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## ***Exploitative Abuses***

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## **1. Introduction**

This paper investigates the role of exploitative abuse under Article 82. Unlike exclusionary practices, there is relatively little economic commentary on the proper role of exploitative abuses in competition policy,<sup>1</sup> even though the legal perspective in Europe has consistently emphasized the importance of enforcing antitrust action in the arena of exploitative practices.<sup>2</sup>

In this paper I will address the following two questions: (i) what are the effects of antitrust action against exploitative conduct?; and (ii) when should antitrust action be taken against exploitative abuses?

Before addressing these questions I'd like to make some general observations about Article 82.

Let me begin by stating that any anticompetitive behaviour involves both exclusionary and exploitative abuses. Anticompetitive conduct must ultimately lead to exploitation. In fact, the sole purpose of firms engaged in business through exclusionary practices is to increase their market power, which in turn will allow firms to increase their rents. The typical anticompetitive story is thus one in which a firm reduces competition through anticompetitive means (exclusion) in order to reap the benefits of higher market power (exploitation). In this sense, exclusionary and exploitative abuses are part of the same economic logic for antitrust, and it is no surprise that both types of behaviours are at the core of Article 82.

Against the backdrop of this basic economic logic regarding how markets work, it is important to understand that while it is correct to say that "*one excludes in order to exploit*", it is not correct to say that all exploitation is rooted in exclusionary abuse. In fact, the essence of pro-competitive behaviour is to increase market power, which will in turn increase rents by

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<sup>1</sup> See, e.g., David S. Evans and A. Jorge Padilla, "Excessive Prices: Using Economics to Define Administrable Legal Rules", 1(1) *Journal of Competition Law and Economics* 97 (2005); Massimo Motta and Alexandre de Stree, "Excessive Pricing and Price Squeeze under EU Law", in Claus-Dieter Ehlermann and Isabela Atanasiu (eds.), *Competition Law Annual 2003: What is an abuse of a dominant position?*, Hart Publishing, 2006, pp. 91 *et seq.*

<sup>2</sup> For a historical account of the balance between exclusionary and exploitative abuses under Article 82, see the paper by Emil Paulis, "Article 82 and exploitative conduct", this Volume.

means of exploiting this very market power. In fact, if there were no possibility to ever exploit one's market power, there would be no incentive to compete.<sup>3</sup> Thus, pro-competitive behaviour must also involve exploitation ("positive effects").

Another possibility is that some government has – or has in the past – granted an exclusive right, as in the case of network industries (post, telecommunications, rail, etc.). As a result, firms may hold strong market positions and may price accordingly, if left unregulated. In this situation, exploitative abuses would not be due to exclusionary conduct.

The above considerations suggest that both pro- and anticompetitive behaviour involve exploitation. Since the goal of antitrust is to discriminate between pro- and anticompetitive conduct, it follows that the mere existence of exploitative behaviour is insufficient to identify anticompetitive practices. By contrast, the existence of exclusionary practices does provide a sound basis for identifying anticompetitive behaviour. As a result, one might conclude that it is indeed solely exclusionary conduct that antitrust should focus on.

In this spirit, I now turn to the first question, in the context of which I consider what the economic basis for antitrust action under exploitative conduct might be (Section 2). Then I return to the above point on the proper role of exploitative abuse in Europe (Section 3).

## **2. What are the effects of antitrust action against exploitative conduct?**

Perhaps the most widely held view in favour of antitrust action on the grounds of excessive pricing is that it leads to lower prices and thereby increases consumer surplus.<sup>4</sup> It is argued that such price reductions benefit consumers directly and in the short-run. Given that consumers are at the heart of competition policy, interventions in cases of excessive pricing are therefore on this view an integral element of antitrust enforcement.

Despite a certain appeal of the above argumentation, there are very credible arguments as to why excessive pricing interventions in fact will not benefit consumers. Whether prices are higher or lower under antitrust enforcement is fundamentally associated with the analysis of the relevant counterfactual. In other words, one has to address what the prices would have been (both in the short and long run, i.e., is the price reduction temporary or not?) in the absence of antitrust actions (or the threat of it). In other words, one has to take the likelihood of entry into account and how antitrust intervention affects this.

