narrowly circumscribed set of justifications in which primacy is given to ensuring that entry and expansion is possible.

It appears that, for DG COMP, its concept of foreclosure is saved from being overly inclusive by the (frequently repeated) proposition that, at least when considering pricing abuses, it is only the foreclosure of "as efficient" competitors that should engage Article 82.[17] Even if that is accepted at face value, it does not answer the central question of whether Article 82's guiding philosophy consists in the protection of competition as a structural phenomenon or a process of rivalry. It is consistent with either approach.

In any event, the significance of the concept is qualified (possibly substantially) by the pregnant note that "it may sometimes be necessary in the consumers' interest to also protect competitors that are not (yet) as efficient as the dominant firm."[18] It is far from clear how DG COMP intends to apply this qualification.[19] There is a significant risk that a policy that measures competitive health by long-term structural factors will deny

[16] See, for example, the discussion of conditional rebates, where DG COMP says that: "In its assessment the Commission will in particular be attentive that the rebate system does not foreclose potential competitors" (Discussion Paper, *supra* note 1, at para. 157).

[17] *Id.* at para. 63. It is this notion that enables DG COMP to say that Article 82 is concerned with the protection of competition not competitors. The philosophical difficulty that that disjunction can present is neatly illustrated by the interim measures rulings in *IMS Health* where the President of the CFI asserted that Article 82 was concerned with safeguarding the interests of consumers rather than protecting the position of individual competitors. The President of the ECJ responded that that approach could not be accepted without reservation "in so far as it could be understood as excluding protection of the interests of competing undertakings from the aim pursued by Article 82 EC, even though such interests cannot be separated from the maintenance of an effective competition structure." Case C-481/01, NDC Health v. Commission, 2002 E.C.R. I-3401 (ECJ), at para. 84 on appeal from Case T-184/01, IMS Health v. Commission 2001 E.C.R. II-2349 (CFI) [hereinafter *IMS Health*]. To the same effect, see the extract from the Advocate General's opinion in *Virgin/British Airways (ECJ)* quoted in *supra* note 15.

[18] Discussion Paper, *supra* note 1, at para. 67.

[19] Although DG COMP does not specify when that may be necessary, it appears that at least one set of cases will be those in which there are economies of scale and scope, learning curve effects, or first mover advantages that a rival could not match even if it achieved the same scale of output as the dominant firm. The framing of the qualification is curious. It implies that the assessment should be made on the hypothesis that the rival achieves comparable scale yet refers to advantages (including specifically economies of scale) that should have been eroded by the time that comparable scale is

consumers the immediate benefit of lower prices based on a dominant firm's superior economies of scale and scope or impose on consumers the costs of supporting inefficient entry.

Indeed, it is striking that there is no express reference to the merits of productive efficiency in DG COMP's recital of virtuous competitive objectives.[20] Especially where economies of scale or scope are substantial, there is an unavoidable tension between optimizing the gains from productive efficiency and facilitating entry and expansion. The Discussion Paper clearly resolves that tension in favor of entry and expansion, arguing that, in the long run, consumers must benefit more from the maintenance of a competitive structure.[21] The implications of that approach appear most starkly when DG COMP denies a dominant firm the right to justify conduct that has the effect of eliminating competition even if that conduct is necessary to achieve consumer benefits that would not otherwise be realized.

3. An Alternative Approach

DG COMP's vision for the future of Article 82 is based on the laudable policy of promoting consumer welfare through an effects-based analytical model. To accomplish that vision, the rules that implement it must be consistent with it. For the reasons explained above, rules based on a precautionary principle do not satisfy that requirement. To the contrary, there is a substantial risk that the precautionary principle will lead the European Commission to place undue weight on the assumed gains from long-term improvements in structure at the expense of the arguably more tangible gains from short-term dynamism.

Any rule should seek to avoid a result that encourages entry or expansion at the expense of weakening the intensity of competition among existing rivals.[22] To

footnote 19 cont'd
achieved. A more comprehensible hypothesis would make the assumption that the rival can match the dominant firm's efficiency once it reaches comparable scale, but is precluded from doing so by its present lack of scale. If, to the contrary, DG COMP means literally what it says, that only reinforces the concerns expressed in the text.

[20] Discussion Paper, *supra* note 1, at para. 5. This approach contrasts sharply with the philosophy that: "Antitrust aims at preserving competition as an instrument for creating economic efficiency" (Frank H. Easterbrook, *The Limits of Antitrust,* 63 Texas L. Rev. (1984), *reprinted in* 1 Competition Pol'y Int'l 179, 190 (Spring 2005). However, it is consistent with EC competition law's focus on consumer welfare in preference to total welfare under which little or no value appears to be assigned to gains in productive efficiency that are retained as part of the producer surplus.

[21] Discussion Paper, *supra* note 1, at para. 91.

[22] Admittedly, DG COMP refers at various points to the need to take account of rivals' ability to counteract the dominant firm's conduct but, when viewed in the context of the Discussion Paper as a whole, those references are cursory and undeveloped. They do little to counterbalance the powerful thrust in the opposite direction.

avoid that result while achieving the goals of Article 82, the Commission should base its assessment on whether the disputed conduct gives rise to a substantial lessening of competition that can be effectively avoided by the proposed remedy.

This is particularly important for markets where there is already active competition, even if it is impaired by the presence of the dominant firm. In such cases, the assessment of foreclosure should concentrate on actual exclusion and deterred investment to expand. Entry and expansion are present realities; the fact that appreciable competition already exists should make a competition authority question whether entry is in fact as difficult as may be claimed.[23] More importantly, the Commission should take full account of rational competitive behavior among established competitors. If it did so, it would not place the emphasis that it does, at several points, on a criterion related to the dominant firm's coverage of total costs. Rational pricing decisions for competitors of all sizes should disregard sunk costs with the result that there are numerous instances in which prices would be set at a level below total costs. The decision-making process would start from the proposition that such pricing works to the benefit of consumers, unless the contrary is established, rather than presuming that harm will result.

This approach would also remove at least some of the difficulties presented by DG COMP's strict approach to the available defenses to an alleged abuse. In particular, the narrow construction of the meeting competition defense would be more comprehensible if that defense were to be implemented in a framework that more accurately assesses the anticompetitive impact of the disputed conduct.

B. ANALYTICAL FRAMEWORK

The precautionary principle is embodied in the analytical framework adopted by DG COMP. The Discussion Paper is devoted primarily to abuse, but equal attention should be given to the discussion of the prior issues (market definition and dominance) as well as the scope allowed for justification of conduct that is prima facie abusive because the impact of Article 82 is a function of the mutually reinforcing effect that the treatment of all four elements has.

Consistent with the precautionary principle, the Discussion Paper appears to proceed on the basis that:

(a) markets should be narrowly defined;

(b) dominance is principally a function of a firm's share of a (narrowly-defined) market;

(c) abuse is strongly dependent on the assumption that that dominance

[23] It does not follow that, where the dominant position is stronger, the possibility of entry should be disregarded. On the contrary, while greater skepticism may be justified in that case, the Commission should always be careful to consider realistically the possibilities available to putative entrants.

entails a weakened state of competition that creates a need for active intervention; and

(d) justification must be stringently defined and strictly applied to ensure that the abuse so identified is not inadvertently permitted to continue.

1. Market Definition and Dominance

If an analytical framework of that kind is adopted, it is critical that the connected issues of market definition and dominance are analyzed in a way that provides a sound framework for the identification of abuse. While DG COMP correctly and helpfully recognizes some technical issues,[24] its opening premise points to what appears to be an excessively narrow approach when it focuses on *actual* competitors that provide an *immediate* competitive constraint to the putative dominant firm.[25] Taken literally, this approach ignores less immediate, but nonetheless real, competitive constraints on a firm such as those presented by supply-side substitutes. Its effect is compounded by an approach to dominance that likewise focuses on static considerations.

It is critical that the connected issues of market definition and dominance are analyzed in a way that provides a sound framework for the identification of abuse.

While dominance is expressed (non-controversially) as the possession of "substantial market power," that proposition comes to be defined by the proxies that are used to measure it. Although DG COMP acknowledges the limitations of market shares and the need to explore wider competitive conditions (notably, the significance of entry barriers), in practice the primacy of market shares is maintained:

> It is *very likely* that very high market shares, which have been held for some time, indicate a dominant position. This would be the case where an undertaking holds 50% or more of the market, provided that rivals hold a much smaller share of the market. In the case of lower market shares, dominance is more likely to be found in the market share range of 40% - 50% than below 40%, although also undertakings with market shares below 40% could be considered to be in a dominant position. However, undertakings with market shares of no more than 25% are not likely to enjoy a (single) dominant position on the market concerned. (footnotes omitted and emphasis added)[26]

[24] The significance of the marginal customer is a case in point.

[25] Discussion Paper, *supra* note 1, at para. 12.

[26] *Id.* at para. 31.

The discussion of entry and expansion focuses on the extreme ends of the spectrum. Thus, such barriers are likely to be found if previous attempts to enter or expand have been unsuccessful. At the opposite end of the spectrum, where entry has been frequent and successful, such barriers are not likely to be found. DG COMP leaves open its approach to those cases that fall between the two extremes. The tone of the document, however, suggests that it will favor a finding of dominance absent proof of successful entry.

Cumulatively, this discussion means that Article 82 is applicable in a range of widely differing circumstances where, at the lower end of the range, the existence of substantial market power is highly contentious. That only emphasizes the need, at a minimum, to develop rules that recognize the differences between those cases and to avoid a precautionary principle that is insensitive to such differences.

