

# Dominant Firm Pricing and EU Competition Law

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# Content of the presentation

- This presentation will focus on two types of conduct by dominant firms that have generated significant case-law and policy debate in recent years:
  - Conditional rebates
  - Margin squeeze

# Rebates: The case-law of the ECJ (1)

- In *Hoffman-La Roche*, the ECJ took a strict position vis-à-vis rebates adopted by dominant firms:
  - The ECJ adopted a *per se* rule of illegality against so-called fidelity rebates in exchange of which buyers commit to buy all or a large percentage of their requirement from the dominant supplier
  - Volume rebates are similarly in breach of Article 102, except when the rebate amounts to the cost savings a dominant firm is able to realize by selling larger volumes to buyers
  - The Commission does not need to analyse the effects of the rebates granted by the dominant firm on competition and consumer welfare

## Rebates: The case-law of the ECJ (2)

- The ECJ adopted a few additional judgments dealing with rebates (*Michelin I and II*, *British Airways*) in which it found that:
  - Rebates will long reference periods (e.g., one year) are more likely to be anti-competitive than rebates with short reference periods (e.g., three months)
  - Rebate regimes that are opaque (because the terms and conditions of the rebates are not clear) are more likely to be anti-competitive than transparent rebate regimes
  - “Retroactive” rebates, i.e. which even if they only kick in after a certain volume is purchased “roll back” to the first unit purchased, are anti-competitive

# The modernization of the enforcement of Article 102 TFEU

- The case-law of the ECJ has been harshly criticized as unnecessarily strict and following a form-based approach that sits uneasily with modern economic theory
- In response to such criticisms, DG COMP published in December 2005 a Discussion Paper, which promotes an effects-based approach to the assessment of rebates
- In December 2008, the Commission issued a Guidance Paper which, as far as conditional rebates are concerned, essentially relies on the analytical framework contained in the Discussion Paper
- In May 2009, the Commission adopted a decision finding that Intel infringed Article 102 TFEU by abusing its dominant position on the x86 CPU market through anticompetitive rebates and imposing a fine of € 1.06 billion

# Categories of conditional rebates

- Conditional rebates can be classified into different categories. Rebates can be distinguished, according to:
  - The type of threshold, which can be defined in terms of volume targets (quantity rebates) or percentage of total requirements (market-share rebates) or increase in purchases (growth rebates)
  - The scope of application, whether they are forward-looking, i.e. they apply to incremental units above the threshold (incremental rebates) or backward looking, i.e. applying to both units below and above the threshold (retroactive rebates)
  - The products or set of products to which they apply, whether they apply to one category of product (single product rebates) or across several distinct products (multi-product or bundled rebates)

## Areas of consensus regarding the assessment of conditional rebates

- Rebates are generally pro-competitive.
- Rebates should not be assessed under *per se* rules
- The form of rebates is not relevant to their assessment under the competition rules
- The “equally efficient” standard is the correct standard of review
- The assessment of rebates should focus on the presence of foreclosure
- Efficiencies should be taken into account