Whether entry takes place or not depends on the existence and magnitude of entry barriers. There are a number of different types of entry barriers, such as strategic entry barriers (e.g., excess capacity and first mover advantages), legal entry barriers (e.g., access

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<sup>3</sup> This includes situations where firms are under the threat of bankruptcy. In this case, engaging in pro-competitive behaviour allows firms to increase their rents, even though they are close to zero (as opposed to negative).

<sup>4</sup> This section will couch the discussion on exploitative abuses in terms of excessive pricing, which constitutes the vast majority of all antitrust cases dealing with such abuses.

regulation, IPRs), absolute cost advantages, asymmetric information, etc. If such entry barriers are not significant, high post-entry margins attract entry. In other words, the market does self-correct. Since antitrust enforcement against excessive pricing lowers post-entry margins, it will tend to discourage entry and negatively affect the market's propensity to self correct, which may ironically lead to higher prices. For this reason, it makes sense to restrict antitrust interventions in the arena of excessive pricing to situations where entry barriers are so high that entry (absent antitrust action) is unlikely.<sup>5</sup>

A further fundamental objection against the use of excessive pricing interventions is that they negatively affect investments and/or innovation. By lowering prices *ex post*, incentives to invest or to innovate *ex ante* are reduced or even eliminated. As was mentioned above, the essence of pro-competitive behaviour is to increase market power, which will in turn increase the incentive to invest or innovate. In industries where innovation or large up-front investments play a major role, consumers ultimately do not benefit from excessive pricing interventions.

A final reason why intervention in excessive pricing cases may not benefit consumers is that such cases entail a very complex assessment. It is difficult to say what constitutes an "excessive" price without referring to practically all aspects of a market and its competitive environment. Invariably, price-cost tests raise a number of difficult methodological issues, such as how to allocate costs, how to define efficient costs, how to find the proper benchmark, and how to determine the nature of competition (including demand).

An example of these difficulties of empirically assessing price-cost margins can be illustrated by a recent analysis of past data from the European airline industry.<sup>6</sup> In a structural approach, all the above aspects of competition are taken into account (demand, cost, and the nature of competition in the industry) in order to properly estimate price-cost margins. In addition, the authors allow for "endogenous costs", i.e., costs linked to product market competition and associated with labour unions in the following way. If price-cost margins are high, unions bargain for higher wages; this, in turn, raises costs, thereby lowering those price-cost margins. If, on the other hand, price-cost margins are low, union demands are moderate, which will exert upward pressure in price-cost margins. In equilibrium, all these factors are taken into account and balanced. The main result of the study is as follows. Observed prices in the European airline industry are virtually identical to monopoly prices, even though

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<sup>5</sup> It is also important to take into account the extent to which prices in *related* markets are affected by the intervention. For example, some commentators have claimed, in the recent debate on regulation of charges for international roaming, that the impact of regulating such charges will lead to higher prices in *domestic* markets. I am not aware of much analytical work in this area of antitrust economics, let alone systematic empirical evidence. Absent formal analysis, a reasonable conjecture is to assume that firms will raise prices in related markets whenever antitrust action lowers prices in complementary markets, while the opposite happens when products are substitutes.

<sup>6</sup> Damien J. Neven, Lars-Hendrik Röller, and Zhentang Zhang, "Endogenous Costs and Price-Cost Margins: an Application to the European Airline Industry", 54 *Journal of Industrial Economics* 351 (2006). The data analyzed in this paper cover the period from 1976 to 1994. This period is particularly well suited to analyze the impact of unions. Notice also that low-cost airlines did not play a major role at that time.

observed margins are consistent with competition. The reason is that costs had been inflated to the point that European consumers were faced with *de facto* monopoly prices. In other words, the empirical evidence suggests that prices have been “excessive”, while price-cost margins are “normal”.

In sum, antitrust action under the banner of exploitative abuse needs to be applied with great caution. Not only is it difficult to identify price-cost margins properly, but it is also far from obvious what an “excessive price” would be and how antitrust action would then benefit consumers.