2. Abuse

The general discussion of abuse is almost wholly concerned with the concept of foreclosure and does not extend to other questions, such as the relevance of intent or sacrifice.[27] The level of foreclosure that engages Article 82 is a function of two components: the level of competitive harm and the degree of probability that that harm will occur. The Discussion Paper articulates a standard based on the likelihood of foreclosure where foreclosure includes eliminating, constraining, and disciplining competitors. By contrast, *Microsoft* articulated a standard based on a risk that competition would be eliminated.[28] The higher level of probability in DG COMP's proposed standard is balanced by a lower level of competitive harm.[29]

[27] DG COMP quotes the hallowed formula originally stated in *Hoffman-La Roche* which distinguishes abusive behavior from "normal competitive behaviour." Case 85/76, Hoffmann-La Roche v. Commission, 1979 E.C.R. 461 [hereinafter *Hoffman-La Roche*]. In practice, that concept has had little impact on the application of Article 82. Normally, it is trumped by the other elements of the *Hoffman-La Roche* rule which has come to embody the dominant firm's special responsibility not to weaken competition. In the Discussion Paper, the concept appears through DG COMP's recognition that broad adoption of certain types of behavior indicates their efficiency-enhancing potential but that has little, if any, impact on the way in which the foreclosure and efficiency tests are applied to dominant firms' employment of such behavior.

[28] *See, e.g.,* Commission Decision, Case COMP/C-3/37.792, Microsoft (Mar. 24, 2004, not yet reported) [hereinafter *Microsoft*], at para. 992.

[29] Given the Commission's concern to preserve its position in relation to past cases and (especially it may be imagined pending litigation), it is most unlikely that any substantive change is intended. In that context, note that one of the FAQs accompanying the Discussion Paper (accessible through the reference at note 1) stated that:

> There is nothing in the discussion paper that calls into question any of the Commission's past decisions. At the same time, the Commission must always work to improve its decisions and its policies. The review is about a better focus and a better argumentation in future cases. Furthermore, the fact that if the discussion paper leads to a more refined economic analysis, the Commission would in future argue a case in a different way than in the past, does not mean that the decision taken in a past case was wrong, only that the argumentation would today have been different.

The opinion of the Advocate General in *Virgin/British Airways (ECJ)* appears to articulate both approaches, stating that what is to be proved is the "likelihood" that the disputed conduct will "hinder" the maintenance or development of competition and deducing from that a requirement to prove that the rebates offered by BA were "capable" of making it "difficult or impossible" for its rivals to have access to the market and its business partners to choose between various sources of supply.[30]

The precise content of both elements of the standard is, however, important. First, if it is decided that a high degree of competitive harm (such as elimination of competition) is required to engage Article 82 in a particular case, then it is important to avoid assigning a low level of probability because that would effectively reduce the observed level of competitive harm at which intervention occurs. To treat a risk of competitive harm as sufficient to justify intervention sacrifices the gains to consumer welfare that unfettered competition would create if that risk did not materialize.

Second, the required degree of probability has a substantial bearing on the nature and quality of the evidence to be produced. If it is sufficient to show that there is a risk of elimination, then it is easy to slip into reliance on weak evidence and speculative analysis. Yet, that takes us into an area where, as the European Court of Justice (ECJ) has said, "the chains of cause and effect are dimly discernible, uncertain and difficult to establish."[31] It is the consequent risk of a false prognosis that led the Court to insist that the Commission provide convincing evidence of its theories of harm. What holds true for merger control holds no less true in the context of Article 82.[32]

The two components of the standard need to be determined independently. The required degree of harm should be determined by reference to the conduct and market impact that would substantially lessen competition in that context. The required degree of probability should be a likelihood. Anything less lacks evidential rigor and will dilute the standard of harm.

3. Objective Justification

The strength of the precautionary principle is also demonstrated by the narrow scope given to the concept of objective justification. The so-called "efficiency defense" states four cumulative elements, reflecting those laid down in Article

[30] *Virgin/British Airways (ECJ)*, AG Opinion, *supra* note 5, at para. 71.

[31] Case C-12/03P, Commission v. Tetra Laval (Feb. 15, 2005, not yet reported), at para. 44.

[32] The distinction between the categories of case should not be exaggerated. While merger control cases are wholly forward-looking, Article 82 cases may contain substantial forward-looking elements: *Microsoft*'s focus on the risk that competition will be eliminated is a strong example. In any event, whatever differences there may be do not justify a difference in the legal standard. It may simply mean that the legal standard is easier to satisfy in one case than the other.

81(3), which cumulate the requirements of indispensability and non-elimination of competition. DG COMP acknowledges explicitly that "ultimately the protection of rivalry and the competitive process is given priority over possible procompetitive efficiency gains."[33]

Without necessarily limiting the scope of this constraint, it is clear that it will have the most direct impact in respect of those firms that might be regarded as "super-dominant." Yet, it is precisely because of such firms' super-dominance that consumers are particularly dependent on them for efficiency gains. Assuming that the conduct that would otherwise be abusive truly is indispensable to realizing those efficiencies, DG COMP's position entails the long-term denial of those gains to consumers.

The Discussion Paper itself appears to recognize an exception to this principle when it says that it is lawful for a dominant firm to withhold supplies of an essential input, at least for a sufficient period to recover its investment, even though that results in an elimination of competition for a period.[34] DG COMP could, of course, reply that there is no conflict with its basic principle because the entitlement to withhold supplies is always time-limited so that there can be no permanent elimination of competition.[35] There is, however, no connection between that limit (which is defined by reference to the dominant firm's payback period) and a limit based on the elimination of competition. A stronger form of the argument would say that the time limit must be curtailed even further if that is necessary to avoid the elimination of competition (for example, because withholding the input even for the duration of the minimum payback period would be sufficient to choke off subsequent entry). To accept that argument entails acceptance of the proposition that it is preferable to forego the benefit of that development, however valuable to consumers it might be, than to risk the elimination of competition in the supply of goods that are less valuable to consumers. The legislator can, of course, decide that that is the right choice, but it is a mistaken choice to make for all cases and under all circumstances.[36]

[33] Discussion Paper, *supra* note 1, at para. 91.

[34] *Id.* at para. 235.

[35] The concept of a universal time limit on the entitlement to withhold supplies is highly controversial and is discussed in Section VI.D of this paper.

[36] *Microsoft* indicates the Commission's apparent willingness to grasp that nettle. The Commission canvassed, only to reject, the possibility that Microsoft's incorporation of Windows Media Player (WMP) into the Windows operating system could be justified on the basis that there was a cognizable benefit in the certainty of a single platform standard. It said that: "Under Community competition law an undistorted competition process constitutes a value in itself as it generates efficiencies and creates a climate conducive to innovation (innovation being, in markets such as the software market, a key competition parameter)" (*see Microsoft, supra* note 28, at para. 969). Unfortunately, that statement in that context is rhetorical rather than substantive. The Commission concluded that incorporation of WMP into Windows was not necessary to accomplish the benefits of integration, but then more crucially, allowed Microsoft to continue selling that product provided that it also made available a

It should also be said (if the contrary is argued) that neither consistency with Article 81(3) nor Article 82's own purpose compel that outcome. While the two provisions share the same direct objective (preservation of a system of undistorted competition), that objective is a means to maximizing consumer welfare and must be seen within the context of the Treaty's primary aim to secure economic development. Consumer welfare or economic development may prevail over the competition rules (unless the Treaty expressly dictates otherwise as it does in the case of Article 81(3)) where conduct that would otherwise infringe those rules is necessary to secure one of those goals. There is, moreover, a substantial difference between controlling an agreement between independent undertakings and imposing an affirmative duty to supply on a single undertaking. While freedom of contract is an important value that is recognized and protected by EC law, both EC law and the individual legal systems of the EC Member States recognize a broad competence to regulate that freedom where that is appropriate in the interests of public policy. By comparison, an undertaking's freedom to choose its business partners and to dispose of its property as it chooses are fundamental values that European legal systems are reluctant to limit except in the most extreme circumstances. To put it simply, the law is more willing to tell a citizen that he may not conclude a certain contract than it is to fetter his property rights. Consistently, competition law should be more willing to apply Article 81 to prohibit a particular agreement than it should be to apply Article 82 to force a firm to deal with its property against its will.

The meeting competition defense poses a similar dilemma in view of the two restrictions imposed by DG COMP. First, it requires that the dominant firm's response be proportionate to the competitive challenge. The proportionality condition is expressed in the narrowest terms possible, demanding proof that the conduct is the least restrictive option available to the dominant firm and that it is pursued for the absolute minimum period of time.[37] Second, it requires that the response does not significantly delay or hamper competitive entry.[38] It is axiomatic that successful price competition must delay or hamper entry. The only question, therefore, is whether that effect is significant. It has to be said that it is hard to envisage what sort of decision a dominant firm can make faced with that problem. To say that it may compete provided that, by and large, it fails is not compelling either to the firm or to public policy.

footnote 36 cont'd
version of Windows that did not incorporate WMP. The Commission, therefore, did not have to confront the hard choice which, in principle, this issue provokes.

[37] Discussion Paper, *supra* note 1, at paras. 81-83.

[38] *Id.* at para. 132.

III. Predation

DG COMP defines predation by reference to the conventional concepts of a short-term sacrifice that causes foreclosure and is recouped thereafter.[39] The Discussion Paper recognizes the need to distinguish between price reductions that form part of the normal competitive process and predation. The litmus tests that it proposes follow a cost-based model developed from the existing precedents. In summary:

(a) prices below average avoidable costs (AAC) infringe in the absence of credible explanation;[40]

(b) prices between AAC and average total costs (ATC) infringe if a predatory strategy can be established; and

(c) prices above ATC only infringe in extreme circumstances.

The only significant change is the replacement of the average variable costs (AVC) standard stated in *AKZO*[41] by an AAC standard.

A. THE CONCEPT OF PREDATION: SACRIFICE AND RECOUPMENT

While DG COMP's general definition of predation is founded on sacrifice and recoupment, two complementary elements of seemingly equal standing, its discussion of the evidence for predation treats recoupment as a possible, but non-essential, element.[42] DG COMP finally concludes that, in general, proof of dominance is sufficient to establish the likelihood of recoupment.[43] So, the notion of recoupment appears to progress from an element that it is important to prove independently to an element that is assumed to exist by virtue of the proof of dominance.