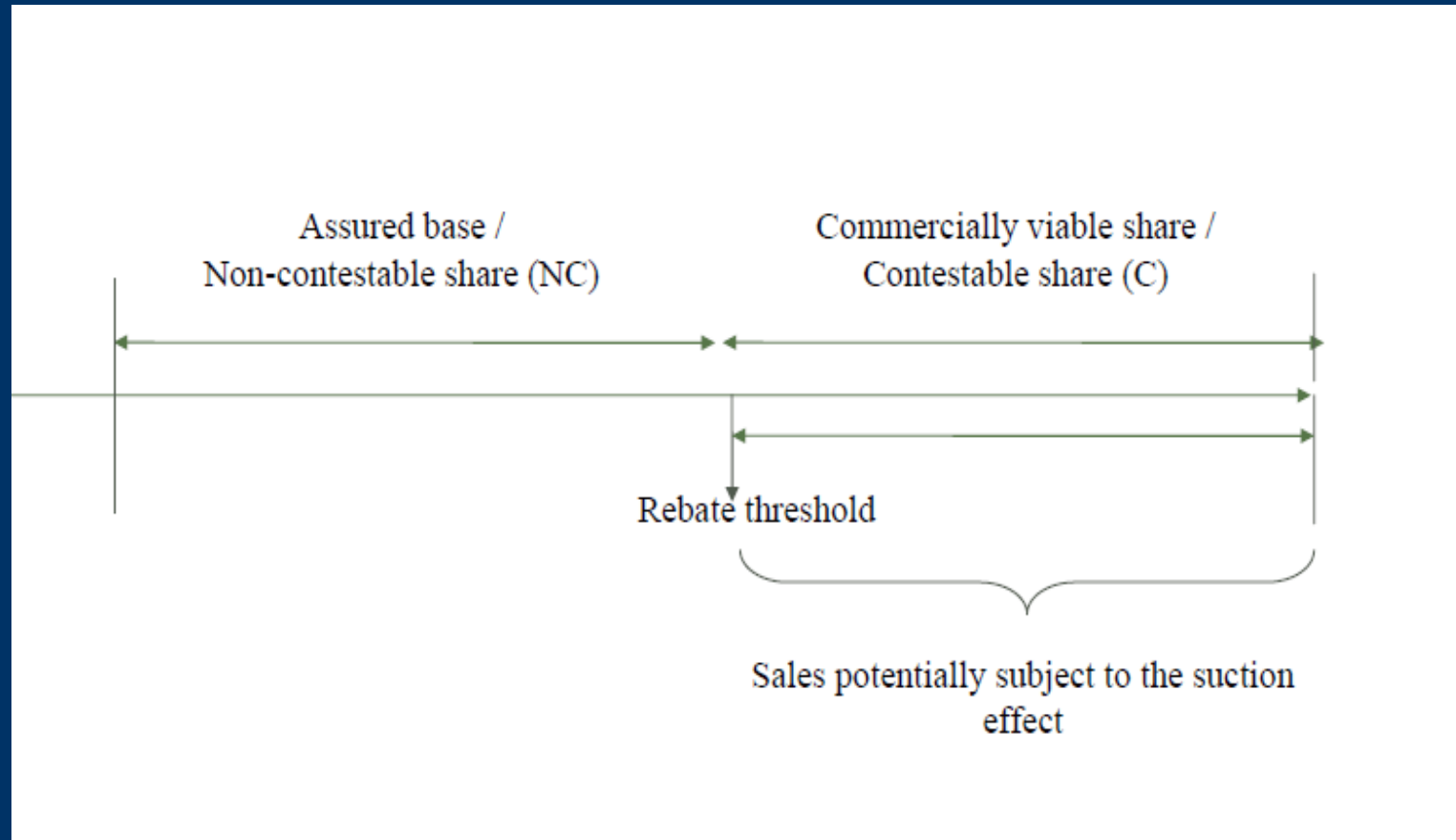
# Framework for the assessment of rebates

- Establishing that a rebate regime has an anticompetitive effect requires a three-step test:
  - Do the relevant rebates foreclose competitors because the dominant firm's customers cannot turn to alternative suppliers without incurring substantial switching costs, which equally efficient competitors cannot overcome?
  - If so, do the customers eligible to receive the challenged rebate represent a substantial share of the market to which equally efficient rivals can turn, depriving them of the possibility to profitably enter and/or expand?; and
- If the answers to the above questions are in the affirmative, the dominant firm should be allowed to demonstrate that its rebates are
  - Offset by pro-competitive efficiencies

