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Article 82 EC and Exploitative Conduct

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1. Introduction

The history of the views concerning the correct balance between enforcement against exploitative abuses and against exclusionary abuses is an interesting one. In the early days of European competition policy, some commentators were of the opinion that, from a legal perspective, Article 82 (then Article 86) was exclusively concerned with exploitative abuses.[1] This debate effectively ended with the judgment of the European Court of Justice (ECJ) in *Continental Can,* which clarified that Article 82 also covers exclusionary abuses. The Court stated that Article 82 "is not only aimed at practices which may cause damage to consumers directly, but also at those which are detrimental to them through their impact on an effective competition structure".[2] Many contributors to the recent lively debate on Article 82 take a view almost completely opposite to that of the early commentators mentioned above, arguing that enforcement of Article 82 should concentrate on exclusionary abuses; competition authorities should thus either abstain from or be very restrained in enforcement actions against exploitative abuses.[3]

In this paper I will present my views on the proper role of enforcement against exploitative conduct under Article 82 EC. This includes both some thoughts on the general characteristics of markets in which it makes sense to intervene, as well as a short discussion of methodologies for identifying exploitative conduct in such markets. I distinguish here between "exploitative" and "discriminatory" conduct. The paper does not deal with discriminatory conduct, which raises particular issues not necessarily related to exploitation,

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[1] See, e.g., René Joliet, *Monopolization and Abuse of Dominant Position*, Martinus Nijhoff, 1970.

[2] Case 6/72, *Europemballage Corporation and Continental Can Company, Inc. v Commission* [1973] ECR 215, para. 26.

[3] See, e.g., David Evans and Jorge Padilla, "Excessive Prices: Using Economics to Define Administrable Legal Rules", 1 *Journal of Competition Law and Economics* 97 (2005); Bruce Lyons, "The Paradox of the Exclusion of Exploitative Abuse", *Centre for Competition Policy Newsletter,* Spring 2007; Massimo Motta and Alexandre de Streel, "Exploitative and Exclusionary Excessive Prices in EU Law", in Claus-Dieter Ehlermann and Isabela Atanasiu, eds., *European Competition Law Annual 2003: What Is an Abuse of Dominant Position*?, Hart Publishing, 2006, pp. 91 *et seq*.; Robert O'Donoghue and Jorge Padilla, *The Law and Economics of Article 82 EC,* Hart Publishing, 2006.

such as discrimination as part of exclusionary conduct and discrimination based on nationality.

The ECJ in *Continental Can* made clear that the potentially abusive practices mentioned in the text of Article 82 do not form "an exhaustive enumeration of the sort of abuses of a dominant position prohibited by the Treaty".[4] Nevertheless, most discussions of exploitative abuses take as their starting point Article 82(a), which states that an abuse may consist in "directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions". Exploitative conduct may thus both concern pricing and "other" trading conditions. Most recent contributions focus on the pricing aspect – and then only on selling prices. I will also mostly discuss this aspect, which usually is called "excessive" pricing.

2. Why take action against exploitative conduct?

At first sight it may seem strange to question why competition authorities should take enforcement actions against exploitative conduct. After all, many competition authorities seem to think that competition policy is ultimately about protecting consumer welfare. Commissioner Kroes, for example, stated in her 2005 Fordham speech that "Article 82 enforcement should focus on … behavior that has actual or likely effects on the market, which harms consumers".[5] However, she went on to say that "it is sound for our enforcement policy to give priority to so-called exclusionary abuses, since exclusion is often at the basis of later exploitation of customers". This is what one commentator has called the "paradox of the exclusion of exploitative abuse".[6]

Various arguments have been brought forward to explain this "paradox". They may be divided into two types. One type of argument focuses on the practical difficulties of competition authorities to intervene against excessive prices. The other type of argument focuses more on what one (only slightly polemically) could call the "positive effects" of excessive prices in a market economy. My discussion below will show that I have more sympathy for the first type of argument than for the second.