### 3. When should antitrust action be taken against exploitative abuses?

Let me now return to the statement made in the introduction, namely that, since pro- and anticompetitive behaviour both involve exploitation, it is indeed solely exclusionary conduct that antitrust should focus on. If anything, the discussion summarized in the previous section would certainly support such a policy. However, I do believe that antitrust action against exploitative abuse does have a role to play, although only under certain circumstances.

#### (i) “Gap cases”

In principle, an abuse case must identify anticompetitive conduct that results in increased market power, relative to the counterfactual. As was mentioned above, it is the road to dominance that is important in order to identify pro- from anticompetitive conduct. If dominance (or for that matter, any kind of market power) is obtained through competition on the merits, then this is good for consumers; otherwise, it is not. By contrast, Article 82 only applies to firms that are *already* dominant. In other words, anticompetitive conduct that *leads* to a dominant position cannot be caught in Europe under Article 82 as an exclusionary abuse. This is an enforcement “gap”, since it is precisely the way in which dominance is acquired that matters in terms of economic effects.<sup>7</sup>

I would suggest that antitrust enforcement against exploitative abuses can be used to close this important gap. That is, exploitative abuse cases should be based on acquiring a dominant position through anticompetitive exclusionary conduct. In this way, exploitative abuse cases lead us back to investigating exclusionary conduct, which is in fact the proper way to identify anticompetitive practices. By focusing on the road to dominance via anticompetitive behaviour, exploitative abuse cases are firmly grounded on the way markets work; they do not make it necessary to decide what is “excessive” from an *ex post* point of view.

Note that this approach is very much in line with the observation that there are many exploitative abuse cases in sectors with formerly state-owned monopolies. Perhaps this

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<sup>7</sup> There may be other gaps under Article 82, such as anticompetitive conduct below the level of dominance, or anticompetitive behaviour by an oligopoly.

observation has something to do with the fact that these firms did not obtain their dominant positions based on merit alone, but rather by virtue of a public policy decision (which itself was likely based on a theory of natural monopoly). To the extent that the road to dominance matters, these scenarios should in fact be considered gap cases, even though here dominance was not achieved by anticompetitive exclusionary conduct on the part of the undertaking.

Overall, there appear to be three main advantages in defining exploitative abuse as acquiring dominance as a result of an exclusionary abuse. First, it is in line with sound economics. Second, it avoids the standard debate on what is “excessive” (which I believe is impossible to define operationally). And third, it closes the gap described above under Article 82.

(ii) “Mistakes”

A second reason for antitrust action against exploitative abuses may be “mistakes”. In other words, for some reason an antitrust authority may not have effectively prosecuted an exclusionary abuse. In this situation, one may argue that, since the exclusionary abuse was not caught, or perhaps because there was uncertainty as to the effect of the exclusionary conduct (a type II error), there is need for a second “shot” at enforcement, this time on the basis of an exploitative abuse, (a “two shot” policy).

A related argument is that the mistakes are due to *uncertainty*. Given that exclusionary abuses are based on “likely effects”, there is of course also a likelihood that the agency will get it wrong. As a result, one may argue that two instruments are better than one. In other words, exploitative abuses can be stopped whenever the exclusionary abuse has had an actual effect, even where it was previously deemed unlikely.

On the other hand, one may legitimately wonder whether the better policy response is not to eliminate the mistakes (or reduce the uncertainty), rather than to maintain a two shot policy. It may be, for example, that once an exclusionary abuse has taken place the damage has been done and remedies imposed at a later stage may come too late. Moreover, a two shot policy may give rise to over-enforcement, reducing type II errors but leading to more type I errors.<sup>8</sup>

(iii) When to take action

Summarizing the above argumentation, one may conclude that exploitative action under Article 82 is limited to very special circumstances. Building on the above discussion, the following circumstances for antitrust action in cases of excessive pricing can be identified.<sup>9</sup>

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<sup>8</sup> Note that mistakes may go either way, i.e., there are both type I and II errors under exclusionary abuse cases. A two shot policy based on uncertainty about the likely effects would control the actual effects *ex post*. In principle, there will be cases where both type I and type II errors may be found. Nevertheless, one would presume that a two shot policy would only be applied when type II errors have occurred (i.e., where an exclusionary abuse was not caught).