## Step 1: Can the rebates foreclose equally efficient competitors from the dominant firm's customers?

- The Guidance Paper applies the following price-cost tests:
  - Unconditional rebates: The Commission proposes a predation test whereby (i) when effective price  $P_e$  ( $P$  minus a rebate  $R$ )  $< AAC$  the rebate will be presumed predatory, (ii) when  $P_e > LRAIC$ , the rebate will be presumed non-predatory; and (iii) when  $AAC < P_e < LRAIC$  unlawful predation can only be established on the basis of additional evidence of predatory intent
  - Conditional rebates: The Commission makes a further distinction:
    - Incremental rebates are subject to a predation test similar to the one applicable to unconditional rebates
    - Retroactive rebates are subject to a much more problematic “suction effect” test

# Retroactive rebates



# Competition concern

- The competition concern is that when the non-contestable part ( $NC$ ) of relevant customer demand is large compared to the contestable part ( $C$ ), the retroactive rebate may allow the dominant supplier to leverage its position of strength in the non-contestable part to the contestable part of a customer's sales
- This retroactive rebate scheme could thus have the effect of excluding equally efficient rivals from that part of the customer's sales that would otherwise be contestable
- This would happen if the rebate scheme leads to the dominant supplier selling units in the contestable part of demand at an effective price  $P_e$  that does not cover the  $LRAIC$  of supplying them

# Numerical example (1)

- Customer A always buys *50 Units* that are available only from the dominant supplier, so non-contestable share  $Q_{ANCS} = 50$  *Units*
- But customer's total demand  $Q_{AT} = 100$  *Units*, and the remaining *50 Units* could be sold by either the dominant supplier or one of its competitors. Thus the contestable share  $Q_{ACS} = 50$  *Units*. The  $AAC = 1$   $\$/Unit$ . The  $LRAIC = 2$   $\$/Unit$ 
  - The dominant supplier makes the following offer. Customer pays *4*  $\$/Unit$  if it buys any quantity less than 100 units. So  $P_{Before\ Rebate} = 4$   $\$/Unit$  if  $Q < 100$  *Units*
  - But if Customer buys 100 units ( $Q = 100$  *Units*) it receives a rebate  $R$  worth \$ 120 in total, or *1.2* \$ for each of the 100 units bought in total.  $P_{After\ Rebate} = 2.8$   $\$/Unit$  if  $Q = 100$  *Units*
- The Guidance Paper states that there is a suction effect if  $P_e$  for the units that belong to the contestable share  $< AAC$
- If  $AAC < P_e < LRAIC$  the Commission will look at whether the dominant firm's rivals have counterstrategies

## Numerical example (2)

- $P_{\text{Before Rebate}} = 4 \text{ \$/Unit}$
- $P_{\text{After Rebate}} = 2.8 \text{ \$/Unit} = 4\text{\$/Unit} - 1.2 \text{ \$/Unit}$
- Contestable share  $C = 50 \text{ Units}$ 
  - $\text{TotalWith rebate} = 100 \times 2.80 \text{ \$} = 280 \text{ \$}$
  - $\text{TotalWithout rebate} = 50 \times 4 \text{ \$} = 200 \text{ \$}$
- $\text{TotalWith rebate} - \text{TotalWithout rebate} = 280 \text{ \$} - 200 \text{ \$}$   
 $= 80 \text{ \$}$  is being paid for the last 50 contestable units
- The effective price ( $P_e$ ) over the last 50 =  $80 \text{ \$} / 50 = 1.6 \text{ \$}$
- As  $AAC < P_e < LRAIC$ , the Commission will look at whether the dominant firm's rivals have counterstrategies

# Bundled rebates

- The test proposed by the Commission in its Guidance Paper is that:

“If the incremental price that customers pay for each of the dominant undertaking’s products in the bundle remains above the LRAIC of the dominant firm from including this product in the bundle, the Commission will normally not intervene since an equally efficient competitor with only one product should in principle be able to compete profitably against the bundle”

# Test is hard to apply to complex rebate regimes

- Numerical example taken above is highly stylized and relies on a number of assumptions ( $NC$  is  $> C$ , the respective sizes of  $NC$  and  $C$  do not fluctuate, etc.), which may not be true in practice
- Test complex to apply to certain categories of rebate. Ex: Rebates taking the form of “grids”
- This may explain why the Commission indicates in the Guidance Paper that it “will take into account the margin of error that may be caused by the uncertainties inherent in this kind of analysis”