There are two basic reasons why enforcement actions against excessive prices are particularly difficult – and especially so for a "generalist" competition authority. First, determining whether a specific price is "excessive" involves complicated comparisons of prices with costs of production and investment. This may involve difficult decisions about the profitability of a dominant firm. Determining whether a price is excessive may also involve difficult comparisons with whatever useful "benchmark" prices can be identified. Some of the problems involved in these comparisons – for example, the issue of cost allocation in multi-product firms – are also present for other price-based abuses. However, when these problems

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[4] *Supra* note 2, para. 26.
[5] Neelie Kroes, "Tackling Exclusionary Practices to Avoid Exploitation of Market Power: Some Preliminary Thoughts on the Policy Review of Article 82", 29 *Fordham International Law Journal* 593 (2005).
[6] Lyons, *supra* note 3.

are "solved" for the other abuses, the price/cost question becomes relatively "simple" in that the issue is whether the price is higher or lower than some well-defined cost measure. To determine whether excessive pricing has taken place, there is another layer of complication since it has to be decided whether a price – which may be higher than all relevant cost measures – is in fact too high. According to many commentators, such a decision will necessarily be somewhat arbitrary, unless one takes the rather draconian position that any price over some well-defined cost benchmark is excessive.

Second, intervening against excessive pricing may entail the risk of a competition authority finding itself in the situation of a semi-permanent quasi-regulator. The authority may have to come back time and again to the pricing of the dominant firm when cost or other conditions change in the industry, something that a "generalist" competition authority is much less equipped for than proper regulators with their deep knowledge of and continuous involvement in their industries. An authority may be able to establish a simple price comparison rule that can avoid such a situation. An example of such a rule could be that the dominant firm cannot charge more (or only X % more) in market A than it does in market B where the freely determined price in market B is for some reason more acceptable than the freely determined price in market A. There may still be recurring problems where such a rule can be imposed; the dominant firm may come back after a few years, claiming that conditions have changed and that the rule needs to be revised. But at least the problems seem of a lesser magnitude than a rule establishing a link between price and costs, as costs are normally less easy to observe than other prices.

I consider these practical difficulties so convincing and the risk of competition authorities arriving at the wrong result so great that enforcement actions against exploitative conduct in my view should only be taken as a last resort. In many markets, prices may temporarily be high but once market forces have had the time to play out the prices will come back to more normal levels. In such cases it would be unwise to run the risk of taking a wrong decision, and furthermore to spend enforcement resources, on solving a problem that would solve itself over time anyway. Note that price erosion can occur even where entry barriers are so high that there may be a dominant firm operating on the market. Of course, it may be that a dominant firm tries to prevent prices from dropping by raising entry barriers artificially. In such a situation it is wiser for the competition authority to tackle these entry barriers directly, since they will likely amount to an exclusionary abuse. However, if the market is characterized by such "natural" entry barriers that it is unlikely that market forces over time will bring prices down, enforcement actions aimed directly against excessive prices may be appropriate. I will be a bit more specific on this shortly. First, I would like to be clear about what I am not arguing.

The other argument – besides the practical difficulties that I have just discussed – was the "positive effects" argument. This has perhaps most famously been expressed by Justice Scalia in his opinion in *Trinko,*[7] where he argued that "[t]he mere possession of monopoly

[7] *Verizon Communications, Inc v. Law Offices of Curtis V. Trinko, LLP,* 540 U.S. 398 (2004).

power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system. The opportunity to charge monopoly prices – at least for a short period – is what attracts 'business acumen' in the first place; it induces risk taking that produces innovation and economic growth".[8] I realize that Scalia did soften his argument slightly by adding: "at least for a short period". This makes it rather difficult to argue vehemently against his position, since it is not entirely clear what Scalia meant by "a short period". Let us therefore pretend, for the sake of argument, that this apparent qualification does not appear in the judgment. The argument would then be that monopoly profits are good, perhaps even necessary, because that is what attracts the type of risk taking and investment that drives innovation and economic growth. I do not want to argue against human nature, and I therefore fully accept that much risk taking and investment is indeed done in the hope of achieving significant financial returns.[9] What I do object to is the idea that the only – or the "optimal" – way of giving dominant firms the correct incentives is to allow them to charge monopoly profits without any possibility of intervention on the part of competition authorities. Taking that argument to the extreme, it would seem difficult to justify interventions against exclusionary abuses. Restraining the possibility of dominant firms to exclude others probably reduces their profits, which – according to this logic – would have a negative impact on risk taking and innovation.