DG COMP bases its assumption on a finding of dominance without considering the quality of that dominance and, in doing so, does not respect its own direction to determine whether the disputed conduct is likely to have an exclusionary effect in the specific circumstances of the case.[44] In a case where dominance co-exists with active (albeit not fully effective) competition and the prey

[39] *Id.* at para. 93.

[40] DG COMP gives the conventional example of a new product launch.

[41] Case C-62/86, AKZO v. Commission, 1991 E.C.R. I-3359 (ECJ).

[42] Discussion Paper, *supra* note 1, at para. 115.

[43] *Id.* at para. 122. That is, in outcome, consistent with the position taken by the ECJ that it is unnecessary to prove recoupment because EC law does not have to wait until the predatory strategy has succeeded. *See* Case T-83/91, Tetra Pak v. Commission, 1994 E.C.R. II-755, 1997 4 C.M.L.R. 726 (CFI), and on appeal, Case C-334/94P, 1996 E.C.R. I-5951, 1997 4 C.M.L.R. 662 (ECJ).

[44] Discussion Paper, *supra* note 1, at para. 22.

remains in the market, it cannot simply be assumed that the dominant firm will be able to recover the full amount of any sacrifice that it makes.

As a general proposition, placing such weight on the sacrifice element imposes a burden that is too great for it to bear, largely because it is so hard to identify with precision whether a sacrifice has been incurred. Consider, for example, the case where a dominant firm responds selectively to an entrant's introductory price. If the dominant firm's discount is no greater than the absolute minimum that is required to win the contract and the contract makes a contribution to the dominant firm's sunk costs, it is not evident that there is any sacrifice at all: the dominant firm is better off having entered the contract than it would have been had it not entered the contract at all. The line between sacrificial and non-sacrificial behavior is hard to discern with precision and it is for that reason that evidence of recoupment is needed to strengthen the analysis.

This analysis points to the conclusion that it is a mistake to rely exclusively on any one element. A finding of predation necessitates an assessment that considers the evidence relating to sacrifice, exclusion, and recoupment to determine whether the conduct does indeed display the characteristics of a predatory strategy correctly identified by DG COMP in its introduction to this section.

B. PRICES BELOW AAC

DG COMP's treatment of pricing below AAC as presumptively predatory is unobjectionable in principle, but it does conceal a number of challenging evidential questions. First, what costs should be treated as avoidable? DG COMP contents itself with saying that, while in many cases AAC will equate to AVC, in some cases it will exceed AVC.[45]

Second, over what period of time is the possibility of avoidance to be considered? DG COMP proposes to take the period over which the alleged predation has occurred or (if it is still continuing) the period over which it is expected to occur.[46] In the latter case, is the Commission entitled to assume a period as long as it takes to secure the (assumed) foreclosure effect? Or should a finite period be selected? What basis is there, absent specific evidence, for preferring either choice?

The difficulties with a general use of the AAC standard (which could point equally to over- or under-assessment of avoidable costs) are such that, as framed in the Discussion Paper, it provides an inadequate basis on which to proceed. As a general principle, it is important that competitive harm be proved rather than presumed. That is especially important here because the location of the AAC

[45] The only specific example that it gives of the latter condition is where the dominant firm invests in excess capacity to allow it to predate. *See id.* at paras. 108 and 109.

[46] *Id.* at para. 105.

boundary could determine the outcome. Uncertainty as to its location can only chill price competition. For those reasons, it is preferable to proceed on the basis of a rule that AAC are taken to be equal to AVC unless there is clear evidence that some additional costs should be included such as the investment in excess capacity identified by DG COMP.

C. PRICING BETWEEN AAC AND ATC

DG COMP identifies three grounds, any one of which is sufficient to establish a predatory strategy. They are:

(1) direct evidence of intent;

(2) the absence of any reasonable commercial explanation for the pricing; and

(3) other sufficient indirect evidence.[47]

The most acute problems occur with the third category. By definition, there is no direct evidence of predatory intent and the strategy is capable of making commercial sense independently of its predatory effect. The question, therefore, is what factors are sufficient to justify rejection of the reasonable commercial explanation in favor of a finding that the dominant firm has a predatory strategy. DG COMP says, first, that a foreclosure effect must be shown and adds that it is usually necessary to investigate additional elements. Given that any successful price competition likely will satisfy the broad standard of foreclosure proposed by DG COMP, the additional elements become critical.

For that purpose, DG COMP identifies a list of factors—none of which is said to be necessary, but some unspecified combination of which is sufficient.[48] Of the factors identified, some are likely to be established by reason of the low pricing itself (e.g., an actual or likely exclusionary effect, the scale, duration and continuity of the low pricing, and an ability to recoup the short-term losses all fall into that category).[49] Others may be relevant, but will not be present in every case and need not be decisive differentiators (e.g., incurring specific costs in order to expand capacity that enables the dominate company to react to entry, concurrent application of other exclu-

THE CHALLENGES WITH DEALING WITH THESE CASES SUGGESTS THAT THE COMMISSION SHOULD BE WARY OF APPLYING ARTICLE 82 TO THESE PRICES IN THE ABSENCE OF CLEAR EVIDENCE OF PREDATORY INTENT OR LACK OF COMMERCIAL RATIONALE.

[47] *Id.* at para. 111 et seq.

[48] *Id.* at para. 115.

[49] It is striking that exclusion and recoupment are two essential facts to be proved in a predation case yet they are listed as optional components in the determination of whether a predatory strategy exists.

sionary practices,[50] reputational effects in other markets,[51] and the prey's particular dependence on external financing). While DG COMP includes the counter-strategies available to the prey in its list, it is not clear what significance those strategies have in the assessment process.

Absent those issues, the decisive factor is likely to be the characterization of a dominant firm's selective response to competitive entry. The narrow scope offered to the meeting competition defense, under which any successful response likely falls outside the scope of the defense, suggests an intention to prohibit any selective response that falls below ATC. An exception may be made where it can be shown that there is no sacrifice involved though, even then, the difficulties of relying exclusively on sacrifice to identify infringement discussed earlier in this paper should be recalled.

In any event, that outcome is a strong example of the dangers of the precautionary principle in a situation in which a firm, albeit dominant, confronts a number of rivals already established in the market. In such a case, price discrimination and pricing below ATC may be perfectly rational responses independently of any exclusionary effect. It is not obvious in those circumstances where the line between selective discounting that represents normal competitive behavior and selective discounting that represents predation should be drawn. While the change in behavior implicit in the concept of selective discounting may be relevant, the fact that behavior changes may simply reflect a competitive norm that could be lost through an overly extensive enforcement of predation rules.[52]

The challenges with dealing with these cases suggests that the Commission should be wary of applying Article 82 to these prices in the absence of clear evidence of predatory intent or lack of commercial rationale. When conduct has a plausible non-

[50] Reliance on the cumulative effect of disparate pieces of conduct to establish that each is an abuse requires great caution to avoid the errors of the "monopoly broth" argument now generally repudiated under U.S. law.

[51] The theory that a predatory reputation may have an exclusionary effect confronts the difficulty that the issue of predation typically arises following unsuccessful entry by a firm that was (presumably) not deterred by that reputation. In that case, as in most other cases of alleged predation, the entrant will already have incurred any sunk costs and it must be questionable, therefore, whether it is appropriate to set a rule that assumes that those costs will be recovered. It is also important to consider whether theories based on a reputation for exclusion are in fact well-founded. Paradoxically, the greater the number of instances where entry allegedly has been deterred, the more acute that requirement is-precisely because the more common the attempts at entry, the more questionable the deterrent effect of the reputation.

[52] It may be relevant to distinguish between discounts offered to retain existing customers and discounts offered to attract new customers away from the entrant. In the former case, the dominant firm's incentive to meet the threat of competitive entry is obvious and, so long as it makes a positive contribution to fixed costs, seemingly reasonable. The latter case may be more questionable but, even here, it would be useful to compare the dominant firm's behavior on this occasion with its past conduct. If its present conduct is materially more aggressive than on past occasions, that may raise legitimate questions about why it is more concerned to win that business on this occasion. Even that, however, cannot be conclusive: firms' circumstances change and what may not have been a sensible discount in the past could have become one.

predatory explanation, that explanation should prevail unless the Commission can offer convincing evidence and argument to show that it is ill-founded. In such circumstances, it is questionable whether there is (or should be) any difference between these cases and those that fall within categories (1) and/or (2).

D. PRICING ABOVE ATC

DG COMP's identification of predation in this context is heavily influenced by its existing jurisprudence, most notably *Compagnie Maritime Belge*.[53] It does, however, take a broader position that predation may occur where the dominant firm enjoys non-replicable advantages or there are substantial economies of scale such that the dominant firm could price above its ATC and still exceed the entrant's ATC. While DG COMP seeks to limit the scope of this exception,[54] the concerns expressed in relation to a finding of predation in cases where prices fall between AAC and ATC apply with even greater force here. If it is ever acceptable to treat any price exceeding ATC as predatory, then it can only be treated as such in the most exceptional circumstances where there is incontrovertible evidence that it will lead to the creation or maintenance of absolute and persistent monopoly.

IV. Rebates[55]

A. DG COMP'S APPROACH

1. Overview

It was the case law on conditional rebates[56] that, above all, sparked the review of Article 82 and it is this area that shows the most innovative thinking by DG COMP. It no longer treats a conditional rebate as the functional equivalent of

[53] Joined Cases T-24, 25, 26 and 28/93, Compagnie Maritime Belge v. Commission, 1996 E.C.R. II-1201, 1997 4 C.M.L.R. 273 (CFI), and on appeal, Joined Cases 395/96P et al., 2000 E.C.R. I-1365, 2000 4 C.M.L.R. 1076 (ECJ).