## Problem of the determination of the size of the contestable share of a given customer's demand

- Suction effect test assumes that:
  - Dominant supplier controls a part of the demand of the customer to which it gives a rebate, the NC part, and
  - NC part is large (otherwise, the dominant firm would not be able to leverage its control of the non-contestable part to the contestable part)
- This test is quite intuitive for multi-product rebates where it is easy to distinguish between the competitive and non-competitive products since they are distinct
- For single-product rebates, it is by contrast extremely difficult to determine in practice whether – and, if so, the extent to which – the demand of a given customer for a particular product or service is contestable

# Factors for determination of the size of the contestable share

- Switching costs: When such costs are significant, they may have the effect of locking-in customers to the dominant supplier even if they were willing to switch part of their requirements to alternative suppliers
- Must-have brands (or must-stock products): Some brands or products may be essential for various categories of retailers
- Capacity constraints: Even if customers were willing and able to switch to alternative suppliers, such suppliers may be unable to satisfy resulting demand, hence ensuring an assured base to the dominant firm
- Single-source supply: In sectors where transaction costs savings are of critical importance, customers may prefer to buy from a single supplier that is able to supply them with the full, or at least a large part, of the range of the products they need

# Is the suction effect "administrable" and sufficiently "certain"?

- Does the suction effect test meet the requirements of “administrability” and “certainty” that should *always* apply to the tests used by competition authorities and courts for assessing the legality of dominant firms’ practices?
  - Dominant firms adopting certain types of potentially anti-competitive rebate may not be able to self-assess their practices as they may not have the information to run complex price-cost tests such as the suction effect test
  - Moreover, because of the complexity of applying a suction effect test and the extensive information and technical resources needed to apply it properly, it is subject to question whether the suction effect is administrable at all

# Proposed alternative approach

- When it is not possible to establish with a sufficient degree of certainty the size of the contestable part of a given customer's demand, the best approach is probably – as it is in the case of unconditional or conditional incremental rebates – to apply a classic predation test over all the units sold by the dominant firm
- Some may argue that a predation test is insufficient to identify the potential anticompetitive effects of all-unit rebates, and thus creates a risk of Type II errors. One way to reduce the risk of Type II errors is to combine the standard predation test with an analysis of a series of market factors

## Step 2: Do the foreclosed customers represent a significant share of the relevant market?

- The fact that a given rebate forecloses one or several competitors of the dominant firm from supplying one or several customers is not sufficient to demonstrate the presence of anti-competitive effects. Such effects will only appear when such customers represent a substantial share of the market that is critical for rivals' competitiveness

## Step 3: Are the rebates' anti-competitive effects counterbalanced by efficiencies? (1)

- The Guidance Paper signal the importance of taking efficiencies into account in the assessment of rebates.
- Such efficiencies include:
  - Price reductions
  - Economies of scale and faster fixed costs recovery
  - Economies of scope and reduction of transaction costs
  - Avoiding double marginalization
  - Preventing hold-up
  - Supplementary services

## Step 3: Are the rebates' anti-competitive effects counterbalanced by efficiencies? (2)

- The question is the extent to which the Commission will be willing to accommodate efficiency defenses when assessing rebates producing foreclosure effects. The outlook for dominant firms is bleak:
  - The efficiency claims that the Commission will be willing to consider as a justification for conditional rebates are limited (based on the restrictive case-law of the ECJ).
  - The Guidance Paper requires that to succeed under an efficiency defense the dominant firm adopting conduct leading to the foreclosure of competitors must satisfy the four conditions of Article 101(3).

## Is there a need for safe harbours? (1)

- Competition experts believe that competition authorities (and courts) should provide safe harbours designed to give firms immediate assurances, without the need to invest significant resources in a full- scale competitive analysis in order to ascertain that a given rebate regime will not be challenged by a competition authority or, more generally, create antitrust liability.