It seems to me that the position behind having provisions such as Article 82 can only be that "not all monopoly profits are good". It is then up to competition authorities – of course under the control of courts – to figure out which monopoly profits are "good" and which are not. And here I fully accept that – as a matter of administrability – it may be very difficult to make that call when deciding whether to intervene against excessive prices. So much so that some legal systems do not provide for that possibility at all.

This raises the obvious question of why the possibility is envisaged in Article 82 EC but not in the Sherman Act or in other US antitrust laws. One explanation may be found in the fact that the Article 86 does not prohibit the acquisition of dominance through unilateral abusive behaviour, and that this justifies greater protection against direct exploitation of consumers by dominant firms. After all, it can be considered that the reward of a dominant position need not come from unfair exploitation of consumers, as the dominant firm has enough incentives resulting from the revenues gained from its higher volume of sales at a price which will in most cases be at a supracompetitive level anyhow.

3. What markets are candidates for intervention?

Several commentators have recently given their opinion on what kinds of markets could be candidates for intervention by competition authorities against excessive prices. Let me quickly give you a flavour of some of these contributions before offering my own thoughts.

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[8] *Ibid.* at 407.

[9] I suspect, however, that many innovators are just as motivated by the sheer joy and stimulus of the innovative process itself.

Motta and de Steel[10] argue that intervention should be limited to industries where there are: (a) high and non-transitory barriers to entry; and (b) monopoly or near-monopoly situations due to current or past exclusive or special rights. They add two "institutional issues". First, there should be no effective way for the competition authority to eliminate the entry barriers. Second, there should be no sector-specific regulator.

Evans and Padilla[11] suggest, as candidates for intervention, circumstances where: (a) the firm enjoys a (near) monopoly position in the market; (b) the prices charged by the firm widely exceed its average *total* costs; and (c) there is a risk that those prices may prevent the emergence of new goods and services in adjacent markets.

O'Donoghue and Padilla conclude the chapter on excessive prices in their book on Article 82 by stating that:[12]

> "[t]here is a growing consensus on the need to identify administrable limiting principles to ensure that Article 82(a) is enforced only when strictly necessary, i.e. minimising the likelihood of false convictions. The emerging consensus is that intervention should be restricted to industries: (1) protected by high barriers to entry; (2) where one firm enjoys considerable market power; and (3) where investment and innovation play a relatively minor role."[13]

Let me continue by commenting briefly on these proposals – and in the process I will formulate my own views. The one element common to the proposals is the presence of high entry barriers. I agree that competition authorities should not intervene in markets where it is likely that normal competitive forces over time will eliminate the possibilities of a dominant company to charge high prices. Intervention should therefore indeed be limited to markets characterized by very high and long-lasting barriers to entry – although I would add barriers to expansion.

Motta and de Streel would furthermore require that there be a monopoly or a near-monopoly situation due to current or past exclusive or special rights. This condition has two parts: first, it requires "a monopoly or a near-monopoly"; second, this market position must be due to "current or past exclusive or special rights". A "monopoly or near-monopoly" is presumably something more than a dominant position. If there are very high and long-lasting barriers to entry <u>and</u> expansion, I believe that we can be confident that the position of the dominant firm will not be challenged for the foreseeable future. I must admit that I do not then see the need to introduce a category of "monopoly" – or "near monopoly", for that matter

[10] *Supra* note 3.
[11] *Supra* note 3.
[12] *Supra* note 3, at p. 638 (footnotes omitted).
[13] Later on the same page they reformulate these conditions slightly to: "(1) the market is protected by high barriers to entry; (2) consumers have no credible alternatives to the products of the dominant firm; and (3) firms compete in a mature environment, where investment and innovation play little or no role".

– into our analysis. However, it almost sounds as if Motta and de Streel think that the combination of a dominant position and "high and non-transitory barriers to entry" more or less automatically will lead to a situation of "monopoly or near monopoly", so perhaps in reality our views on this point are not that far apart.