[54] It states that there must be a clear strategy to exclude on the part of the dominant firm. The entrant must only be less efficient by reason of the non-replicable advantages or economies of scale and there must be specific price cuts that have the effect of deterring and preventing entry (Discussion Paper, *supra* note 1, at para. 129).

[55] This topic has been the subject of extensive academic debate in recent years. *See* J. Kallaugher & B. Sher, *Rebates Revisited: Anti-competitive effects and exclusionary abuse under Article 82*, 25(5) Eur. Competition L. Rev. 263-285 (2004) and RBB Economics, Selective Price Cuts and Fidelity Rebates (U.K. Office of Fair Trading, Economic Discussion Paper, Jul. 2005. For an extended discussion, see the papers presented at European University Institute's Eighth Annual EU Competition Law and Policy Workshop, *available at* http://www.iue.it/RSCAS/Research/Competition/2003(papers).shtml and Symposium, *A Symposium on Loyalty Rebates*, 1(2) Competition Pol'y Int'l 89 (2005).

[56] The Discussion Paper distinguishes between rebates that are conditional on the purchaser's buying behavior (such as purchasing a definable quantity of goods from the dominant firm) and those that are unconditional (such as those that are offered in respect of all the purchases made by selected customers). This paper is concerned solely with DG COMP's treatment of conditional rebates.

an exclusive dealing contract, recognizing that theories of predation have something relevant to say about the topic.

The essence of DG COMP's theory is that a rebated price is abusive (absent justification) unless either it covers the dominant firm's ATC or there is no evidence of possible foreclosure.[57] In applying that theory, DG COMP devises different price/cost models for retrospective rebates[58] and prospective rebates.[59] In both cases, narrowly circumscribed efficiency defenses are envisaged, but a meeting competition defense is ruled out.

It should be noted that the Advocate General in *Virgin/British Airways (ECJ)* takes no account of DG COMP's new thinking, saying that that case has to be decided under current legal standards.[60] In that context, the Advocate General says that, while the classes of exclusionary rebates are not closed, such an effect is to be expected in the normal course of events where targets are individually defined and retrospective rebates are employed.[61]

2. Retrospective Rebates: The Price/Cost Standard

DG COMP proposes a standard under which the rebate should fail if the share of the market at which the rebated price covers the dominant firm's ATC is greater than the share that an efficient entrant can reasonably be expected to capture.[62] That standard is explained by reference to a simple rebate system where there is a single threshold above which purchases qualify for a rebate on a

[57] In the case of retrospective rebates, that occurs where (a) the rebate scheme does not affect a substantial part of market demand, (b) the threshold is set substantially below the level that customers would expect to buy from the dominant firm in any event, or (c) there are clear indications of a lack of foreclosure effect such as aggressive and significant entry and/or expansion by customers and/or switching of customers. In the case of prospective rebates, DG COMP only articulates the first of those possibilities.

[58] Retrospective rebates are rebates that apply to the totality of a customer's purchases once a certain threshold has been passed.

[59] Prospective rebates are rebates that only apply to the portion of the customer's purchases that exceed the threshold.

[60] *See Virgin/British Airways (ECJ)*, AG Opinion, *supra* note 5, at para. 28.

[61] *Id.* at paras. 47 et seq. The Advocate General also refers to the defendant's dominance, but that is necessarily present in any event (*id.* at para. 52). Although the Discussion Paper advances DG COMP's thinking in this area, it remains the case that under its new standards, retrospective rebates based on individual sales targets would only escape prohibition in exceptional cases. The Advocate General's opinion does not, therefore, create a material obstacle to the evolution of the law in the way contemplated by DG COMP.

[62] Assuming a standard progressive rebate schedule (such that, as the volume of rebated sales increases, the marginal price declines), this test implies that the dominant firm's effective discounted price does not exceed its average total costs.

single scale.[63] The litmus test stated by the model is based on a comparison of two market shares:

(1) The required share, that is the share of the market at which the rebated price covers the dominant firm's ATC where:

   a) The rebated price is calculated on the basis that the entirety of the rebate is allocated to the sales that comprise the required share; and

   b) The ATC are calculated on the basis of a volume equal to the threshold specified in the rebate scheme.

(2) The commercially viable share, that is the share of the market that an efficient entrant can reasonably be expected to capture.

Having established those two shares, the test is disarmingly simple. If the commercially viable share exceeds the required share, the rebate scheme is non-exclusionary. Conversely, if the required share exceeds the commercially viable share, the rebate scheme is exclusionary.[64]

3. Prospective Rebates: The Price/Cost Standard

In the case of prospective rebates, DG COMP proposes a more straight-forward application of its predation standards under which a rebate should fail if the rebated price for purchases above the threshold does not cover the dominant firm's ATC.[65]

B. COMMENTARY

This commentary is organized in the following way. First, it sets out some reasons why DG COMP's approach to rebates, of both forms, is unduly restrictive. It follows with a consideration of two topics that present particular difficulty, namely the selection of a benchmark based on ATC and the treatment of retrospective rebates. Finally, it advances an alternative approach to that proposed in the Discussion Paper.

1. DG COMP's Overall Approach Is Unduly Restrictive

DG COMP acknowledges that rebates have an ambivalent effect, with the capability both to enhance efficiencies and to foreclose competitive entry and expan-

[63] DG COMP does not elaborate on the application of its model to multi-tier rebate structures. As discussed in this paper, the differences between retrospective and prospective rebates once the initial threshold has been exceeded may not be large (*see* Section IV.B.3 of this paper).

[64] Discussion Paper, *supra* note 1, at paras. 155 and 156.

[65] *Id.* at paras. 166-169.

sion.[66] Consistent with its general approach, however, it applies its precautionary principle to the assessment of rebates. That approach is mistaken for two reasons: first, it takes an unduly narrow view of the pro-competitive function of rebates and, second, it takes an unduly optimistic view of the effect that regulation may have.

DG COMP's approach ignores two connected factors: first, conditional rebates may be an element in price competition and, second, rebates may achieve efficiencies that are no less real even though they do not approach the level of specificity or proof demanded by DG COMP. Those propositions are evidenced by the behavior of firms that commonly employ conditional rebates (of either form) even though they lack market power. In some cases, the starting point is a disagreement over price that is resolved by the use of a conditional rebate in what is a simple commercial deal trading volume for price. That rebate is quite likely to be a retrospective rebate, reflecting the fact that the deal is essentially one about the price for the totality of the supplies. From the supplier's perspective, the justifications for the rebate no doubt include the efficiencies that it derives from a strengthened expectation that the threshold volume of sales will be accomplished in the broad sense that likely capacity utilization over an extended period is increased.[67] There is no reason to believe that those factors are systematically inapplicable to dominant firms' employment of rebates. Similarly, in a distribution context, rebates provide a sales incentive that is useful to dominant and non-dominant firms alike.[68] It is, therefore, a mistake to proceed on the basis that a strict abuse standard has no adverse welfare consequences.

The strictness of that standard should be contrasted with DG COMP's faith in the price neutrality of regulatory intervention that is apparent in its statement: "The customer may not derive a direct benefit from the rebate system as the rebate may only bring the average price down to the level existing without the rebate system."[69] If that is intended to be a general proposition, then it is optimistic as an assessment of a dominant firm's likely behavior and mistaken as to the technical structure of prices under the two scenarios.

It assumes that the dominant firm would prefer to sacrifice the higher margin that it obtains on the assured sales for the prospect of a volume of contestable sales equal to that achieved with the rebate. That assumption fails, at least as a

[66] *Id.* at para. 138.

[67] A parochial example is provided by the experience of law firms where conditional price deals of the kind described in the text are not uncommon. Law firms' principal costs (staff, premises, and technology) are effectively fixed over a longer period than demand. There is, therefore, significant value in a pricing structure that gives greater assurance (though rarely certainty) of order flow.

[68] For example, in *Virgin/British Airways (CFI)*, BA's competitors also offered incentive commissions of the kind employed by BA.

[69] Discussion Paper, *supra* note 1, at para. 154.

general proposition, because the dominant firm may rationally prefer to retain the higher margin, especially where (absent the rebate) there must be a reduced expectation that it will achieve the same level of sales. DG COMP cannot consistently maintain that the rebate is objectionable because it induces increased sales and that removal of the rebate has no effect on such sales. In cases where that assumption does fail, there must be a probability that the price to the assured base will be held constant or, at least, not reduced to the average level produced by the rebate and that the effective price paid in respect of the contestable sales will rise.

More technically, the structure of the rebate systems that DG COMP opposes is such that their prohibition must reduce the intensity of price competition, at least in the short run. As DG COMP notes, the marginal price charged by the dominant firm is substantially below its average price.[70] It follows that the marginal price for the next unit that is not sold by the dominant firm will be even lower. As it is that price that a competitor must beat in order to secure a sale, even if the average price remains constant, raising the marginal price to equal the average price must raise the price that the competitor has to beat.

This is not to argue that rebates cannot have a foreclosure effect or that the Commission should not apply Article 82 to such cases. However, the balance of benefit and harm posed by rebates is far more complex than DG COMP allows and the precautionary principle that it has applied risks a loss of consumer welfare that may not necessarily be compensated by the long-term structural changes that it seeks to promote.

2. Universal Application of an ATC-based Standard Is Inappropriate

While DG COMP correctly stresses the importance of using predation theory to assess rebates, its implementation of that theory in this context requires that the dominant firm's effective price for sales that are, or should be, contestable must exceed the firm's ATC. By comparison, other commentators have proposed a test based on the dominant firm's AAC.[71] DG COMP justifies its departure from normal predation theory on the basis that, because the rebate structure is self-sustaining over the long term, it does not involve any sacrifice on the part of the dominant firm.[72]

[70] *Id.* at para. 153.