## Is there a need for safe harbours? (2)

- The price-cost tests described above could be helpful as safe harbours rather than simply as one of the steps in the assessment of a given rebate by a competition authority or a court
- Turning price-cost tests into safe harbours would imply that a dominant firm would be given complete assurances that when the effective price ( $P_e$ ) – i.e. standard price minus the rebates – is superior to a given measure of costs ( $LRAIC$ ), that rebate would not be challenged by the relevant competition authority or give rise to antitrust liability in court

## Is there a need for safe harbours? (3)

- However, the Commission shows its willingness to deviate from the “as efficient” standard to protect less efficient competitors:

“the Commission recognises that in certain circumstances a less efficient competitor may also exert a constraint which should be taken into account when considering whether a particular price-based conduct leads to anticompetitive foreclosure. The Commission will take a dynamic view of this constraint, given that in the absence of an abusive practice such a competitor may benefit from demand-related advantages, such as network and learning effects, which will tend to enhance its efficiency”

# The Commission May 2009 decision in the *Intel* case

- This Decision contains a number of flaws as it:
  - Relies in substance on a *per se* prohibition of conditional rebates recognized by the formalistic case-law of the ECJ, notwithstanding the Guidance Paper
  - States, contrary to sound policy, that it need not conduct an “as efficient competitor” test, but conducts a misguided one anyway
  - Insufficiently supports its speculative theory that the OEMs’ purchasing policy was influenced by their understanding of Intel’s alleged intention to reduce or eliminate their rebates should they buy x86 CPUs from AMD
  - Fails to demonstrate its contention that Intel’s rebates harm competition and consumers
  - Conducts an excessively restrictive analysis of the efficiencies created by Intel’s rebates

# Margin squeeze

- Margin squeeze refers to situations in which a vertically-integrated dominant firm uses its control over an input supplied to downstream rivals to prevent them from trading profitably on a downstream market in which the dominant firm is also active
- The dominant firm could in theory do this in a number of different ways:
  - Raise the input price to levels at which rivals could no longer sustain a profit downstream
  - Engage in below-cost selling in the downstream market, while maintaining a profit overall through the sale of the upstream input.
  - Raise the price of the upstream input and lower the price of the downstream retail product to create a margin between them at which a rival could not be profitable

# Basic conditions under which a margin squeeze abuse may occur

- A margin squeeze abuse requires several basic, cumulative conditions to be satisfied:
  - A margin squeeze only arises in situations of vertical integration
  - The input the vertically-integrated firm supplies to rivals must in some sense be “essential” for competition on the downstream market
  - The input supplied by the dominant firm constitutes a relatively high, fixed proportion of the downstream costs
  - Dominant firm’s upstream price, downstream price, or the combination of both prices, causes the activities of a downstream rival to be uneconomic
  - The absence of an objective justification or redeeming efficiencies

# Deutsche Telekom

- In *Deutsche Telekom*, DT was found guilty of a margin squeeze in circumstances where it charged competitors more for unbundled broadband access at the wholesale level than it charged its subscribers for access at the retail level
- The Commission stated that a margin squeeze would occur where the competing services were comparable and “the spread between DT's retail and wholesale prices is either negative or at least insufficient to cover DT's own downstream costs”
  - This meant that DT would have been unable to offer its own retail services without incurring a loss if it had had to pay the wholesale access price as an internal transfer price for its own retail operations
  - As a consequence the profit margins of competitors would be squeezed, even if they were just as efficient as DT
- DT appealed the decision of the Commission to the GC, which supported the Commission decision

# Telefónica (1)

- The Commission found that the margin between the wholesale prices Telefónica's subsidiaries charge their competitors for wholesale broadband access in Spain and the retail prices they charge end-users was not sufficient to enable equally efficient competitors to compete in the broadband retail market
- An interesting question at stake in Telefónica was whether, to prove a breach of Article 102, the Commission had to demonstrate that access to Telefónica's DSL network was "essential" to its competitors to provide retail broadband services.
- Because a margin squeeze is nothing less than a "constructive" refusal to supply, it appears logical that the conditions that had been set by the ECJ in *Bronner* should be met to establish a margin squeeze infringement

