



Competition Competence Report

## **MORE ECONOMICS BASED APPROACH IN ARTICLE 102 TEFU: NEW TEST PROCEDURES**

The “more-economics-based-approach” in European competition policy has now been implemented also in the assessment of abusive exclusionary conduct by dominant companies. On December 19<sup>th</sup> 2005, the European Commission issued a comprehensive discussion paper<sup>1</sup> which rejected the former legalistic straight-jacked approach in favour of an effects-based approach. After a long public consultation, the “Guidance on the Commission's enforcement priorities in applying Article 82 (now 102) of the EC Treaty to abusive exclusionary conduct by dominant undertakings” was adopted in February 2009.<sup>2</sup>

The guidance paper first describes the economic and effect-based approach that will guide the Commission in the assessment of exclusionary practices and then presents an analytical framework for the assessment of the most common examples of exclusionary conduct, namely exclusive dealing, conditional rebates, tying and bundling, predatory pricing, refusal to supply and margin squeeze.

The new effects-based approach means that the key in the assessment of an exclusionary conduct are the measurable effects on the market of such conduct. In other words, by applying the effects-based approach the Commission intends to carefully discern competition on the merits, which has beneficial effects for consumers and should therefore be promoted, from competition that is liable to lead to anticompetitive foreclosure, i.e. foreclosure that is likely to harm consumers. This new approach requires convincing evidence and sound economic analysis.

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<sup>1</sup> “DG competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses”, available at:  
<http://ec.europa.eu/competition/antitrust/art82/index.html>

<sup>2</sup> OJ C 45, 24.2.2009

The guidance paper also provides instructions to national competition authorities on how to assess an abuse of a dominant position. Most importantly, the paper gives guidance to dominant companies on how to defend themselves against allegations of abuse and to competitors on how to plead their case in front of the competition authorities.

### **Objective of Article 102 EC Treaty**

Two forms of abuse by a dominant company can be distinguished: exclusionary abuses (behaviours by a dominant firm which are likely to have a foreclosure effect on the market) and exploitative abuses (behaviours where a dominant company takes advantage of its market power, e.g. by charging excessive prices). The guidance paper covers exclusionary abuses only.<sup>3</sup>

The focus of the analysis is on the potential harm to consumers: The aim of the Commission's enforcement activity is to "ensure that dominant undertakings do not impair effective competition by foreclosing their competitors in an anti-competitive way, thus having an adverse impact on consumer welfare". Competition and consumers benefit if companies are able to expand, to enter new markets and compete on the merits without competition conditions being distorted or impaired by a dominant firm. On the other hand, exclusionary conduct might produce substantial efficiencies which are passed-on and outweigh the anti-competitive effects on consumers.

An economics-based approach requires a careful examination of how competition functions in each particular market. Key to the economic approach is the analysis of the economic effects of certain business conduct. Restrictions to competition need to be proven on a case-by-case basis. In addition, as already stated, the analysis has to include an evaluation on whether efficiency gains outweigh negative effects. The identification of the harm to competition and of the likely harm to consumers must be based on sound economic theories and supported by empirical evidence. Similarly, efficiencies should be properly assessed on the basis of economic analysis and grounded on the facts of each case.

In order to assess the competitive harm arising from specific business practices, the European Commission adopted the "as-efficient-competitor-test". This test is a price-cost test which is less effects-based than compared to other possible tests.<sup>4</sup> Furthermore, the European Commission

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<sup>3</sup> According to the European Commission this is because "it is better to prevent than to cure."

<sup>4</sup> A fully effects-based approach would derive the assessment whether a given practice is detrimental to competition or not solely from the effects of the prac-

presented the criteria that need to be met in order to apply an efficiency defence. Both concepts are illustrated in the following sections.

### **As-efficient-competitor-test**

Article 102 prohibits exclusionary conduct which produces actual or likely anticompetitive effects in the market and which can harm consumers in a direct or indirect way. Harm to intermediate buyers is generally presumed to harm final consumers as well. Therefore, the central concern of the Commission is to inhibit business practices that foreclose competitors and create harm to final consumers in terms of higher prices or reduced quality. Thereby not only short term harm, but also medium and long term harm arising from foreclosure is taken into account. Foreclosure means that actual or potential competitors are completely or partially denied profitable access to a market.

The possible effects of an abusive conduct are: 1) rivals are disadvantaged; 2) rivals compete less aggressively; 3) rivals leave the market or 4) rivals do not enter the market in the first place. The dominant company can reduce demand for the rivals' products or directly raise rivals' costs. In the first case, foreclosure occurs because a dominant company can strengthen its market position by using exclusionary practices such as predatory pricing or loyalty rebate systems. In the latter case, a dominant company which is vertically integrated or disposes of a strong position both on the downstream market (relevant market) and on the upstream-market (input market), can raise prices of input factors and thereby increase costs for the its rivals on the relevant market.

The key issue is to differentiate between business conducts that are part of a healthy competition in the market and those conducts that are part of an abusive strategy of the dominant company. The guidance paper suggests to use the as-efficient-competitor-test as a benchmark test: The Commission will investigate whether a the conduct is capable of excluding a competitor which is as efficient as the dominant company. The "as-efficient-competitor" is a hypothetical competitor having the same costs as the dominant company. Therefore, foreclosure of an as-efficient-competitor means that the dominant company is pricing below its own costs.