[71] *See* R. O´Donoghue, *Over-Regulating Lower Prices: Time for a Rethink on Pricing Abuses under Article 82 EC*, and D. Ridyard, *Article 82 Price Abuses - Towards a More Economic Approach*, presented at European University Institute's Eighth Annual EU Competition Law and Policy Workshop, *available at* http://www.iue.it/RSCAS/Research/Competition/2003(papers).shtml. *See also* H. Hovenkamp, *Discounts and Exclusions*, University of Iowa Legal Studies Research Paper, Number 05-18 (August, 2005).

[72] Discussion Paper, *supra* note 1, at para. 154.

In taking that approach, however, DG COMP loses sight of two things. First, its analysis of predation correctly recognizes that it is necessary to fashion a rule that avoids undue constraints on price competition by dominant firms. DG COMP's approach to this issue neglects the fact that rebates are commonly a form of price competition and in effect treats the attachment of purchase conditions to a rebate program as conclusive proof of a strategy to predate. Second, the sacrifice analysis is a part of an analytical framework that is useful to differentiate 'good' from 'bad' price competition in certain situations. It does not follow from its inapplicability in other situations that a full cost recovery benchmark is dictated in those cases. The challenge remains to consider whether, as a matter of general principle and in the specific circumstances at hand, a rebate structure that produces an effective price below ATC should be held to have an anticompetitive effect.

So far as general principle is concerned, DG COMP's proposed test would capture discounts that are perfectly rational for any firm (dominant or not) to employ, independently of any exclusionary effect, thus weakening the intensity of competition already existing within the market. Given that state of affairs, Article 82 should not be applied in a way that is predisposed towards the prohibition of all conditional rebates that yield an effective incremental price below ATC. Furthermore, consistent with the approach to predation that should be adopted, it should be incumbent on the competition authority or the plaintiff to produce additional evidence and analysis that is sufficiently convincing to show that a substantial lessening of competition is likely to occur where the effective price exceeds AAC.

IT SHOULD BE INCUMBENT ON THE COMPETITION AUTHORITY OR THE PLAINTIFF TO PRODUCE ADDITIONAL EVIDENCE AND ANALYSIS THAT IS SUFFICIENTLY CONVINCING TO SHOW THAT A SUBSTANTIAL LESSENING OF COMPETITION IS LIKELY TO OCCUR WHERE THE EFFECTIVE PRICE EXCEEDS AAC.

3. The Treatment of Retrospective Rebates Is Unduly Hostile

The intensity of the attention that the Discussion Paper devotes to retrospective rebates suggests that if there is one way in which DG COMP wishes to influence dominant firms' behavior, it is to abandon such rebates. If there is any justification for a conditional rebate, it appears to say, it will be satisfied by a prospective rebate. Such a position, if it were to be intended, would ignore the pro-competitive value that such rebates can have. Even if the Discussion Paper does not intend to go that far, it overstates the differences between the two types of rebate and, as a result, proposes a regime for retrospective rebates that is unduly rigorous.

At a conceptual level, the difference between the effects that retrospective and prospective rebates are capable of having is insignificant. A simple example, set out in the following table, illustrates the point.

Figure 1

Level	Sales (£m)	Rebate (£K)	Prospective rebate		Retrospective rebate	
			%	Per unit (£)	%	Per unit (£)
0	< 1.0	0	–	–	–	–
1	1.0 – 1.099	5	5	4	.45	4.5K/0.36
2	1.1 – 1.199	15	10	8	1.25	13.75K/1.00
3	1.2 – 1.299	30	15	12	2.3	27.6K/1.84

Note: Calculations assume an unrebated unit price of £80. The rebate in column 3 represents the total rebate payable for sales within the corresponding range stated in column 2. The unit values for retrospective rebate state, first, the value payable for the sale at the change of level and, second, the value payable for other sales within the level.

The example is, of course, oversimplified, but it does illustrate two obvious yet important points. First, the difference between the two types of rebate is a function of system design not inherent concept. Therefore, care should be taken to avoid rules that are based on the latter without allowing for consideration of the former. Second, the incentive created by a retrospective rebate is uneven while the incentive created by a prospective rebate is more consistent. Although a retrospective rebate clearly creates stronger incentives at the thresholds, a prospective rebate creates stronger incentives for sales between the thresholds. Which of those is the more important is once again a matter of design in the case at hand, not concept, especially when dealing with second and subsequent levels in multi-level schemes.

That said, the potential to design schemes where that impact is substantial means that a model that seeks to determine the effect of the scheme on sales below the initial threshold may be useful. In broad concept, the model proposed by DG COMP is not unreasonable, but there are three substantial areas of difficulty:

(1) It adopts a price/cost benchmark based on ATC that, for the reasons that already have been discussed in this paper, are fundamentally mistaken.

(2) The test is dependent on identifying the commercially viable share, that is the share of the market that an efficient entrant can reasonably be expected to capture. DG COMP states that it initially will base its assessment on the position of a competitor who wants to enter at minimum efficient scale.[73] However, that operates only as a measure of efficiency, not entry. We are left with a completely open question as to the level of entry that such a competitor should be assumed to achieve. That problem is made more acute by the absence of any guid-

[73] *Id.* at para. 157.

ance as to the period over which a competitor's entry and expansion should be assessed. The focus is, moreover, on structural change rather than the rivalry that may occur within a given structure.

In the aggregate, the document points to a commercially viable share that is to the lower end of the plausible range. The significance of that lies in the fact that the lower the commercially viable share, the more likely it is (all else equal) that the rebate will fail the test. That, coupled with the fact that the test is based on a decision maker's assessment of likely performance rather than a cost-based assessment of comparable efficiency, means that the test provides dominant firms with a limited and unreliable basis on which to determine their behavior.

(3) DG COMP adds the rider that a retrospective rebate will be presumed to deter switching and so enhance loyalty where the rebate is either based on a percentage of customers' total requirements, is an individualized volume target, or is a standardized volume target where the thresholds are well targeted to customers' purchasing requirements.[74] It is unclear whether these features (which of course correspond to those found in the precedents that DG COMP is anxious to preserve) supplement or replace the price/cost model. Probably, they will be taken into account as a ground for (further) reducing the commercially viable share. No indication is given, however, as to the extent to which that will happen. Of course, it may be said that that is impossible outside the specific facts of a particular case but, conversely, that makes it impossible for a dominant firm to predict the likely application of the test and further diminishes its utility as a source of guidance for courts, agencies, or firms.

THE ASSESSMENT OF REBATES OF ANY FORM SHOULD BE BASED ON AN OVERALL CONSIDERATION OF WHETHER THEY SIGNIFICANTLY LESSEN COMPETITION BY COMPARISON WITH THE POSITION THAT WOULD BE CREATED FOLLOWING REGULATORY INTERVENTION.

4. An Alternative Approach[75]

Consistent with the approach advocated above, the assessment of rebates of any form should be based on an overall consideration of whether they significantly lessen competition by comparison with the position that would be created following regulatory intervention. While that involves an assessment of substantially the same issues discussed by DG COMP, it requires a fundamentally different approach to their content and application.

[74] *Id.* at paras. 158 and 159.

[75] This paper does not claim striking (or indeed any) originality for any sensible features of this proposal. There is, for example, a parallel discussion in RBB Economics' study (*see supra* note 55) which overlaps significantly, though not wholly, with this discussion.

The starting point is identification of an appropriate price/cost benchmark. For the reasons already stated in this paper, DG COMP's use of a benchmark based on ATC is mistaken. Use of that benchmark is not appropriate unless it is clear that the dominant firm's ability to charge an effective rebated price that is below ATC does indeed have an exclusionary effect and that requiring the dominant firm to raise that price to cover ATC would not lessen the intensity of competition currently prevailing in the market. That would not be expected to occur unless the dominant firm enjoys a virtual monopoly and it is evident that the rebate structure does have a material deterrent effect on entry.

When dealing with facts where there are established competitors in the market, the benchmark should not be lower than the dominant firm's AAC over the range of sales affected by the rebate scheme and should not exceed the AAC over the same range of a competitor that has the scale of the next largest firm and that is otherwise as efficient as the dominant firm.[76] The reason for selecting the upper bound is that rational competitors would disregard the sunk costs that fall between AAC and ATC in their pricing decisions and, therefore, would be willing to lower prices to that level. To set a threshold at a level that is higher than that would result in an immediate lessening of competition that would only be justified if there were strong grounds for believing:

(a) that encouraging further entry or expansion would eventually produce a market structure in which competition is more intensive than it is otherwise likely to be and

(b) that longer term gain outweighs the short-term loss of competition.

It seems that those requirements would rarely, if ever, be satisfied where the present facts are consistent with single firm dominance. They might be satisfied where the present facts reflect collective dominance, but that requires a level of analysis that the Discussion Paper does not attempt.

The merit of the lower bound is that it is, self-evidently, consistent with the as efficient competitor standard. It would capture any incremental fixed costs to be incurred by the dominant firm while, conversely, making proper allowance for any economies of scale or scope. The fact that it would disregard the greater investments potentially required of a smaller competitor in order to achieve a similar expansion is implicit in the notion of the as efficient competitor standard.[77] Many commentators would likely say that that should be dispositive of the issue. For them, there are no circumstances in which a rebate scheme that

[76] In this context, the selection of AAC has greater merit than in the case of conventional predation because the typical rebate scheme is likely to be a much longer-run strategy than the paradigm cases of predation. That does not mean that the use of an AAC benchmark in this context is wholly free from the difficulties discussed in the context of predation, but they are not so substantial as to compel selection of an alternative benchmark.

[77] See the discussion of the nascent "as efficient" competitor in Section II.A.2 of this paper.

satisfies that standard should be challenged and, even if there are risks that competitive entry or expansion would be constrained, they are outweighed by maximizing the retained level of price competition and by minimizing the incidence of false positives that would otherwise occur.