## Telefónica (2)

- The Commission argued that the particular circumstances of this case “fundamentally differed” from those in *Bronner*:
  - Telefónica had a duty to supply the upstream inputs in question and it was clear from the considerations underlying both the EU and Spanish law that
    - “Telefónica's duty to supply the relevant upstream products results from a balancing by the public authorities of the incentives of Telefónica and its competitors to invest and innovate.”
  - The Commission estimated that “Telefónica’s ex ante incentive to invest in its infrastructure [we]re not at stake in the present case.” Indeed, Telefónica’s infrastructure
    - “was to a large extent the fruit of investments that were undertaken well before the advent of broadband in Spain and that thus bore no relation to the provision of broadband services (but for the provision of traditional fixed telephony services). Also, those original investments were undertaken in a context where Telefónica was benefiting from special or exclusive rights that shielded it from competition.”

# TeliaSonera (1)

- One of the questions addressed to the ECJ was again whether to constitute a margin squeeze abuse “the good or service supplied by the dominant undertaking on the wholesale market [should be] indispensable to competitors.”
- The ECJ answered that while essentiality must be demonstrated in a refusal to supply case, it does not have to be demonstrated in a margin squeeze case as it is a distinct abuse. Specifically, the ECJ provided that its *Bronner* judgment could not be interpreted in such a way that:
  - “the conditions to be met in order to establish that a refusal to supply is abusive must necessarily also apply when assessing the abusive nature of conduct which consists in supplying services or selling goods on conditions which are disadvantageous or on which there might be no purchaser.”
- Margin squeeze could, “in itself, constitute an independent form of abuse distinct from that of refusal to supply.”

## *TeliaSonera (2)*

- While “essentiality” is not a condition to establish an abuse, the ECJ nevertheless considered that “when assessing the effects of the margin squeeze, the question whether the wholesale product is indispensable may be relevant.” The ECJ added that  
“the possibility cannot be ruled out that, by reason simply of the fact that the wholesale product is not indispensable for the supply of the retail product, a pricing practice which causes margin squeeze may not be able to produce any anti-competitive effect, even potentially.”
- The Court concluded that:  
“in order to establish that a pricing practice resulting in margin squeeze is abusive, it is necessary to demonstrate that, taking into account, in particular, the fact that the wholesale product is indispensable, that practice produces, at least potentially, an anti-competitive effect on the retail market which is not in any way economically justified.”

# Guidance Paper

- The Commission follows the approach taken in *Telefónica* as it observes that
  - “in certain specific cases, it may be clear that imposing an obligation to supply is manifestly not capable of having negative effects on the input owner's and/or other operators' incentives to invest and innovate upstream, whether *ex ante* or *ex post*.”
- The Commission considers that this is particularly likely to be the case when the particular circumstances it identified in *Telefónica* are present, i.e. where:
  - “regulation compatible with Community law already imposes an obligation to supply on the dominant undertaking and it is clear, from the considerations underlying such regulation, that the necessary balancing of incentives has already been made by the public authority when imposing such an obligation to supply.”; or
  - “the upstream market position of the dominant undertaking has been developed under the protection of special or exclusive rights or has been financed by state resources

# Conclusions

- The case-law of the EU Courts regarding pricing abuses by dominant firm is formalistic and sits uneasily with modern economic theory
- The European Commission has sought to modernize the enforcement of Article 102 through the adoption of the Guidance Paper, but it continues to adopt legalistic positions when it suits it
- The effects-based approach contained in the Guidance Paper represents significant progress compared to the per se approach of the EU Courts, but various implementation issues remain
- Dominant firms must take a cautious approach when they price their goods and services. This may prevent them from adopting pro-competitive pricing schemes out of fear of violating Article 102 TFEU