Competition Competence Report

MORE ECONOMICS BASED APPROACH IN ARTICLE 102 EC TREATY: THE NEW APPROACH TO THE ESTABLISHMENT OF DOMINANCE AND DEFINITION OF MARKETS

The first step in assessing the abuse of a dominant position within Article 102 requires, prior to the identification of abusive behaviour, evidence that the firm under scrutiny enjoys a dominant position. In the CCR at hand we will deal with the effects-based approach in assessing a dominant position as well as with the issue of market definition in Article 102 cases.

Definition of Dominance

In the Discussion Paper the European Commission points out that dominance within the meaning of Article 102 EC amounts to substantial market power. Equating dominance to market power constitutes an important step towards a more-economics-based-approach in the assessment of market dominance within Article 102.

Market Power in Welfare Analysis

Market power is a crucial concept in the economics of competition law. It refers to the ability of a firm to raise a price above some competitive level – the benchmark price – in a profitable way. Since the lowest possible price a firm can profitably charge is the price which equals the marginal cost of production, market power is usually defined as the difference between prices charged by a firm and its marginal costs of production.

Economists are concerned with firms having a large degree of market power, because market power brings about welfare losses: Allocative inefficiencies occur when prices are above marginal costs, because this entails higher producer surplus caused by higher prices. Productive and dynamic inefficiencies (higher production costs and lower innovation rates) might also be associated with market power. However the total elimination of market power should not be the objective of competition policy. Indeed, the prospect of having some market power (i.e., some profits) represents a most powerful incentive for firms to innovate and invest. Competition law enforcement should therefore ensure that firms will be able to enjoy the rewards for their investments.

Market Power in the European Commission's Discussion Paper

Against this background, the definition the European Commission gives for market power in their discussion paper is based on sound economic grounds. Market power is not only seen to encompass the ability to raise prices, but also the ability to lower quality or to reduce the pace of innovation. This allows for taking into account that a certain degree of market power is indispensable in order to ensure that firms will have incentives to innovate. Furthermore the European Commission's definition of market power also comprises the ability to exclude and foreclose which can be found when a firm or group of firms raise prices above the competitive level or prevent it from falling to a lower competitive level by raising its rival's costs and thereby causing them to restrict output. The foreclosure of competitors may therefore allow the dominant company to further raise prices or keep prices high. The economic theory of contestable markets shows that if entry into markets is easy, rapid and costless, a firm would not be able to charge a high margin because large profits would attract competitors in to the industry. Therefore it corresponds to an economic understanding of market power that it is necessary to assess a firm is able to exclude and foreclose their rivals.

Econometric Techniques for the Assessment of Market Power

The clear commitment to the concept of market power has another consequence. It allows the measurement of market power on sound economic grounds: A theoretical measure of market power is given by the Lerner index, defined as the firm's mark-up (that is the difference between the price and the marginal cost over price ration). The index increases with the mark-up charged by the firm, which should be the most desirable feature of any index of market power. Because of some estimation problems entailed by the direct application of the Lerner index, an alternative approach is based on the fact that the Lerner index of a monopolistic firm corresponds to the inverse of the elasticity of demand faced by it. Indeed the direct estimate of the elasticity of the (residual) demand faced by a firm is at the core of one of the modern econometric techniques of the assessment of market power by logit demand models.

These econometric techniques represent a very promising tool for antitrust analysis. However, as reliable data does not always exist, a more qualitative approach might be used for the assessment of market power. This approach traditionally attributes a key role to market shares held by

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the firm under investigation. But market share is only one variable that one has to look at in order to determine market power. What are the proposals for establishing market dominance submitted by the European Commission?

Factors for Establishing Dominance

In the discussion paper the European Commission takes into account that a finding of dominance requires a careful assessment of market conditions, without giving to much weight to market shares.

Relevance of Market Shares the European Commission's Discussion Paper

They point out that the market shares of the various players are just the starting point for the analysis of the market position of the allegedly dominant undertaking. They consider very high market shares as likely to indicate a dominant position, but emphasise that any indication based on market shares depends on the facts of each individual case. What is remarkable is that the importance of market shares are said to be qualified by an analysis of the degree of product differentiation. Furthermore they point out that it is unlikely that a company with high market shares will have the possibility of sustaining supra-competitive prices in the long run if barriers to expansion and entry are low. In order to determine whether or not there are barriers to expansion and entry in a market they propose a full analysis of the conditions of competition prevailing on the relevant market.