<sup>9</sup> Again, I concentrate on excessive pricing, as this is the most prominent area.

- (a) *significant entry barriers*
- (b) *market is unlikely to self-correct*
- (c) *no (structural) remedy is available* [=> otherwise advocacy]
- (d) *no regulator or regulatory failure* [=> otherwise *ex ante* regulation]
- (e) *“gap cases” or “mistake cases”* [=> otherwise exclusionary abuse]

The above conditions are cumulative, i.e., they are necessary conditions and must all be met. The first two conditions (a) and (b) have already been discussed and are self-evident. If there are no entry barriers, or if the market would self-correct, there is no compelling need to intervene. The market is best left to itself and consumers will benefit.

Condition (c) and (d) have not been addressed above, but have been mentioned by other authors. They are based on the fact that remedies in exploitative abuse cases (especially excessive pricing) essentially amount to price regulation and that there are better placed instruments and institutions to deal with this. Specifically, (c) specifies that if there are structural remedies available – such as removing relevant entry barriers, opening markets, liberalizing, etc. – then the proper policy would be advocacy in favour of these structural remedies, as opposed to *ex post* intervention in exploitative abuse cases. To the extent that exploitative abuse cases can be used to achieve structural remedies, or to the extent that exploitative abuse cases are complementary to advocacy action, exploitative abuse cases under Article 82 would be helpful – but only because they support a structural remedy.

Similarly, condition (d) specifies that regulatory-type antitrust action (as in excessive pricing cases) is only warranted if there is no regulatory agency, or if the regulator does not operate effectively. Where there is a regulator, intervention by an antitrust authority is thus limited, as specialized regulatory institutions are likely to have superior regulatory know-how. However, antitrust intervention remains possible, not least because industry-specific regulators are more likely to be subject to regulatory capture (and hence may fail to protect consumer welfare) than an antitrust authority, whose competence extends horizontally across most or all economic sectors.

Finally, condition (e) refers to “gap cases”. As argued above, this category refers to cases where dominance is a *result* of exclusionary conduct, and not the other way around. If this condition is not met, then any relevant anticompetitive conduct can be addressed by taking action to remedy the exclusionary abuse. In other words, if the defendant did not achieve dominance by means of exclusionary behaviour, then antitrust intervention is unlikely to be able to discriminate between pro- and anticompetitive conduct. It will run into methodological problems, and it will be difficult to implement in line with sound economics. Recall that there is also the possibility of achieving dominance through government action, and these are also gap cases.

Condition (*e*) also mentions “mistake cases”, primarily for completeness. However, the above discussion has expressed some doubt as to the appropriateness of arguing that a second shot is needed.

#### 4. Concluding remarks

I have argued that excessive pricing cases should be limited to certain special circumstances. Focus should be on “gap cases”, where anticompetitive exploitation exists if and only if exclusionary abuse – or government actions – have led to a dominant position. Specifically, it is the *road* to dominance that becomes important in those cases.

Overall, there appear to be three main advantages in defining exploitative abuse, in particular excessive pricing, as acquiring dominance through exclusionary abuse or governmental action. First, it is in line with sound economics (i.e., it is more capable of discriminating between pro- and anticompetitive conduct). Second, it avoids the standard debate on what is “excessive” (which in my view, as I mentioned earlier, is impossible to define operationally<sup>10</sup>). Third, it closes a gap under Article 82.

Finally, let me submit that the above approach, which directs exploitative abuse cases towards analyzing exclusionary behaviour, is in line with an effects-based approach under Article 82.

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<sup>10</sup> How do we identify excessive pricing? What is the standard? Recall that any standard based on costs is methodologically doubtful. Note that the approach proposed in this paper does provide a benchmark, which is rather natural and consistent with the rest of Article 82. The benchmark for excessive prices is simply the price that would prevail “but for the exclusionary conduct”.