Since the as-efficient-competitor-test is a cost-benchmark-test, the choice of the appropriate cost benchmark is crucial for the analysis. The Commission chose as a benchmark the average avoidable cost (AAV) and the long-run incremental cost (LRAIC). According to the Commission, failure

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tice on the consumer. A multi-stage approach could e.g. include a Sacrifice-Profit-Test, an Exclusion-Test and a Recoupment-Test.

to cover AAC indicates that the dominant undertaking is sacrificing profits in the short term and that an equally efficient competitor cannot serve the targeted customers without incurring a loss. Failure to cover LRAIC indicates that the dominant undertaking is not recovering all the (attributable) fixed costs of producing the good or service in question and that an equally efficient competitor could be foreclosed from the market. Other effects need to be considered as well including the existence of economies of scale and scope, learning curve effects or first mover advantages which may favour declining costs. The exact application of the as-efficient-competitor-test as well as the chosen cost benchmarks vary on a case-by-case basis.

In the following, the analysis of a rebate system is illustrated as an example.

### **Example: As-efficient-competitor-test for rebate schemes**

Issue: What is the economic effect of a fidelity rebate scheme? Do customers buy additional output from the dominant company applying such scheme by diverting purchases from other suppliers to the dominant company?

The analysis of a rebate scheme has to assess the likelihood and economic incentives to switching: What is the threshold level that would convince customers to switch? What is the economic effect once the threshold level is reached or passed? Is it possible that a hypothetical as-efficient undertaking meets the price level of the dominant company and set its own prices at the same level? Which other factors have an impact on the threshold? Within the analysis, the following concerns have to be addressed:

"Retroactive" effect: once the threshold is met, the rebate applies not only to the purchases above the threshold, but also to all previous purchases. Retroactive rebates can foreclose the market significantly as they may make it less attractive for customers to switch small amounts of demand to an alternative supplier, if this would lead to loss of the retroactive rebates. Prices for the last units which are bought before the threshold is reached are significantly lower and possibly even negative because the transaction triggers the rebate for all the purchases below the threshold as well. The dimension of the retroactive effect depends on the relative size of the threshold and has to be assessed empirically.

Supply of commercially viable amounts: As competitors may not be able to compete for the entire demand, the question is, whether the rebate system hinders competitors from supplying commercially viable

amounts to individual customers. To answer this issue a market simulation analysis has to be performed.

Price analysis: What is the effective price level for the purchase with respect to the rebates offered by the dominant company?

Cost analysis: What are the average avoidable costs of the dominant company or of a hypothetical efficient competitor?

Price/cost analyses: Is the effective price for a commercially viable share of a competitor below the average avoidable cost of an efficient competitor?

Price/cost comparison: Is the effective price below the average avoidable cost of an efficient competitor, so that it is impossible to compete with the dominant undertaking for this part of the demand?

## Efficiency Defence

If the results of the as-efficient-competitor-test show that the business conduct causes foreclosure effects, the dominant company can still claim that its conduct is justified. The burden of proof for such justification is on the dominant company: The dominant company has to demonstrate that a) its conduct is objectively necessary and proportionate, and b) that its conduct produces substantial efficiencies which outweigh any anticompetitive effects on consumers.

For the efficiency defence to be accepted, the dominant company must demonstrate that the following cumulative conditions are fulfilled:

- Efficiencies are realised or are likely to be realised as a result of the conduct;
- The conduct is indispensable to realise these efficiencies;
- The likely efficiencies outweigh any likely negative effects on competition and consumer welfare;
- The conduct does not eliminate effective competition, by removing all or most existing sources of actual or potential competition.

Considering again the example of a rebate scheme, the following questions have to be addressed when applying the efficiency defence.

### Example: Efficiency defence in case of a rebate scheme

When assessing the indispensability of the rebate scheme, the following questions have to be addressed.

- Can cost advantages be obtained and passed on to the customers?
- Is the rebate scheme necessary for the dominant firm to make certain relationship-specific investments?
- Can other less-restrictive measures create the same incentives for the dominant company?

## **Conclusion**

In the guidance paper on the application of Article 102 to abusive exclusionary conduct, the European Commission provides a detailed description on how to assess cases of alleged abuse of a dominant position. These guidelines are useful for:

- Companies that have to defend themselves against allegations of abusive conduct, either by a national competition authority or the European Commission; or
- Companies that are disadvantaged or prevented from entering a market by exclusionary practices from the incumbent dominant company.

In either case, the introduction of the “more-economics-based-approach” means that market facts need to be presented based on sound economic theories and grounded on empirical evidence. With this approach, the European Commission addresses the criticism of the European Courts which in several Article 102 cases judged inadequate the economic analyses carried out by the Commission.

In particular, with the “as-efficient-competitor test”, the European Commission developed a detailed framework for the assessment of specific cases of exclusionary abuses. In addition, the implementation of the efficiency defence reflects a basic insight from economic theory, i.e. that many business practices can both harm and promote competition and consumer welfare. The practical implementation of this effects-based approach requires broad experience and substantiated empirical analyses.

EE&MC has a solid know-how on how to collect data and broad experience with economic and econometric analyses. EE&MC advises clients on abuse of dominance cases both at European and at national level in line with the “more-economic-based-approach” developed by the European Commission.