Requirement of Extensive Assessment of Market Conditions

Furthermore, when identifying possible barriers of expansion or entry they consider important to focus on whether rivals can reasonably replicate circumstances that give advantage to the allegedly dominant undertaking. The following factors are regarded as possible origins of barriers to expansion and entry.

- Legal barriers
- Economies of scale and scope
- Absolute cost advantages
- Privileged Access to supply
- Highly developed distribution and sales network
- Established position of the incumbent firm
- Other strategic barriers to expansion and entry, e.g. network effects

Eventually, the current discussion paper also addresses the power of buyers to counteract supra-competitive prices by suppliers. The point out that certain strong buyer can pave the way for effective new entry or lead

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existing suppliers in the market to significantly expand their output so as to defeat the price increase.

This shows that the European Commission intends to shift from a pure checklist approach and delve into the analysis of the particular features of the industry prior to reaching a finding of dominance. From an economic perspective this is an appropriate approach. Although the direct measurement of market power by the means of estimating the elasticity of residual demand with econometric techniques is recommendable the more qualitative approach put forward by the European Commission is very reasonable in cases where reliable data are not available.

In order to assess market power it is inevitable to define the relevant market first. Let us have a short look at the economic rationale for market definition within Article 102 and the European Commission's proposals concerning this matter.

Market Definition

Form an economic perspective the relevant market should be a set of products that exercise some competitive constraints on each other. A Test that satisfies all the requirements and that should guide the analysis of market definition in both the product and the geographic dimension is the Hypothetical Monopolist Test (HM Test).

Difficulties of HM-Test in Article 102 Cases

However, the use of the HM Test presents some difficulties when it is to be used in Article 102 cases: The correct benchmark for Article 102 cases is the price that would prevail in the absence of anti-competitive behaviour. But the currently prevailing price may not be the competitive price, but rather have been substantially increased. This fact must be taken into account. Otherwise, the market could be defined too widely, as it might include products or geographic areas, which only impose a competitive constraint due to the fact that prices have already been elevated above competitive levels. Against this background one has to apply some additional methods in order to identify the appropriate price benchmark for the HM Test.

Market Definition the European Commission's Discussion Paper

In the discussion paper on Article 102 the European Commission points out that the HM Test remains useful even at prevailing prices in the sense that it is indicative of substitution patterns at such prices. Furthermore, they present some additional tools which are useful in checking whether the market has been defined too widely so as to include false substitutes:

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- Restructuring the competitive price, i.e. to estimate the competitive price and use that price for the purpose of applying the HM-Test
- Examination of the characteristics and the intended use of the products concerned and assessment whether they are capable of satisfying an inelastic consumer need
- Comparison of prices across various regions

Form an economic perspective this approach is reasonable. It allows for the application of a state-of-the-art method in market definition – the HM Test – but gives the necessary tools in order to complement the results of the HM Test with a more traditional approach.

Conclusion

We have seen that the DG Competition discussion paper on the application of Article 102 is a milestone on the way towards a more economic based approach within Article 102. The most important elements of an assessment of an Article 102 case are supposed to be based on sound economic concepts. Dominance is equated to substantial market power, while market power is seen as both "power over price, quality, service and innovation" and "power to exclude or deter competitors". Market definition is going to be based on the HM-Test adjusted by some additional analysis. Eventually, in order to establish dominance, a careful assessment of market conditions has to be carried out, without giving to much weight to market shares. From this it follows that the employment of economic tools (both qualitative and quantitative) will become increasingly important in assessing Article 102 cases.

EE&MC offers a wide array of economic tools in order to assess the abuse of an allegedly dominant position within the new framework as outlined in the European Commission's discussion paper. EE&MC possess extensive experience in assessing market dominance within Article 102 and the Merger Regulation. The analysis of market power is carried out both by means of quantitative econometric techniques and more qualitative methods, depending of the availability of the relevant data. Within the definition of the relevant market they have long standing experience with the HM-Test and an outstanding success rate in court.

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