However, I am not convinced by the proposal to restrict intervention to situations where current or past exclusive or special rights are the cause of the dominant position (or, according to Motta and de Streel, "monopoly or near monopoly”). I don't see why competition authorities need be restricted in such a way. My angle would rather be to focus once again on the question of "high and long-lasting barriers to entry and expansion". A legal monopoly would certainly qualify as a situation where such barriers exist. But high and long-lasting barriers to entry and expansion would normally also be found in situations of natural monopoly. These are, of course, also the sectors where there often are or have been exclusive or special rights, so there will be a certain overlap anyway. But still, I prefer to focus directly on the barriers to entry and expansion, and not to be restricted as to which barriers I can look at.

As to the "institutional issue" of whether we should intervene when there is a sector-specific regulator, I do not think that the Commission can say that it will never intervene whenever there is such a (national) regulator. Of course, I hope that, in practice, we would not have to do so. However, there are examples of the Commission intervening even though a national regulator either had decided not to intervene or had positively endorsed the behaviour of a dominant company.[14] These were not excessive pricing cases, but the principle is the same. The Commission should maintain the option to intervene when a national regulator is not acting or when it takes decisions that are not in conformity with Community law.

The other institutional issue mentioned by Motta and de Streel is that there should not be an effective way for the competition authority to eliminate the entry barriers. They are not referring here to the obvious example of strategic entry barriers, which can be attacked by the competition authority as exclusionary abuses. What they have in mind are "current legal barriers", where they argue that it "may be more cost-effective for the authority to lobby the government to lift the barriers and liberalise effectively the sector than to open several exploitative abuse cases". I entirely agree with the general proposition that competition authorities should always intervene in the most effective way. At the Community level the considerable efforts spent on liberalizing certain sectors can be seen as an example of what Motta and de Streel propose. However, it may be that, generally, such "lobbying efforts" by competition authorities are more effective at the national level than at the Community level. Consumers may pay excessive prices for quite some time before Community legislation removes the legal barriers. It may therefore be necessary to work on two fronts at the same time, that is, by both "lobbying" and intervening directly against excessive prices.

[14] See Joined Cases C-147/97 and C-148/97, *Deutsche Post AG v Gesellschaft für Zahlungssysteme mbH (GZS) and Citicorp Kartenservice GmbH* [2000] ECR I-825.

Evans and Padilla propose a condition that I have not discussed so far, namely that intervention should only take place if the excessive prices are such that they may prevent the emergence of new goods and services in adjacent markets. They point out that this condition "corresponds" to the ECJ's "new product test" in *Magill*[15] and *IMS Health.*[16] However, they would apply this test in situations beyond the exclusionary refusal to supply cases such as *Magill and IMS Health* to situations where it is consumers that are not served because prices are too high. They mention *General Motors* and *British Leyland* as cases consistent with this approach. While I find the idea interesting, I do not think the Commission can restrict itself to intervening only in such cases.

Finally, O'Donoghue and Padilla introduce yet another idea that competition authorities should only intervene where investment and innovation play a "minor role." I think that in practice this will indeed often be the case. In many markets with considerable investment and innovation, barriers to entry and expansion may be high, but not necessarily long-lasting. Furthermore, as I will discuss below, investment costs should be taken into account when determining whether prices are excessive. Prices may need to be considerably above production cost in order to finance innovation costs. However, one should not forget that there may be, for example, network effects in industries with considerable investment and innovation. I am not convinced that competition authorities should be prevented from intervening in such industries – even if they are very innovative.

Where does this discussion leave me? I'm afraid that, for the moment, I can only see one reasonable criterion that we can use to identify markets that could be candidates for interventions against excessive prices, and that is that there should be very high and long-lasting barriers to entry or expansion. The other conditions that have been brought forward in the debate are interesting, and I have some sympathy for all of them. But I do not feel comfortable with restricting the area of possible intervention to only markets that fulfil these conditions on top of the requirement of entry or expansion barriers that I just mentioned.