Even if that goes too far, at a minimum, those factors mean that strong grounds should be required to intervene where the rebated price does exceed the lower bound provided by the dominant firm's AAC. It would be necessary to identify evidence that demonstrates that an effective price between the upper and lower bounds will constrain the growth of effective competition by established or new competitors and that the design of the scheme indicates the pursuit of a strategy to exclude rather than the pursuit of any legitimate commercial objective. Among the factors that should be considered in that respect are:

(1) *The scale of the divergence between the upper and lower bounds*. Further inquiry should only be undertaken when the divergence is substantial because it is only in those circumstances that a rebate scheme falling into that range can have the significantly constraining effect on competition that is necessary to justify intervention.[78]

(2) *Actual evidence of the scheme's impact on entry and expansion by rivals*. DG COMP acknowledges that that is a relevant factor but only, it seems, if it can be regarded as aggressive and significant. Certainly, it has to be assumed, both from the language of the Discussion Paper and from the express endorsement of both *Michelin II* and *Virgin/British Airways (CFI)* (where evidence of market share loss was advanced without success), that it will not prevail unless there is evidence of a substantially greater loss of position than either of those companies suffered. Indeed, it might be said that the loss envisaged is so substantial that it would require a level and intensity of competition sufficient to cast doubt on a finding of dominance.[79]

[78] Parenthetically, it may be said that the existence of a substantial gap between the two AAC values indicates that there are substantial efficiencies associated with the dominant firm's sales such that intervention creates a significant risk of promoting inefficient entry. That could lead to the proposition that either the efficiency gap is slight, such that the risk of successful foreclosure is too small to justify intervention, or that the efficiency gap is large, such that the risk of inefficient entry is too large to justify intervention. While that may be so, it is not sufficiently persuasive to conclude the inquiry without further investigation of the issues of competitive effect. It does underscore, nonetheless, the need for that inquiry to be rigorous.

[79] Any argument that evidence of actual entry or expansion contradicts foreclosure is always vulnerable to the riposte that, but for the conduct in dispute, that entry or expansion would have been even greater. So stated, that is an unanswerable proposition because there is no evidence that can be advanced to contradict it. Indeed, as soon as it is accepted that the rebate program secures the dominant firm an extra sale, the proposition is substantiated. At the same time, that renders the debate meaningless. The step forward that the Discussion Paper does take is to restore meaning to that debate. The question is now no longer an unanswerable counterfactual but a question of the level of entry that contradicts foreclosure.

That approach is overly demanding. Evidence of continuous market share loss or fluctuating market shares suffered by the dominant should be sufficient to show that a rebate scheme does not have an exclusionary effect.

(3) *Counter-strategies available to competitors*. This concept should be construed broadly to include the availability of alternative distribution channels as well as other commercial responses. DG COMP itself says that, in assessing likely foreclosure effects, "[the Commission] will also consider the possibilities of the existing and possible future competitors to curb and counter the fidelity enhancing potential of the dominant company's conduct."[80] When read with the remainder of the Discussion Paper, however, that consideration appears to be too limited and undemanding. Where the answer lies in any particular case requires an assessment of its specific facts in which actual market evidence must be more compelling than prediction. In assessing that evidence, close attention should be paid to the fact that the dominant firm's rivals have managed to establish themselves in the market. If that has occurred despite the existence of the rebate scheme, then the Commission should approach claims that further expansion is constrained with a healthy measure of skepticism.

If, and only if,

(a) the scale of the divergence between the upper and lower bounds is substantial,

(b) the dominant firm's market share is stable or increasing, and

(c) there is insufficient evidence of available circumvention strategies

is it then necessary to consider whether the rebate scheme is predatory. Each of the specific factors enumerated below could be perceived as evidence of such a strategy.

(4) *The use of a retrospective rebate*. Although DG COMP's treatment of retrospective rebates is unduly harsh and draws an excessively sharp distinction between them and prospective rebates, it is equally not possible to exclude the fact that a retrospective rebate can have a particularly strong effect at the initial threshold.[81] The larger the value of the initial rebate relative to the customer's total purchases, the more

[80] Discussion Paper, *supra* note 1, at para. 144.

[81] As noted above, one cannot generalize about the relative effects of retrospective and prospective rebates at subsequent levels in a multi-tier scheme. The retrospective rebate's stronger effect at the thresholds is counterbalanced by the prospective rebate's stronger effect between the thresholds. Their relative potency in a specific case depends on factors such as the relationship between average order size and the scale of the levels. The closer together the two are, the more plausible it is to say that a retrospective rebate continues to exercise a suction effect throughout the range of the rebate scale. Conversely, the further apart they are, the less plausible such a claim is.

plausible it is to think that the rebate structure might be acting as a constraint. In those circumstances, it would be necessary to test the initial rebate's price/cost relationship. For that purpose, a structure similar to that devised by DG COMP would probably be necessary subject to modifications to:

(a) substitute AAC for ATC[82] and

(b) clarify the assessment of a commercially viable share.[83]

(5) *The degree of correlation between the initial threshold and increments in efficiency*. It would be a contrary indicator if the thresholds (especially the initial threshold in a retrospective rebate scheme) were set at a level that manifestly bears no relationship with the increments in efficiency (such as economies of scale and scope that partially explain the employment of rebates), especially if those increments occur at sales levels significantly lower than the thresholds. That factor would tend to confirm that the rebate was designed to exploit the higher assured base of sales that the dominant firm enjoys.

When considering this factor, it should be recalled that we only reach this point in the analysis where the divergence between the upper and lower bounds is substantial, implying that there are substantial economies to be achieved by growth to the scale of the dominant firm. It is perfectly possible, therefore, that an initial threshold that is set significantly above the level of sales achieved by rivals would be reasonable.

(6) *The format of the rebate*. At least in the context of retrospective rebates, DG COMP treats rebate structures based on percentage requirements, growth in purchases, individualized targets, and well-targeted standardized targets as presumptively loyalty-enhancing. That observation may be reasonable in a limited number of cases, where the targets directly or indirectly account for a high proportion of customers' requirements, but, otherwise, they appear insufficient to strengthen the case that the rebates have an exclusionary effect.

(7) *Other evidence of exclusionary intent*. Is there other credible evidence available to suggest that the rebate scheme has been designed to exclude or limit the growth of competitors rather than meet legitimate business objectives? That said, such evidence should be treated with skepticism if there is limited evidence of exclusionary intent that can be derived from points (4), (5), or (6) given that, if such intent exists, one would expect it to manifest itself in at least one of those ways.

[82] Admittedly, application of an AAC-based model would not be easy and further work would be required to establish a robust approach.

[83] So far as possible, the subjective elements in the structure proposed by DG COMP should be excluded.

> A conventional predation analysis should conclude by asking whether recoupment is plausible, normally through raised prices following foreclosure brought about by price reduction. In this context, where that initial sacrifice is not an essential feature of the strategy, the question manifests itself rather in the form of whether it enables the dominant firm concurrently to maintain prices at a level higher than they would be otherwise. Essentially, that becomes subsumed in the general question of whether the rebate substantially lessens competition. While the specific factors suggested above should inform that analysis, they cannot exclude the need for a full assessment of the effects of the conduct that is under scrutiny.

Finally, it is important to recall that this is only the first stage in the process. Even if the rebate scheme fails these tests, it is still open to the dominant firm to advance a legitimate business reason to justify the scheme. The Discussion Paper places severe constraints on the justifications that may be advanced. Not only does it do inadequate justice to the efficiency arguments that may be advanced, it wholly excludes the possibility of relying on a meeting competition defense. There is insufficient justification for such an approach. If competitors choose to use a rebate scheme as a competitive tool, it must be permissible (and desirable for consumer welfare) for a dominant firm to respond proportionately in the same way.[84]

V. Tying[85]

A. DG COMP'S APPROACH

DG COMP adopts a conventional approach to the definition of tying,[86] identifying the four usual elements, namely that:

(1) there are distinct tying and tied products;

(2) the firm concerned is dominant in the market for the tying product;

[84] It is not a sufficient response to that observation to say that competitors' use of a rebate scheme may be an effort on their part to mitigate the dominant firm's scheme. The fact that they are able to use a scheme that is structurally comparable with that of the dominant firm tells us something important about the conditions of competition on that market.

[85] For a recent discussion of this area, *see* Colloquium, *A Colloquy on Tying*, 1(1) COMPETITION POL'Y INT'L 1 (2005). *See also* B. Nalebuff, *Bundling, Tying and Portfolio Effects*, DTI ECONOMICS PAPER 1, Feb. 2003, *available at* http://www.dti.gov.uk/ccp/topics2/pdf2/bundle1.pdf and C. Ahlborn, D. Evans, & J. Padilla, *The Antitrust Economics of Tying: A Farewell to Per Se Illegality*, ANTITRUST BULL. (2004).

[86] Tying is defined broadly to cover both contractual and technological tying as well as pure price bundling (where the products are only available at the bundled price) and mixed price bundling (where the bundled price offers a discount to the sum of the stand-alone prices at which the bundle components are offered).

(3) the tying practice is likely to have a market-distorting foreclosure effect; and

(4) there are no efficiency or other justifications for the tying practice.

The discussion of the (critical) third test concludes that:

> "Where the Commission . . . finds that the dominant company ties a sufficient part of the market, the Commission is likely to reach the rebuttable conclusion that the tying practice has a market distorting foreclosure effect and thus constitutes an abuse of dominant position."[87]

DG COMP envisages that a tie may be justified where it produces cost savings or an improved product provided that it satisfies the four general pre-conditions.

B. COMMENTARY

The Discussion Paper says little about this topic that is new, a fact that is unsurprising given that *Microsoft* is pending before the CFI. Therefore, it will not satisfy those critics who have said that EC law's predisposition to prohibit tying mischaracterizes a commercial practice that has a ubiquity (among dominant and non-dominant firms alike) that argues strongly that it is generally efficiency-enhancing and, therefore, merits a predisposition to permit.[88]

The Discussion Paper acknowledges at the outset that tying and bundling are common practices that often have no anticompetitive consequences for dominant or non-dominant firms alike.[89] The Discussion Paper correctly qualifies that general assessment by saying that tying can, in certain circumstances, lead to anticompetitive consequences, of which foreclosure is the only issue that is considered in this paper.[90] It then moves from that premise to articulate the general rule (quoted above) that, provided it has sufficient market coverage, a tying policy will give rise to a "rebuttable" presumption of abuse.