4. How do we identify excessive prices?

The discussion above focused on which markets could be candidates for possible intervention against excessive pricing by a dominant firm. However, even after identifying such a market, there remains the difficult task of determining whether the prices charged by the dominant firm in this market are in fact excessive.

[15] Joined Cases C-241/91 and C-242/91 P, *Radio Telefis Eireann (RTE) and Independent Television Publications Ltd (ITP) v Commission* [1995] ECR 743.
[16] Case C-418/01, *IMS Health GmbH & Co OHG v NDC Health GmbH & Co KG* [2004] ECR I-5039.

A useful starting point is the test indicated by the European Court of Justice in *United Brands*:[17]

> "The questions therefore to be determined are whether the differences between the costs actually incurred and the price actually charged is excessive, and, if the answer to this question is in the affirmative, whether a price has been imposed which is either unfair in itself or when compared to competing products."

A high profit margin may result both from high prices and from low costs. The second limb of the test addresses this issue. The test also implies that high prices, for instance compared to prices in other markets, by themselves are not abusive if they do not lead to an excessive difference between price and costs. High prices could, for instance, be explained by differences in cost conditions.

Before going a bit more into detail with how to implement this test, it is useful to ask a fundamental question. How is a dominant firm actually supposed to behave if it wants to avoid being accused of charging excessive prices? Is it supposed to behave "as if" it were in a competitive "equilibrium"? In other words, is it supposed to behave as if it had no market power? Or is it only supposed to refrain from exploiting its market power "completely", so that prices "somewhat" over the competitive equilibrium prices are accepted but prices that are "excessively" so remain prohibited.

The advantage of the "as if" comparison is that, at least in theory, there is a clear comparator. If prices are above the competitive equilibrium prices, they are excessive. This avoids the messy and somewhat arbitrary decision of when a high price is too high. However, I don't think the "as if" argument works. Market power is found on a continuum. Firms with some market power – but not enough to be called dominant – face no risk of intervention from competition authorities if they charge prices above the competitive level. The more market power they have, the higher the prices they can charge. It would seem a bit odd if somebody who attained a lot of market power – and therefore had a dominant position – suddenly had to lower its prices drastically to the competitive level. It seems to me that the model we must have in mind is instead that once a firm arrives at a certain level of market power it is implicitly told that it now cannot exploit its market power any further. The use of market power is, so to speak, "capped" at a certain level. This model implies that only very large deviations from competitive conditions may be indicative of abusive pricing.

Of course, this invites the natural question of whether I can say how large is "very large". I'm afraid not, at least not if I am supposed to give a number, like "prices are excessive if they are X % over costs". I don't think I am willing at this stage to provide a "safe harbour" either. Cost and profit margin calculations are so complicated – and so far we have little experience in doing them – that I do not feel able to do so. Of course, you and others may be

[17] Case 27/76, *United Brands Company and United Brands Continentaal BV v Commission* [1978] ECR 207, para. 252.

able to change my mind, but for the moment I prefer to remain at a more conceptual level. I know that this position leaves me open to criticism – or to joking comparisons with the remark of US Supreme Court Justice Potter Stewart that he could not define which pornographic materials rose to the level of obscene (and hence constitutionally unprotected) speech, but that he *knew it when he saw it*.[18] However, this is how it has to be for the moment.

I will not spend time mentioning the various price and cost comparisons that may be relevant. I think most of you are well aware of them, and I don't think I have much new to add. However, I would like to come back briefly to the point concerning investments and innovation. When calculating the profit margin, it is important to give proper consideration to the investment risks involved in the industry concerned. Profit margins are typically calculated on the basis of the prices and costs of products that are sold on the market. And the products of a dominant company will often be among the most successful of those products that are actually brought to market. However, in many industries there are substantial risks involved in developing such products. There may be several unsuccessful products for each product that is successfully brought to market. Intervening too easily against the pricing of the few successful companies in such industries could risk chilling welfare-enhancing investment efforts.

[18] See *Jacobellis v. Ohio,* 378 U.S. 184, 197 (1964) (Stewart, J., concurring) (recently recalled by Michael Salinger, "*Moneyball* and Price Gouging", address to Antitrust Committee of Boston Bar Association, Boston, 27 February 2006, at p. 6).