[87] Discussion Paper, *supra* note 1, at para. 188.

[88] For a detailed discussion of these issues, see the articles cited in *supra* note 85.

[89] Discussion Paper, *supra* note 1, at para. 178.

[90] *Id.* at para. 179. Price discrimination and price elevation are exploitative abuses and so fall outside the scope of this paper. They will be considered in the second phase of DG COMP's study.

Given DG COMP's own starting point, that is inappropriate. First, as a matter of general principle, the legal burden rests on the Commission to establish the essential elements of the abuse. In this context, DG COMP's Discussion Paper suggests that foreclosure arises in three specific situations.[91] If indeed they do define the circumstances in which tying may give rise to market foreclosure, then proof that one or more of those circumstances exists forms an essential part of establishing the abuse that must be discharged by the Commission.

Second, the adverse effects specified by DG COMP appear to be dependent on a more severe degree of foreclosure than is consistent with its general description of foreclosure, that is any limitation on a rival's entry, expansion, or competitive independence.

Third, the finding of foreclosure presupposes the existence of a tie. DG COMP's discussion of that topic requires development in the contexts of technological tying and mixed bundling. It presupposes that the incorporation of one product into another necessarily creates a tie between those products without addressing the question whether that has the quality of coercion that is the hallmark of a hard tying practice.[92] As for mixed bundling, it stipulates a standard for the pricing of the tied component of the bundle based on the long run incremental costs associated with that product.[93] That approach is equivalent to the use of an ATC-based standard for rebates and is open to objections comparable with those discussed in that context.

Fourth, the generally benign assessment of tying sits uneasily with the very limited circumstances under which DG COMP contemplates that a tie may be justified. That problem, of course, is particularly acute if the law states an overly broad prohibition (although the correct solution is to restate the scope of the prohibition). Independently of that issue, a defense based on necessity must discount valuable efficiency gains. This is particularly relevant to the case of product integration.

More specifically, the Discussion Paper's approach to efficiencies ignores metering as a non-exclusionary commercial explanation for tying. Admittedly, that may raise issues of exploitation (both as to price discrimination and price elevation) which will require consideration in that part of DG COMP's analysis.

[91] Namely, where (a) foreclosure in relation to the tied product is caused by a reduction in the number of potential customers available to firms that only supply the tied product, leading to their marginalization, exit, or restricted entry, or (b) foreclosure in relation to the tying product is caused by (i) making it impossible to supply the tying product without also supplying the tied product or (ii) causing exit in respect of a tied product that could eventually compete with the tying product.

[92] This issue is central in *Microsoft* where the company argues that consumers' ability to download alternative media players at no cost means that the integration of Windows Media player into the Windows operating system lacks any coercive element.

[93] Discussion Paper, *supra* note 1, at para. 190.

However, it would be wrong to preempt that debate by fashioning a rule that treats tying in such circumstances as an unjustifiable instance of foreclosure.

DG COMP's treatment of the transmission of consumer benefits is obscure. It says that tying should be considered abusive when a retailer is able to obtain, on a regular basis, supplies of equivalent products on the same or better terms than those offered by the supplier that applies the tying practice, as evidently the pass on is not realized. In the first instance, it is necessary to consider how, in those circumstances, the tie creates a market foreclosure that requires justification. If the relevant products (it is not clear whether tying and tied products or tied products alone are intended) are available on the same or better terms, one would expect customers to buy them. Second, that caveat reduces consumer benefit to a matter of price or other contractual terms. There may well be other non-contractual benefits that customers derive from the tie (such as the convenience of the combination for which they may be willing to pay more) that are cognizable under this standard. Indeed, the fact that customers are willing to pay more for a tied product when the untied products are freely available may simply confirm the value of the tie to customers, not its harmful effects.

THE FACT THAT CUSTOMERS ARE WILLING TO PAY MORE FOR A TIED PRODUCT WHEN THE UNTIED PRODUCTS ARE FREELY AVAILABLE MAY SIMPLY CONFIRM THE VALUE OF THE TIE TO CUSTOMERS, NOT ITS HARMFUL EFFECTS.

VI. Refusal to Supply[94]

A. DG COMP'S APPROACH

DG COMP's discussion of refusal to supply broadly reflects the existing jurisprudence of the EC Courts and the Commission's own decisional practice. It differentiates three principal categories. In all three cases, it is necessary to show that the refusal is likely to have a negative effect on competition and the refusal may be excused by an objective justification. The three cases are differentiated in that:

(1) where the refusal concerns the termination of supplies to an existing customer, no additional element needs to be established;

(2) where the refusal concerns the refusal to start supplying an input, it is also necessary to establish that that input is indispensable to a firm's ability to carry on normal economic activity in a downstream market; and

[94] For a recent discussion of these issues, *see* Symposium, *Aspen Skiing 20 Years Later,* 73 ANTITRUST L.J. 59 (2005). *See also* D. Geradin, *Limiting the scope of Article 82 EC: What can the EU learn from the U.S. Supreme Court's judgment in Trinko in the wake of Microsoft, IMS and Deutsche Telekom?*, 41 COMMON MARKET L. REV. 1481-1518 (2004) and C. Ahlborn, D. Evans, & J. Padilla, *The Logic & Limits of the Exceptional Circumstances Test in Magill and IMS Health*, 28 FORDHAM INT'L L.J. 1109-1156 (2005).

(3) where the refusal concerns the refusal to license an intellectual property right, it is also necessary to establish that:

(a) the IPR is indispensable (as described in the previous case); and

(b) the would-be licensee intends to produce new goods or services for which there is a potential consumer demand and that are not simply duplicative of those supplied by the dominant firm already.

At the end, DG COMP tacks on two brief and somewhat opaque paragraphs to deal with the refusal to supply interoperability information that clearly have been included with *Microsoft* in mind. They state that, while a dominant firm generally is not obliged to secure interoperability between one market and another, it may be an abuse to use the refusal of interoperability information to leverage market power from the dominated market into another market and, in those circumstances, lower intervention thresholds (for example, with regard to the protection of trade secrets) may be justified.[95]

B. THE CONCEPT OF A MARKET IN THE CONTEXT OF REFUSAL TO SUPPLY CASES

Refusal to supply doctrines are commonly described, as they are by the Discussion Paper, in terms of upstream and downstream markets. The way in which the concept of a market is defined for this purpose determines the circumstances in which a refusal to supply can be challenged. In straightforward cases, such as those involving a termination of existing supplies, the fact of the existing commercial relationship answers the question of whether there are two separate markets.

Cases where the complaint is that such relationships do not exist when they should raise potentially more complex questions about the delineation of markets. DG COMP restates the answer provided by the ECJ in *IMS Health* to the effect that, for this purpose, "it is sufficient that a potential market or even hypothetical market can be identified."[96] While the Discussion Paper simply echoes existing EC law, it is important to appreciate the implications of that ruling for cases where new supplies are demanded. Although the Discussion Paper continues to use the terminology of vertical market relationships, it is clear that Article 82 can be applied to require the supply of an input by one competitor to another horizontal competitor where the requirements of competitive impact, indispensability, and novel product are met.

C. ALL CASES: A NEGATIVE EFFECT ON COMPETITION

DG COMP states that satisfaction of this condition depends on the state of the pre-existing competition in the downstream market. Two specific cases are dis-

[95] Discussion Paper, *supra* note 1, at paras. 241 and 242.

[96] *Id.* at para. 227. *See IMS Health*, *supra* note 17, at para. 44.

cussed. In the first case, where the dominant firm is not present and there are several competitors in the downstream market, a negative effect is said to be unlikely unless the refusal to supply is likely to lead to collusion in that market. The second case concerns the situation where the dominant firm is present in the downstream market and there are few competitors present in that market. In that case, DG COMP draws a distinction between the termination of existing supplies and the refusal to commence supplies.[97] Where supplies are terminated, a negative effect on competition will normally be presumed. Where supplies are not commenced, DG COMP simply says that a negative effect is more likely than in the first case (where the dominant firm is not present and there are several competitors in the downstream market).

In no case is it necessary that competition should be completely eliminated in the downstream market. Beyond that, DG COMP does not specify in its assessment of the different classes of refusal what level of competitive impact is necessary to engage Article 82. In its earlier description of refusal to supply, it describes the exclusionary effect as exit, marginalization, or non-entry of the competitor to the downstream market and goes on to say that "[f]or a refusal to supply to be abusive, it must . . . have a likely anticompetitive effect on the market which is detrimental to consumer welfare."[98]

Although this test is common to all three forms of refusal to supply, it is likely that not only its application but also its content will depend on whether the refusal concerns a termination of existing supplies or a refusal to commence supplies. In the latter case, as the content of the test cannot be separated from the additional indispensability and new product tests, the discussion will be continued in the subsequent sections that address those tests.

In the case of termination, there is no additional requirement to be fulfilled. Nonetheless, DG COMP's assessment of foreclosure in such cases is unsatisfactory in a number of respects. First, it says that foreclosure will be presumed where supplies to one of the dominant firm's few competitors on that market are terminated. That statement conflicts with its own direction to consider the specific market impact of the disputed conduct.[99] Second, in any event, it is silent as to the number of competitors that constitutes "a few" for this purpose and the criteria by which that should be determined. Third, it does not address at all the case where several competitors remain in the downstream market.

As a practical matter, it is impossible to dissociate the assessment of the termination's competitive impact from the reasons for its occurrence. Where the termi-

[97] Throughout this and the following sections, a refusal to commence supplies includes a refusal to grant an IP license.

[98] Discussion Paper, *supra* note 1, at para. 210.

[99] *Id.* at para. 22.

nation constitutes a disciplinary measure against a customer for pursuing, or threatening to pursue, a commercial policy that intensifies competition to the dominant firm, the requisite competitive effect likely will be established. That is understandable provided that a sufficient level of market impact is shown.[100] Conversely, where the termination arises from routine and non-contentious commercial factors (such as non-payment of bills), an adverse conclusion is unlikely.

The most challenging cases occur where the dominant firm changes its approach to the downstream market by, for example, vertically integrating or reorganizing its distribution system. The immediate response, that there must be a negative impact on competition, is too vague to advance the debate much further. In such cases, there should be clear additional evidence that the termination of supplies to that customer will distort competition by creating or reinforcing market dominance on either the upstream or downstream market. Market dominance in this context may be either single firm dominance or collective dominance. In the latter case, it would be necessary to show that the conditions for collective dominance are satisfied and that (by reason, for example, of the terminated customer's business model) termination of supplies to that customer creates or reinforces those conditions. Where several competitors remain in the downstream market, it is unlikely that a finding of dominance (in either form) would be justified.

D. REFUSAL TO COMMENCE SUPPLY OR LICENSE IPRS: INDISPENSABILITY

Indispensability is described in the following terms: "A facility is an indispensable input only when duplication of the existing facility is impossible or extremely difficult, or because a second facility is not economically viable in the sense that it would not generate enough revenue to cover its costs."[101] Although DG COMP bases that description on *Bronner*,[102] it is not absolutely clear that the concept of economic viability that it states is wholly consistent with *Bronner*. *Bronner* treats lack of economic viability as an instance of the underlying requirement of impossibility or extreme difficulty rather than an alternative explanation of indispensability (which, purely as a matter of language, does not have to satisfy that underlying requirement). Furthermore, when discussing economic viability, the ECJ adopted the test stated by Advocate General Jacobs to the effect that viability

[100] The Vertical Restraints Guidelines states that "Dominant companies may not impose non-compete obligations on their buyers unless they can objectively justify such commercial practice within Article 82" (*see* Guidelines on Vertical Restraints, 2000 O.J. (C 291) 1, at para. 141). That statement disregards the necessity to demonstrate a level of coverage that evidences foreclosure. The Discussion Paper helpfully acknowledges that that is an issue to be taken into account and, given that, the same issue should be relevant here. What impact the termination has depends on the facts. While the importance of that customer is the starting point, if the termination is intended or likely to discourage others from dealing with a competitor, then its impact is wider than the sales of that customer alone.

[101] Discussion Paper, *supra* note 1, at para. 229.

[102] Case C-7/97, Oscar Bronner v. Mediaprint, 1998 E.C.R. I-7791 (ECJ) [hereinafter *Bronner*].

must be assessed on the assumption that the competitor could achieve the same economies of scale as the dominant firm. DG COMP does not make that assumption clear. On the contrary, its test could be read in exactly the opposite sense, namely to rule out that assumption and to allow for a consideration of whether the competitor could in fact achieve comparable economies of scale.

The concept of indispensability, as developed by the ECJ, is designed to strike a balance between the dominant firm's development incentives and rivals' development opportunities. The Court in *Bronner*, and Advocate General Jacobs in particular, stressed the risks to investment if Article 82 is applied too readily to deprive dominant firms of the fruits of their development activities. While DG COMP acknowledges that point (including the need to permit the cost of failed projects to be recovered), it introduces the notion that refusal to supply may only be justified "for a certain period of time in order to ensure an adequate return on . . . investment."[103] That caveat is not to be found in the jurisprudence and is not consistent with the concept of indispensability. That is a function of the competitor's requirement to obtain access to the facility in question, not the dominant firm's requirement to recover its investment. Admittedly, the latter factor led the Court to insist on the requirement of indispensability, but it did not determine the way in which the requirement was expressed.

On the contrary, the concern (articulated by the Advocate General in *Bronner*) that an overly broad rule would be unworkable argues strongly against the introduction of that concept. There is an enduring and unavoidable tension between intellectual property rights and competition law. However well-drawn the boundaries of an intellectual property right may be, it can never ensure that the IP right holder achieves no more than an adequate return in all circumstances. To the contrary, it is a mathematical necessity that it will not be the case because the scope of an IPR represents the legislator's (presumed) best ex ante estimation of the level of protection that it is reasonable to provide across a range of possible outcomes to induce a socially optimal level of innovation. As the range of outcomes includes both stunning success and abject failure, it is unavoidable that some rewards will appear to be excessive. However repugnant the rewards in an individual case may appear to be with the benefit of hindsight, using a competition law remedy to avoid those excesses necessarily carries with it the risk that the legislative balance will be disturbed.

As the range of outcomes includes both stunning success and abject failure, it is unavoidable that some rewards will appear to be excessive . . . using a competition law remedy to avoid those excesses necessarily carries with it the risk that the legislative balance will be disturbed.

[103] Discussion Paper, *supra* note 1, at para. 235.

The dangers of ad hoc and ex post intervention are also apparent in the approach that DG COMP advocates in its assessment of the trade-off between the protection of the original innovator's incentives and the subsequent innovator's opportunities. In its assessment, it makes explicit reference to the need to have regard for the fact that the costs of the original innovation may have been low and the value of the subsequent innovation may be high. No doubt, it can be said that that would only form part of an overall assessment in which the factors on the other side must also be taken into account, but it sends a signal as to the direction in which DG COMP's sympathies may lie.

E. REFUSAL TO LICENSE IPRS: NEW PRODUCT

DG COMP adopts the formula expressed by the ECJ in *IMS Health* that differentiates between those activities that amount to no more than a duplication of the dominant firm's products (that do not justify a compulsory license) and those that involve the development of a new product not offered by the IP right holder and for which there is a potential consumer demand (that may justify a compulsory license).

On this occasion, DG COMP does not add to the language of the Court. That, however, does mean that it does not address the difficult questions about the concept that were not answered by the Court. There is a strong sense that, for both the Court and the Commission, this is a concept that they wish to develop in a reactive way, responding to the different fact patterns that present themselves. Understandable though that may be, it is not wholly consistent with the concept of this Discussion Paper as a source of ex ante guidance to courts, agencies and firms.

F. ALL CASES: OBJECTIVE JUSTIFICATION

The most contentious justification is the dominant firm's desire to integrate downstream, especially where that involves a departure from its established supply arrangements. In that case, DG COMP states that it is the responsibility of the dominant firm to show that termination of the existing supply relationship makes consumers better off than they would be if the existing supply arrangements were to continue either as they are or in competition with the dominant firm.

This issue was canvassed extensively in *Genzyme v. OFT*[104] where the U.K. Competition Appeal Tribunal (CAT) held that the dominant supplier of a drug that required sophisticated home administration and nursing support could not lawfully reintegrate that activity into its own operation. The CAT attached great importance to patients' freedom to obtain such services from the supplier of their choice, even though the previous arrangement had consisted in an exclusive distribution arrangement with a third party.

[104] Case 1016/1/1/03, Genzyme v. OFT, 2004 C.A.T. 4.

It appears, therefore, that a dominant firm may only switch to a policy of pure vertical integration if it is the only means by which specified, realized, and provable consumer benefits can be accomplished. For example, it likely would be insufficient to argue:

(a) that to dispense with independent distribution would yield internal efficiencies for the supplier; or

(b) that independent distribution is comparatively less efficient than pure vertical integration

unless, perhaps, it could be shown that those efficiency gains would be passed through to customers in the form of prices lower than those likely to be realized under a competitive or independent distribution system. Given the Commission's assumptions about the effects of dominance, it may be challenging to establish that proposition.

To prevail, it may be necessary for the dominant firm to go further and establish that the existing arrangements have failed in a way that goes beyond considerations of "mere" efficiency (for example, in a way that threatens customer safety) and that the only way in which repetition of that failure can be avoided is through reintegration into the dominant firm.

The logic of this approach is dubious. Analytically, a refusal to supply in the distribution context could be perceived as a tying of the supply and distribution activities that should only merit intervention where one of the three exclusionary effects canvassed by DG COMP in that context is established, requiring a showing of foreclosure in relation to either the supply or distribution market. Except in the linguistic sense that pure vertical integration entails the exclusion of independent distributors from the distribution of that product, none of those effects is likely to be made out. In the special circumstances of a monopoly drug of the kind at issue in *Genzyme*, the exception may be pertinent but, other than in such a case, acceptance of the exception would reintroduce the per se concept that this Discussion Paper eschews.

As is the case throughout this Discussion Paper, the solution to the problem, therefore, lies not in a more extensive interpretation of the concept of objective justification, but in a better analyzed approach to the scope of the abuse.

VII. Conclusion

DG COMP's Discussion Paper is a welcome statement that the control of exclusionary conduct is designed to promote consumer welfare and should be tested by an effects-based analytical model. However, the full value of that step forward has yet to be realized because DG COMP's adoption of a precautionary approach appears to capture every constraint on competitive expansion and limits the scope for justification to the bare minimum. There are, of course, paragraphs and sentences in the Discussion Paper that suggest a less conservative approach. Indeed, it is one of the Discussion Paper's features that it contains something for everyone. The danger is that everyone will look to those parts of the document that suit them and disregard the less palatable parts. It is troublesome that the Discussion Paper does not contain enough to move the enforcement of Article 82 (not simply by the Commission, but also by the national courts and national competition authorities) towards an assessment that segregates those cases where dominant firms' conduct does substantially lessen competition from those where it is in fact a part of the competitive process and does maximize consumer welfare, a part that is essential to accomplishing DG COMP's proclaimed objective given the very fact of dominant firms' market position. Until that is fully accomplished, there can be no assurance that enforcement of Article 82 will remove rather than create constraints upon a dynamic process of competition. ◥